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# 26

**Part 1 (§§ 1.908 to 1.1000)**
Revised as of April 1, 2008

## Internal Revenue

Containing a codification of documents of general applicability and future effect

As of April 1, 2008

*With Ancillaries*

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*Cite this Code:* CFR

*To cite the regulations in this volume use title, part and section number. Thus,* 26 CFR 1.911–1 *refers to title 26, part 1, section 911–1.*

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Title 1 through Title 16.....as of January 1
Title 17 through Title 27.....as of April 1
Title 28 through Title 41.....as of July 1
Title 42 through Title 50.....as of October 1

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RAYMOND A. MOSLEY,
*Director*,
*Office of the Federal Register*.
*April 1, 2008*.

## THIS TITLE

Title 26—INTERNAL REVENUE is composed of twenty volumes. The contents of these volumes represent all current regulations issued by the Internal Revenue Service, Department of the Treasury, as of April 1, 2008. The first thirteen volumes comprise part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§1.0–1.60; §§1.61–1.169; §§1.170–1.300; §§1.301–1.400; §§1.401–1.440; §§1.441–1.500; §§1.501–1.640; §§1.641–1.850; §§1.851–1.907; §§1.908–1.1000; §§1.1001–1.1400; §§1.1401–1.1550; and §1.1551 to end. The fourteenth volume containing parts 2–29, includes the remainder of subchapter A and all of Subchapter B—Estate and Gift Taxes. The last six volumes contain parts 30–39 (Subchapter C—Employment Taxes and Collection of Income Tax at Source); parts 40–49; parts 50–299 (Subchapter D—Miscellaneous Excise Taxes); parts 300–499 (Subchapter F—Procedure and Administration); parts 500–599 (Subchapter G—Regulations under Tax Conventions); and part 600 to end (Subchapter H—Internal Revenue Practice).

The OMB control numbers for Title 26 appear in §602.101 of this chapter. For the convenience of the user, §602.101 appears in the Finding Aids section of the volumes containing parts 1 to 599.

For this volume, Jonn V. Lilyea was Chief Editor. The Code of Federal Regulations publication program is under the direction of Michael L. White, assisted by Ann Worley.

# Title 26—Internal Revenue

(This book contains part 1, §§ 1.908 to 1.1000)

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*Part*

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

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

EDITORIAL NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I cross-references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross-reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

SUBCHAPTER A—INCOME TAX (CONTINUED)


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

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

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## EARNED INCOME OF CITIZENS OR RESIDENTS OF UNITED STATES

### § 1.908 [Reserved]

### § 1.911–1 Partial exclusion for earned income from sources within a foreign country and foreign housing costs.

(a) *In general.* Section 911 provides that a qualified individual may elect to exclude the individual's foreign earned income and the housing cost amount from the individual's gross income for the taxable year. Foreign earned income is excludable to the extent of the applicable limitation for the taxable year. The housing cost amount for the taxable year is excludable to the extent attributable to employer provided

amounts. If a portion of the housing cost amount for the taxable year is attributable to non-employer provided amounts, such amount may be deductible by the qualified individual subject to a limitation. The amounts excluded under section 911(a) and the amount deducted under section 911(c)(3)(A) for the taxable year shall not exceed the individual's foreign earned income for such taxable year. Foreign earned income must be earned during a period for which the individual qualifies to make an election under section 911(d)(1). A housing cost amount that would be deductible except for the application of this limitation may be carried over to the next taxable year and is deductible to the extent of the limitation for that year. Except as otherwise provided, §§1.911–1 through 1.911–7 apply to taxable years beginning after December 31, 1981. These sections do not apply to any item of income, expense, deduction, or credit arising before January 1, 1982, even if such item is attributable to services performed after December 31, 1981.

(b) *Scope.* Section 1.911–2 provides rules for determining whether an individual qualifies to make an election under section 911. Section 1.911–3 provides rules for determining the amount of foreign earned income that is excludable under section 911(a)(1). Section 1.911–4 provides rules for determining the housing cost amount and the portions excludable under section 911(a)(2) or deductible under section 911(c)(3). Section 1.911–5 provides special rules applicable to married couples. Section 1.911–6 provides for the disallowance of deductions, exclusions, and credits attributable to amounts excluded under section 911. Section 1.911–7 provides procedural rules for making or revoking an election under section 911. Section 1.911–8 provides a reference to rules applicable to taxable years beginning before January 1, 1982.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2964, Jan. 23, 1985]

### § 1.911–2 Qualified individuals.

(a) *In general.* An individual is a qualified individual if:

(1) The individual's tax home is in a foreign country or countries throughout—

(i) The period of bona fide residence described in paragraph (a)(2)(i) of this section, or

(ii) The 330 full days of presence described in paragraph (a)(2)(ii) of this section, and

(2) The individual is either—

(i) A citizen of the United States who establishes to the satisfaction of the Commissioner or his delegate that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or

(ii) A citizen or resident of the United States who has been physically present in a foreign country or countries for at least 330 full days during any period of twelve consecutive months.

(b) *Tax home.* For purposes of paragraph (a)(i) of this section, the term ''tax home'' has the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). Thus, under section 911, an individual's tax home is considered to be located at his regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense. An individual shall not, however, be considered to have a tax home in a foreign country for any period for which the individual's abode is in the United States. Temporary presence of the individual in the United States does not necessarily mean that the individual's abode is in the United States during that time. Maintenance of a dwelling in the United States by an individual, whether or not that dwelling is used by the individual's spouse and dependents, does not necessarily mean that the individual's abode is in the United States.

(c) *Determination of bona fide residence.* For purposes of paragraph (a)(2)(i) of this section, whether an individual is a bona fide resident of a foreign country shall be determined by applying, to the extent practical, the

principles of section 871 and the regulations thereunder, relating to the determination of the residence of aliens. Bona fide residence in a foreign country or countries for an uninterrupted period may be established, even if temporary visits are made during the period to the United States or elsewhere on vacation or business. An individual with earned income from sources within a foreign country is not a bona fide resident of that country if:

(1) The individual claims to be a nonresident of that foreign country in a statement submitted to the authorities of that country, and

(2) The earned income of the individual is not subject, by reason of nonresidency in the foreign country, to the income tax of that country.

If an individual has submitted a statement of nonresidence to the authorities of a foreign country the accuracy of which has not been resolved as of any date when a determination of the individual's bona fide residence is being made, then the individual will not be considered a bona fide resident of the foreign country as of that date.

(d) *Determination of physical presence.* For purposes of paragraph (a)(2)(ii) of this section, the following rules apply.

(1) *Twelve-month test.* A period of twelve consecutive months may begin with any day but must end on the day before the corresponding day in the twelfth succeeding month. The twelve-month period may begin before or after arrival in a foreign country and may end before or after departure.

(2) *330-day test.* The 330 full days need not be consecutive but may be interrupted by periods during which the individual is not present in a foreign country. In computing the minimum 330 full days of presence in a foreign country or countries, all separate periods of such presence during the period of twelve consecutive months are aggregated. A full day is a continuous period of twenty-four hours beginning with midnight and ending with the following midnight. An individual who has been present in a foreign country and then travels over areas not within any foreign country for less than twenty-four hours shall not be deemed outside a foreign country during the period of travel. If an individual who is in transit between two points outside the United States is physically present in the United States for less than twenty-four hours, such individual shall not be treated as present in the United States during such transit but shall be treated as travelling over areas not within any foreign country. For purposes of this paragraph (d)(2), the term ''transit between two points outside the United States'' has the same meaning that it has when used in section 7701(b)(6)(C).

(3) *Illustrations of the physical presence requirement.* The physical presence requirement of paragraph (a)(2)(ii) of this section is illustrated by the following examples:

*Example 1.* B, a U.S. citizen, arrives in Venezuela from New York at 12 noon on April 24, 1982. B remains in Venezuela until 2 p.m. on March 21, 1983, at which time B departs for the United States. Among other possible twelve month periods, B is present in a foreign country an aggregate of 330 full days during each of the following twelve month periods: March 21, 1982 through March 20, 1983; and April 25, 1982 through April 24, 1983.

*Example 2.* C, a U.S. citizen, travels extensively from the time C leaves the United States on March 5, 1982, until the time C departs the United Kingdom on January 1, 1984, to return to the United States permanently. The schedule of C's travel and the number of full days at each location are listed below:

| Country | Time and date of arrival | Time and date of departure | Full days in foreign country |
|---|---|---|---|
| United States | | 10 p.m. (by air) Mar. 5, 1982. | |
| United Kingdom | 9 a.m. Mar. 6, 1982 | 10 p.m. (by ship) June 25, 1982 | 110 |
| United States | 11 a.m. June 30, 1982 | 1 p.m. (by ship) July 19, 1982 | 0 |
| France | 3 p.m. July 24, 1982 | 11 a.m. (by air) Aug. 22, 1983 | 393 |
| United States | 4 p.m. Aug. 22, 1983 | 9 a.m. (by air) Sept. 4, 1983 | 0 |
| United Kingdom | 9 a.m. Sept. 5, 1983 | 9 a.m. (by air) Jan. 1, 1984 | 117 |
| United States | 1 p.m. Jan. 1, 1984 | | |

Among other possible twelve-month periods, C is present in a foreign country or countries an aggregate of 330 full days during the following twelve-month periods: March 2, 1982 through March 1, 1983; and January 21, 1983 through January 20, 1984. The computation of days with respect to each twelve month period may be illustrated as follows:

First twelve-month period (March 2, 1982 through March 1, 1983):

| | Full days in foreign country |
|---|---|
| Mar. 2, 1982 through Mar. 6, 1982 | 0 |
| Mar. 7, 1982 through June 24, 1982 | 110 |
| June 25, 1982 through July 24, 1982 | 0 |
| July 25, 1982 through Mar. 1, 1983 | 220 |
| Total full days | 330 |

Second twelve-month period (January 21, 1983 through January 20, 1984):

| | Full days in foreign country |
|---|---|
| Jan. 21, 1983 through Aug. 21, 1983 | 213 |
| Aug. 22, 1983 through Sept. 5, 1983 | 0 |
| Sept. 6, 1983 through Dec. 31, 1983 | 117 |
| Jan. 1, 1984 through Jan. 20, 1984 | 0 |
| Total full days | 330 |

(e) *Special rules.* For purposes only of establishing that an individual is a qualified individual under paragraph (a) of this section, residence or presence in a foreign country while there employed by the U.S. government or any agency or instrumentality of the U.S. government counts towards satisfaction of the requirements of §1.911–2(a). (But see section 911(b)(1)(B)(ii) and §1.911–3(c)(3) for the rule excluding amounts paid by the U.S. government to an employee from the definition of foreign earned income.) Time spent in a foreign country prior to January 1, 1982, counts toward satisfaction of the bona fide residence and physical presence requirements, even though no exclusion or deduction may be allowed under section 911 for income attributable to services performed during that time. For purposes or paragraph (a)(2)(ii) of this section, the term ''resident of the United States'' includes an individual for whom a valid election is in effect under section 6013 (g) or (h) for the taxable year or years during which the physical presence requirement is satisfied.

(f) *Waiver of period of stay in foreign country due to war or civil unrest.* Notwithstanding the requirements of paragraph (a) of this section, an individual whose tax home is in, a foreign country, and who is a bona fide resident of, or present in a foreign country for any period, who leaves the foreign country after August 31, 1978, before meeting the requirements of paragraph (a) of this section, may as provided in this paragraph, qualify to make an election under section 911(a) and §1.911–7(a). If the Secretary determines, after consultation with the Secretary of State or his delegate, that war, civil unrest, or similar adverse conditions existed in a foreign country, then the Secretary shall publish the name of the foreign country and the dates between which such conditions were deemed to exist. In order to qualify to make an election under this paragraph, the individual must establish to the satisfaction of the Secretary that the individual left a foreign country, the name of which has been published by the Secretary, during the period when adverse conditions existed and that the individual could reasonably have expected to meet the requirements of paragraph (a) of this section but for the adverse conditions. The individual shall attach to his return for the taxable year a statement that the individual expected to meet the requirements of paragraph (a) of this section but for the conditions in the foreign country which precluded the normal conduct of business by the individual. Such individual shall be treated as a qualified individual, but only for the actual period of residence or presence. Thus, in determining the number of the individual's qualifying days, only days within the period of actual residence or presence shall be counted.

(g) *United States.* The term ''United States'' when used in a geographical sense includes any territory under the sovereignty of the United States. It includes the states, the District of Columbia, the possessions and territories of the United States, the territorial waters of the United States, the air space over the United States, and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and

over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

(h) *Foreign country.* The term ''foreign country'' when used in a geographical sense includes any territory under the sovereignty of a government other than that of the United States. It includes the territorial waters of the foreign country (determined in accordance with the laws of the United States), the air space over the foreign country, and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2965, Jan. 23, 1985]

### § 1.911–3 Determination of amount of foreign earned income to be excluded.

(a) *Definition of foreign earned income.* For purposes of section 911 and the regulations thereunder, the term ''foreign earned income'' means earned income (as defined in paragraph (b) of this section) from sources within a foreign country (as defined in § 1.911–2(h)) that is earned during a period for which the individual qualifies under § 1.911–2(a) to make an election. Earned income is from sources within a foreign country if it is attributable to services performed by an individual in a foreign country or countries. The place of receipt of earned income is immaterial in determining whether earned income is attributable to services performed in a foreign country or countries.

(b) *Definition of earned income*—(1) *In general.* The term ''earned income'' means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered including the fair market value of all remuneration paid in any medium other than cash. Earned income does not include any portion of an amount paid by a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for personal services actually rendered to the corporation.

(2) *Earned income from business in which capital is material.* In the case of an individual engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such trade or business shall in no case exceed thirty percent of the individual's share of the net profits of such trade or business.

(3) *Professional fees.* Earned income includes all fees received by an individual engaged in a professional occupation (such as doctor or lawyer) in the performance of professional activities. Professional fees constitute earned income even though the individual employs assistants to perform part or all of the services, provided the patients or clients are those of the individual and look to the individual as the person responsible for the services rendered.

(c) *Amounts not included in foreign earned income.* Foreign earned income does not include an amount:

(1) Excluded from gross income under section 119;

(2) Received as a pension or annuity (including social security benefits);

(3) Paid to an employee by an employer which is the U.S. government or any U.S. government agency or instrumentality;

(4) Included in the individual's gross income by reason of section 402(b) (relating to the taxability of a beneficiary of a nonexempt trust) or section 403(c) (relating to the taxability of a beneficiary under a nonqualified annuity or under annuities purchased by exempt organizations);

(5) Included in gross income by reason of § 1.911–6(b)(4)(ii); or

(6) Received after the close of the first taxable year following the taxable year in which the services giving rise to the amounts were performed. For treatment of amounts received after

December 31, 1962, which are attributable to services performed on or before December 31, 1962, and with respect to which there existed on March 12, 1962, a right (whether forfeitable or nonforfeitable) to receive such amounts, see §1.72–8.

(d) *Determination of the amount of foreign earned income that may be excluded under section 911(a)(1)*—(1) *In general.* Foreign earned income described in this section may be excluded under section 911(a)(1) and this paragraph only to the extent of the limitation specified in paragraph (d)(2) of this section. Income is considered to be earned in the taxable year in which the services giving rise to the income are performed. The determination of the amount of excluded earned income in this manner does not affect the time for reporting any amounts included in gross income.

(2) *Limitation*—(i) *In general.* The term ''section 911(a)(1) limitation'' means the amount of foreign earned income for a taxable year which may be excluded under section 911(a)(1). The section 911(a)(1) limitation shall be equal to the lesser of the qualified individual's foreign earned income for the taxable year in excess of amounts that the individual elected to exclude from gross income under section 911(a)(2) or the product of the annual rate for the taxable year (as specified in paragraph (d)(2)(ii) of this section) multiplied by the following fraction:

$$\frac{\text{The number of qualifying days in the taxable year}}{\text{The number of days in the taxable year}}$$

(ii) *Annual rate for the taxable year.* The annual rate for the taxable year is the rate set forth in section 911(b)(2)(A).

(3) *Number of qualifying days.* For purposes of section 911 and the regulations thereunder, the number of qualifying days is the number of days in the taxable year within the period during which the individual met the tax home requirement and either the bona fide residence requirement or the physical presence requirement of §1.911–2(a). Although the period of bona fide residence must include an entire taxable year, the entire uninterrupted period of residence may include fractional parts of a taxable year. For instance, if an individual who was a calendar year taxpayer established a tax home and a residence in a foreign country as of November 1, 1982, and maintained the tax home and the residence through March 31, 1984, then the uninterrupted period of bona fide residence includes fractional parts of the years 1982 and 1984, and all of 1983. The number of qualifying days in 1982 is sixty-one. The number of qualifying days in 1983 is 365. The number of qualifying days in 1984 is ninety-one. The period during which the physical presence requirement of §1.911–2(a)(2)(ii) is met is any twelve consecutive month period during which the individual is physically present in one or more foreign countries for 330 days and the individual's tax home is in a foreign country during each day of such physical presence. Such period may include days when the individual is not physically present in a foreign country, and days when the individual does not maintain a tax home in a foreign country. Such period may include fractional parts of a taxable year. Thus, if an individual's period of physical, presence is the twelve-month period beginning June 1, 1982, and ending May 31, 1983, the number of qualifying days in 1982 is 214 and the number of qualifying days in 1983 is 151.

(e) *Attribution rules*—(1) *In general.* Foreign earned income is considered to be earned in the taxable year in which the individual performed the services giving rise to the income. If income is earned in one taxable year and received in another taxable year, then, for purposes of determining the amount of foreign earned income that the individual may exclude under section 911(a), the individual must attribute the income to the taxable year in which the services giving rise to the income were performed. Thus, any reimbursement would be attributable to the taxable year in which the services giving rise to the obligation to pay the reimbursement were performed, not the taxable year in which the reimbursement was received. For example, tax equalization payments are normally received in the year after the year in which the services giving rise to the obligation to pay

the tax equalization payment were performed. Therefore, such payments will almost always have to be attributed to the prior year. Foreign earned income attributable to services performed in a preceding taxable year shall be excludable from gross income in the year of receipt only to the extent such amount could have been excluded under paragraph (d)(1) in the preceding taxable year, had such amount been received in the preceding taxable year. The taxable year to which income is attributable will be determined on the basis of all the facts and circumstances.

(2) *Priority of use of the section 911(a)(1) limitation.* Foreign earned income received in the year in which it is earned shall be applied to the section 911(a)(1) limitation for that year before applying income earned in that year that is received in any other year. Foreign earned income that is earned in one year and received in another year shall be applied to the section 911(a)(1) limitation for the year in which it was earned, on a year by year basis, in any order that the individual chooses. (But see section 911(b)(1)(B)(iv)). An individual may not amend his return to change the treatment of income with respect to the section 911(a)(1) exclusion after the period provided by section 6511(a). The special period of limitation provided by section 6511(d)(3) does not apply for this purpose. For example, C, a qualified individual, receives an advance bonus of $10,000 in 1982, salary of $70,000 in 1983, and a performance bonus of $10,000 in 1984, all of which are foreign earned income for 1983. C has a section 911(a)(1) limitation for 1983 of $80,000, and has no housing cost amount exclusion. On his income tax return for 1983, C elects to exclude foreign earned income of $70,000 received in 1983. C may also exclude his $10,000 advance bonus received in 1982 (by filing an amended return for 1982), or he may exclude the $10,000 performance bonus received in 1984 on his 1984 income tax return. However, C may not exclude part of the 1982 bonus and part of the 1984 bonus.

(3) *Exception for year-end payroll period.* Notwithstanding paragraph (e)(1) of this section, salary or wage payments of a cash basis taxpayer shall be attributed entirely to the year of receipt under the following circumstances:

(i) The period for which the payment is made is a normal payroll period of the employer which regularly applies to the employee;

(ii) The payroll period includes the last day of the employee's taxable year;

(iii) The payroll period does not exceed 16 days; and

(iv) The payment is part of a normal payroll of the employer that is distributed at the same time, in relation to the payroll period, that such payroll would normally be distributed, and is distributed before the end of the next succeeding payroll period.

(4) *Attribution of bonuses and substantially nonvested property to periods in which services were performed*—(i) *In general.* Bonuses and substantially nonvested property are attributable to all of the services giving rise to the income on the basis of all the facts and circumstances. If an individual receives a bonus or substantially nonvested property (as defined in §1.83–3(b)) and it is determined to be attributable to services performed in more than one taxable year, then, for purposes of determining the amount eligible for exclusion from gross income in the year the bonus is received or the property vests, a portion of such amount shall be treated as attributable to services performed in each taxable year (or portion thereof) during the period when services giving rise to the bonus or the substantially nonvested property were performed. Such portion shall be determined by dividing the amount of the bonus or the excess of the fair market value of the vested property over the amount paid, if any, for the vested property, by the number of months in the period when services giving rise to such amount were performed, and multiplying the quotient by the number of months in such period in the taxable year. For purposes of this section, the term ''month'' means a calendar month. A fraction of a calendar month shall be deemed a month if it includes fifteen or more days.

(ii) *Examples.* The following examples illustrate the application of this paragraph (e)(4).

*Example 1.* A, an employee of M Corporation during all of 1983 and 1984, worked in the United States from January 1 through April 30, 1983, and received $12,000 of salary for that period. A worked in country F from May 1, 1983 through the end of 1984, and is a qualified individual under §1.911–2(a) for that period. For the period from May 1 through December 31, 1983, A received $32,000 of salary. M pays a bonus on December 20, 1983 to each of M's employees in an amount equal to 10 percent of the employee's regular wages or salary for the 1983 calendar year. The amount of A's bonus is $4,400 for 1983. The portion of A's bonus that is attributable to services performed in country F and is foreign earned income for 1983 is $3,200, or $32,000×10 percent. The remaining $1,200 of A's bonus is attributable to services performed in the United States, and is not foreign earned income.

*Example 2.* The facts are the same as in example 1, except that M determines bonuses separately for each country based on the productivity of the employees in that country. M pays a bonus to employees in country F, in the amount of 15 percent of each employee's wages or salary earned in country F. A's country F bonus is $4,800 for 1983 ($32,000×15 percent), and is foreign earned income for 1983. If A also receives a bonus (or if A's bonus is increased) for working in the United States during 1983, that amount is not foreign earned income.

*Example 3.* X corporation offers its employees a bonus of $40,000 if the employee accepts employment in a foreign country and remains in a foreign country for a period of at least four years. A, an employee of X, is a calendar year and cash basis taxpayer. A accepts employment with X in foreign country F. A begins work in F on July 1, 1983 and continues to work in F for X until June 30, 1987. In 1987 X pays A a $40,000 bonus. The bonus is attributable to services A performed from July 1, 1983 through June 30, 1987. The amount of the bonus attributable to 1987 is $5,000 (($40,000÷48)×6). The amount of the bonus attributable to 1986 is $10,000 (($40,000÷48)×12). A may exclude the $10,000 attributable to 1986 only to the extent that amount could have been excluded under section 911(a)(1) had A received it in 1986. The remaining $25,000 is attributable to services performed in taxable years before 1986. Such amounts may not be excluded under section 911 because they are received after the close of the taxable year following the taxable year in which the services giving rise to the income were performed.

(iii) *Special rule for elections under section 83(b).* If an individual receives substantially nonvested property and makes an election under section 83(b) and §1.83–2(a) to include in his gross income the amount determined under section 83(b)(1)(A) and (B) and §1.83–2(a) for the taxable year in which the property is transferred (as defined in §1.83–3(a)), then, for the purpose of determining the amount eligible for exclusion in the year of receipt, the individual may elect either of the following options:

(A) Substantially nonvested property may be treated as attributable entirely to services performed in the taxable year in which an election to include it in income is made. If so treated, then the amount otherwise included in gross income as determined under §1.83–2(a) will be excludable under section 911(a) for such year subject to the limitation provided in §1.911–3(d)(2) for such year.

(B) A portion of the substantially nonvested property may be treated as attributable to services performed or to be performed in each taxable year during which the substantial risk of forfeiture (as defined in section 83(c) and §1.83–3(c)) exists. The portion treated as attributable to services performed or to be performed in each taxable year is determined by dividing the amount of the substantially nonvested property included in gross income as determined under §1.83–2(a) by the number of months during the period when a substantial risk of forfeiture exists. The quotient is multiplied by the total number of months in the taxable year during which a substantial risk of forfeiture exists. The amount determined to be attributable to services performed in the year the election is made shall be excluded from gross income for such year as provided in paragraph (d)(2) of this section. Amounts treated as attributable to services performed in subsequent taxable years shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such subsequent years. An individual may obtain such additional exclusion by filing an amended return for the taxable year in which the property was transferred. The individual may only amend his or her return within the period provided by section 6511(a) and the regulations thereunder.

(5) *Moving expense reimbursements*—(i) *Source of reimbursements.* For the purpose of determining whether a moving expense reimbursement is attributable to services performed within a foreign country or within the United States, in the absence of evidence to the contrary, the reimbursement shall be attributable to future services to be performed at the new principal place of work. Thus, a reimbursement received by an employee from his employer for the expenses of a move to a foreign country will generally be attributable to services performed in the foreign country. A reimbursement received by an employee from his employer for the expenses of a move from a foreign country to the United States will generally be attributable to services performed in the United States. For purposes of this paragraph (e)(5), evidence to the contrary includes, but is not limited to, an agreement, between the employer and the employee, or a statement of company policy, which is reduced to writing before the move to the foreign country and which is entered into or established to induce the employee or employees to move to a foreign country. The writing must state that the employer will reimburse the employee for moving expenses incurred in returning to the United States regardless of whether the employee continues to work for the employer after the employee returns to the United States. The writing may contain conditions upon which the right to reimbursement is determined as long as the conditions set forth standards that are definitely ascertainable and the conditions can only be fulfilled prior to, or through completion of the employee's return move to the United States that is the subject of the writing. In no case will an oral agreement or statement of company policy concerning moving expenses be considered evidence to the contrary. For the purpose of determining whether a storage expense reimbursement is attributable to services performed within a foreign country, in the case of storage expenses incurred after December 31, 1983, the reimbursement shall be attributable to services performed during the period of time for which the storage expenses are incurred.

(ii) *Attribution of foreign source reimbursements to taxable years in which services are performed*—(A) *In general.* If a reimbursement for moving expenses is determined to be from foreign sources under paragraph (e)(5)(i) of this section, then for the purpose of determining the amount eligible for exclusion in accordance with paragraphs (d)(2) and (e)(2) of this section, the reimbursement shall be considered attributable to services performed in the year of the move as long as the individual is a qualified individual for a period that includes 120 days in the year of the move. The period that is used in determining the number of qualifying days for purposes of the individual's section 911(a)(1) limitation (under paragraph (d)(2) of this section) must also be used in determining whether the individual is a qualified individual for a period that includes 120 days in the year of the move. If the individual is not a qualified individual for such period, then the individual shall treat a portion of the reimbursement as attributable to services performed in the year of the move, and a portion as attributable to services performed in the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The portion of the reimbursement treated as attributable to services performed in the year of the move shall be determined by multiplying the total reimbursement by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in paragraph (d)(3) of this section) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

The remaining portion of the reimbursement shall be treated as attributable to services performed in the year succeeding or preceding the year of the move. Amounts treated as attributable to services performed in a year succeeding or preceding the year of the move shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such succeeding or preceding year.

(B) *Moves beginning before January 1, 1984.* Notwithstanding paragraph (e)(5)(ii)(A) of this section, this paragraph (e)(5)(ii)(B) shall apply for moves begun before January 1, 1984. If a reimbursement for moving expenses is determined to be from foreign sources under paragraph (e)(5)(i) of this section, then for the purpose of determining the amount eligible for exclusion in accordance with paragraphs (d)(2) and (e)(2) of this section, the reimbursement shall be considered attributable to services performed in the year of the move. However, if the individual does not qualify under section 911(d)(1) and §1.911–2(a) for the entire taxable year of the move, then the individual shall treat a portion of the reimbursement as attributable to services performed in the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The portion of the reimbursement treated as attributable to services performed in the year succeeding or preceding the move shall be determined by multiplying the total reimbursement by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in paragraph (d)(3) of this section) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

and subtracting the product from the total reimbursement. Amounts treated as attributable to services performed in a year succeeding or preceding the year of the move shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such succeeding or preceding year.

(f) *Examples.* The following examples illustrate the application of this section.

*Example 1.* A is a U.S. citizen and calendar year taxpayer. A's tax home was in foreign country F and A was physically present in F for 330 days during the period from July 4, 1982 through July 3, 1983. The number of A's qualifying days in 1982 as determined under paragraph (d)(2) of this section is 181. In 1982 A receives $40,000 attributable to services performed in foreign country F in 1982. Under paragraph (d)(2) of this section A's section 911(a)(1) limitation is $37,192, that is the lesser of $40,000 (foreign earned income) or

$$\$75{,}000\,(\text{annual rate}) \times \frac{181\,(\text{qualifying days})}{365\,(\text{days in taxable year}).}$$

*Example 2.* The facts are the same as in example 1 except that in 1982 A receives $30,000 attributable to services performed in foreign country F. A excludes this amount from gross income under paragraph (d) of this section. In addition, in 1983 A receives $10,000 attributable to services performed in F in 1982 and $35,000 attributable to services performed in F in 1983. On his return for 1983, A must report $45,000 of income. A's section 911(a)(1) limitation for 1983 is the lesser of $35,000 (foreign earned income) or $49,329, the annual rate for the taxable year multiplied by a fraction the numerator of which is A's qualifying days in the taxable year and the denominator of which is the number of days in the taxable year ($80,000×184/365). On his tax return for 1983 A may exclude $35,000 attributable to services performed in 1983. A

may only exclude $7,192 of the $10,000 received in 1983 attributable to services performed in 1982 because such amount is only excludable in 1983 to the extent such amount could have been excluded in 1982 subject to the section 911(a)(1) limitation for 1982 which is $37,192 ($75,000×181/365). No portion of amounts attributable to services performed in 1982 may be used in calculating A's section 911(a)(1) limitation for 1983. Thus, even though A could have excluded an additional $5,329 in 1983 if A had had more foreign earned income attributable to 1983, A may not exclude the $2,808 of remaining foreign earned income attributable to 1982.

*Example 3.* C is a U.S. citizen and calendar year taxpayer. C establishes a bona fide residence and a tax home in foreign country J on March 1, 1982, and maintains a tax home and a residence in J until December 31, 1986. In March of 1982 C's employer, Y corporation, transfers stock in Y to C. The stock is subject to forfeiture if C returns to the U.S. before January 1, 1985. C elects under section 83(b) to include $15,000, the amount determined with respect to such stock under section 83(b)(1), in gross income in 1982. C's other foreign earned income in 1982 is $58,000. C elects under paragraph (e)(4)(iii)(B) of this section to treat the stock as if earned over the period of the substantial risk of forfeiture. The number of months in the period of the substantial risk of forfeiture is thirty-four. The number of months in the taxable year 1982 within the period of foreign employment is ten. For purposes of determining C's section 911(a)(1) limitation, $4,412 (($15,000/34)×10) of the amount included in gross income under section 83(b) is treated as attributable to services performed in 1982, $5,294 is treated as attributable to services to be performed in 1983, and $5,294 is treated as attributable to services to be performed in 1984. In 1982, C excludes $62,412 under section 911(a)(1). That is the lesser of foreign earned income for 1982 ($58,000+$4,412) or the annual rate for the taxable year multiplied by a fraction the numerator of which is C's qualifying days in the taxable year and the denominator of which is the number of days in the taxable year ($75,000×306/365). C continues to perform services in foreign country J throughout 1983 and 1984. C would be able to exclude the remaining $5,294 attributable to services performed in 1983 and $5,294 attributable to services performed in 1984 if those amounts would be excludable if they had been received in 1983 or 1984 respectively. If C is entitled to exclude the additional amounts, C must claim the exclusion by filing an amended return for 1982.

*Example 4.* D is a U.S. citizen and a calendar year taxpayer. In September, 1984 D moves to a foreign country K. D is physically present in K, and D's tax home is in K, from September 15, 1984 through December 31, 1985. D receives $6,000 in April, 1985 from his employer, as a reimbursement for expenses of moving to K, pursuant to a written agreement that such moving expenses would be reimbursed to D upon successful completion of 6 months employment in K. Under paragraph (e)(15)(i) of this section, the reimbursement is attributable to services performed in K. Under the physical presence test of §1.911–2(a)(2)(ii), among other periods D is a qualified individual for the period of August 10, 1984 through August 9, 1985, which includes 144 days in 1984. Under paragraph (e)(5)(ii)(A) of this section, for the purpose of determining the amount eligible for exclusion, the reimbursement is considered attributable to services performed in 1984 (the year of the move) because D is a qualified individual under §1.911–2(a) for a period that includes 120 days in 1984. The reimbursement may be excluded under paragraphs (d)(2) and (e)(2) of this section, to the extent that D's foreign earned income for 1984 that was earned and received in 1984 was less than the annual rate for the taxable year multiplied by the number of D's qualifying days in the taxable year over the number of days in D's taxable year ($80,000×144/366), or $31,475.

*Example 5.* The facts are the same as in example 4 except that D is not a qualified individual under the physical presence test, but is a qualified individual under the bona fide residence test for the period of September 15, 1984 through December 31, 1985. Under paragraph (e)(5)(ii)(A) of this section, for the purpose of determining the amount eligible for exclusion, the reimbursement is considered attributable to services performed in 1984 and 1985 because D is not a qualified individual for a period that includes 120 days in 1984 (the year of the move). The portion of the reimbursement treated as attributable to services performed in 1984 is $6,000×108/366, or $1,770, and may be excluded, subject to D's 1984 section 911(a)(1) limitation. The balance of the reimbursement, $4,230, is treated as attributable to services performed in 1985, and may be excluded to the extent provided in paragraphs (d)(2) and (e)(2) of this section.

*Example 6.* The facts are the same as in example 4, with the following additions. Before D moved to K, D and his employer signed a written agreement that D would perform services for the employer for at least one year, primarily in country K, and, if D did not voluntarily cease to work for the employer primarily in country K before one year had elapsed, the employer would reimburse D for one half of D's expenses, up to a maximum of $4,000, of moving back to the United States. The agreement also stated that, if D did not voluntarily leave the employment in K before two years had elapsed, the employer would reimburse D for all of D's reasonable expenses of moving back to the United States. The agreement further stated that D's right to reimbursement

would not be conditioned upon the performance of services after D ceased to work in K. D worked in country K for all of 1985. On January 1, 1986, D left K and moved to the United States. In February, 1986 the employer paid D $3,500 as reimbursement for one-half of D's expenses of moving to the United States. Although D did not fulfill the condition in the agreement to receive full reimbursement, all of the conditions in the agreement set forth definitely ascertainable standards and no condition could be fulfilled after D moved back to the United States. The agreement fulfills the requirements of paragraph (e)(5)(i) of this section, and therefore is evidence that the reimbursement should not be attributable to future services to be performed at D's new principal place of work. Under the facts and circumstances, the reimbursement is attributable to services performed in K. Under paragraph (e)(5)(ii)(A) of this section, the entire reimbursement is attributable to services performed in 1985. The amount attributable to 1985 may be excluded to the extent provided in paragraphs (d)(2) and (e)(2) of this section.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2966, Jan. 23, 1985]

### § 1.911–4 Determination of housing cost amount eligible for exclusion or deduction.

(a) *Definition of housing cost amount.* The term ''housing cost amount'' means an amount equal to the reasonable expenses paid or incurred (as defined in section 7701(a)(25)) during the taxable year by or on behalf of the individual attributable to housing in a foreign country for the individual and any spouse or dependents who reside with the individual (or live in a second foreign household described in paragraph (b)(5) of this section) less the base housing amount as defined in paragraph (c) of this section. The housing cost amount must be reduced by the amount of any military or section 912 allowance or similar allowance excludable from gross income that is intended to compensate the individual or the individual's spouse in whole or in part for the expenses of housing during the same period for which the individual claims a housing cost amount exclusion or deduction.

(b) *Housing expenses*—(1) *Included expenses.* For purposes of paragraph (a) of this section, housing expenses include rent, the fair rental value of housing provided in kind by the employer, utilities (other than telephone charges), real and personal property insurance, occupancy taxes not described in paragraph (b)(2)(v) of this section, nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, household repairs, and residential parking.

(2) *Excluded expenses.* Housing expenses do not include:

(i) The cost of house purchase, improvements, and other costs that are capital expenditures;

(ii) The cost of purchased furniture or accessories or domestic labor (maids, gardeners, etc.);

(iii) Amortized payments of principal with respect to an evidence of indebtedness secured by a mortgage on the taxpayer's housing;

(iv) Depreciation of housing owned by the taxpayer, or amortization or depreciation of capital improvements made to housing leased by the taxpayer;

(v) Interest and taxes deductible under section 163 or 164 or other amounts deductible under section 216(a) (relating to deduction of interest and taxes by cooperative housing corporation tenant);

(vi) The expenses of more than one foreign household except as provided in paragraph (b)(5) of this section;

(vii) Expenses excluded from gross income under section 119;

(viii) Expenses claimed as deductible moving expenses under section 217; or

(ix) The cost of a pay television subscription.

(3) *Limitation.* Housing expenses are taken into account for purposes of this section only to the extent attributable to housing for portions of the taxable year within the period during which the individual satisfies the requirements of § 1.911–2(a). Housing expenses are not taken into account for the period during which the value of the individual's housing is excluded from gross income under section 119, unless the individual maintains a second foreign household described in paragraph (b)(5) of this section. If an individual maintains two foreign households, only expenses incurred with respect to the abode which bears the closest relationship, not necessarily geographic, with respect to the individual's tax home

shall be taken into account, unless one of the households is a second foreign household.

(4) *Reasonableness.* An amount paid for housing shall not be treated as reasonable, for purposes of paragraph (a) of this section, to the extent that the expense is lavish or extravagant under the circumstances.

(5) *Expenses of a second foreign household*—(i) *In general.* The term ''second foreign household'' means a separate abode maintained by an individual outside of the U.S. for his or her spouse or dependents (who, if minors, are in the individual's legal custody or the joint custody of the individual and the individual's spouse) at a place other than the tax home of the individual because of adverse living conditions at the individual's tax home. If an individual maintains a second foreign household the expenses of the second foreign household may be included in the individual's housing expenses under paragraph (b)(1) of this section. Under no circumstances shall an individual be considered to maintain more than one second foreign household at the same time.

(ii) *Adverse living conditions.* Solely for purposes of paragraph (b)(5)(i) of this section, adverse living conditions are living conditions which are dangerous, unhealthful, or otherwise adverse. Adverse living conditions include a state of warfare or civil insurrection in the general area of the individual's tax home. Adverse living conditions exist if the individual resides on the business premises of the employer for the convenience of the employer and, because of the nature of the business (for example, a construction site or drilling rig), it is not feasible for the employer to provide housing for the individual's spouse or dependents. The criteria used by the Department of State in granting a separate maintenance allowance are relevant, but not determinative, for purposes of determining whether a separate household is provided because of adverse living conditions.

(c) *Base housing amount*—(1) *In general.* The base housing amount is equal to the product of 16 percent of the annual salary of an employee of the United States who is compensated at a rate equal to the annual salary rate paid for step 1 of grade GS–14, multiplied by the following fraction:

$$\frac{\text{The number of qualifying days}}{\text{The number of days in the taxable year}}$$

For purposes of the above fraction, the number of qualifying days is determined in accordance with §1.911–3(d)(3).

(2) *Annual salary of step 1 of grade GS–14.* The annual salary rate for a step 1 of grade GS–14 is determined on January first of the calendar year in which the individual's taxable year begins.

(d) *Housing cost amount exclusion*—(1) *Limitation.* A qualified individual who has elected to exclude his or her housing cost amount may only exclude the lesser of the full amount of either the individual's housing cost amount attributable to employer provided amounts or the individual's foreign earned income for the taxable year. A qualified individual who elects to exclude his or her housing cost amount may not claim less than the full amount of the housing cost exclusion determined under this paragraph.

(2) *Employer provided amounts.* For purposes of this section, the term ''employer provided amounts'' means any amounts paid or incurred on behalf of the individual by the individual's employer which are foreign earned income included in the individual's gross income for the taxable year (without regard to section 911). Employer provided amounts include, but are not limited to, the following amounts: Any salary paid by the employer to the employee; any reimbursement paid by the employer to the employee for housing expenses, educational expenses for the individual's dependents, or as part of a tax equalization plan; the fair market value of compensation provided in kind (including lodging, unless excluded under section 119, relating to meals and lodging furnished for the convenience of the employer); and any amount paid by the employer to any third party on behalf of the employee. An individual will only have earnings that are not employer provided amounts if the individual has earnings from self-employment.

(3) *Housing cost amount attributable to employer provided amounts.* For the purpose of determining what portion of the housing cost amount is excludable and what portion is deductible the following rules apply. If the individual has no income from self-employment, then the entire housing cost amount is attributable to employer provided amounts and is, therefore, excludable to the extent of the limitation provided in paragraph (d)(1) of this section. If the individual only has income from self-employment, then the entire housing cost amount is attributable to non-employer provided amounts and is, therefore, deductible to the extent of the limitation provided in paragraph (e) of this section. In all other instances, the housing cost amount attributable to employer provided amounts shall be determined by multiplying the housing cost amount by the following fraction: Employer provided amounts over foreign earned income for the taxable year. The housing cost amount attributable to non-employer provided amounts shall be determined by subtracting the portion of the housing cost amount attributable to employer provided amounts from the total housing cost amount.

(e) *Housing cost amount deduction*—(1) *In general.* If a portion of the individual's housing cost amount is determined under paragraph (d)(3) of this section to be attributable to non-employer provided amounts, the individual may deduct that amount from gross income for the taxable year but only to the extent of the individual's foreign earned income (as defined in §1.911–3) for the taxable year in excess of foreign earned income excluded and the housing cost amount excluded from gross income for the taxable year under §1.911–3 and this section.

(2) *Carryover.* If any portion of the individual's housing cost amount deduction is disallowed for the taxable year under paragraph (e)(1) of this section, such portion shall be carried over and treated as a deduction from gross income for the succeeding taxable year (but only for the succeeding taxable year) to the extent of the excess, if any, of:

(i) The amount of foreign earned income for the succeeding taxable year less the foreign earned income and the housing cost amount excluded from gross income under §1.911–3 and this section for the succeeding taxable year over,

(ii) The portion, if any, of the housing cost amount that is deductible under paragraph (e)(1) of this section for the succeeding taxable year.

(f) *Examples.* The following examples illustrate the application of this section. In all examples the annual rate for a step 1 of GS–14 as of January first of the calendar year in which the individual's taxable year begins is $39,689.

*Example 1.* B, a U.S. citizen is a calendar year taxpayer who was a bona fide resident of and whose tax home was located in foreign country G for the entire taxable year 1982. B receives an $80,000 salary from B's employer for services performed in G. B incurs no business expenses. B receives housing provided by B's employer with a fair rental value of $15,000. The value of the housing furnished by B's employer is not excluded from gross income under section 119. B pays $10,000 for housing expenses. B's gross income and foreign earned income for 1982 is $95,000. B elects the foreign earned income exclusion of section 911(a)(1) and the housing cost amount exclusion of section 911(a)(2). B must first compute his housing cost amount exclusion. B's housing cost amount is $18,650 determined by reducing B's housing expenses, $25,000 ($15,000 fair rental value of housing and $10,000 of other expenses), by the base housing amount of $6,350 (($39,689×.16)×365/365). Because B has no income from self-employment, the entire amount is attributable to employer provided amounts and therefore, is excludable. B's section 911(a)(1) limitation is $75,000. That is the lesser of $75,000×365/365 or $95,000−18,650. B's total exclusion for 1982 under section 911(a)(1) and (2) is $93,650.

*Example 2.* The facts are the same as in example 1 except that B's salary for 1982 is $70,000. B's foreign earned income for 1982 is $85,000. B's housing cost amount is $18,650, all of which is attributable to employer provided amounts. B's housing cost amount is excludable to the extent of the lesser of B's housing cost amount attributable to employer provided amounts, $18,650, or the foreign earned income for the taxable year, $85,000. Thus, B excludes $18,650 under section 911(a)(2). B's section 911(a)(1) limitation for 1982 is $66,350 (the lesser of $75,000×365/365 or $85,000−18,650). B's total exclusion for 1982 under section 911(a)(1) and (2) is $85,000.

*Example 3.* The facts are the same as in example 2 except that in 1983, B receives $5,000 attributable to services performed in 1982. B may exclude the entire $5,000 in 1983 because such amount would have been excludable

under §1.911–3(d)(1) had it been received in 1982.

*Example 4.* C is a U.S. citizen self-employed and a calendar year and cash basis taxpayer. C arrived in foreign country H on October 3, 1982, and departed from H on March 8, 1984. C's tax home was located in H throughout that period. C was physically present for 330 full days during the twelve consecutive month period August 30, 1982, through August 29, 1983. The number of C's qualifying days in 1982 is 124. During 1982 C had $35,000 of foreign earned income, none of which was attributable to employer provided amounts and $8,000 of reasonable housing expenses. C's housing cost amount is $5,843 ($8,000 − ((39,689×.16)×124/365)). C elects to exclude her foreign earned income under §1.911–3(d)(1). C's section 911(a)(1) limitation for 1982 is $25,479 (the lesser of C's foreign earned income for the taxable year ($35,000) or the annual rate for the taxable year multiplied by the number of C's qualifying days over the number of days in the taxable year ($75,000×124/365=$25,479). C may not claim the housing cost amount exclusion under section 911(a)(2) because no portion of the housing cost amount is attributable to employer provided amounts. C may deduct the lesser of her housing cost amount ($5,843) or her foreign earned income in excess of amounts excluded under section 911(a) ($35,000 − 25,479=$9,521). Thus, C's housing cost amount deduction is $5,843.

*Example 5.* The facts are the same as in example 4 except that C had $30,000 of foreign earned income for 1982, none of which was attributable to employer provided amounts. C elects to exclude $25,479 under §1.911–3(d)(1). C may only deduct $4,521 of her housing cost amount under paragraph (e)(1) of this section because her foreign earned income in excess of amounts excluded under section 911(a) is $4,521($30,000 − 25,479). The $1,322 of unused housing cost amount deduction may be carried over to the subsequent taxable year.

*Example 6.* The facts are the same as in example 4 except that C had $15,000 of foreign earned income of 1982, none of which was attributable to employer provided amounts. C elects to exclude the entire $15,000 under §1.911–3(d)(1). C is not entitled to a housing cost amount deduction for 1982 since she has no foreign earned income in excess of amounts excluded under section 911(a). C may carry over her entire housing cost amount deduction to 1983.

*Example 7.* The facts are the same as in example 6. In addition, during taxable year 1983 C had $115,000 of foreign earned income, none of which was attributable to employer provided amounts, and $40,000 of reasonable housing expenses C elects to exclude her foreign earned income under §1.911–3(d)(1). C's section 911(a)(1) limitation is the lesser of $115,000 or $80,000 ($80,000×365/365). C's housing cost amount for 1983 is $33,650 (40,000 − (39,689×.16)×365/365). Since no portion of that amount is attributable to employer provided amounts, C may not claim a housing cost amount exclusion. C may deduct the lesser of her housing cost amount ($33,650) or her foreign earned income in excess of amounts excluded under section 911(a) ($115,000 − 80,000=35,000). Thus, C may deduct her $33,650 housing cost amount in 1983. In addition, C may deduct $1,350 of the housing cost amount deduction carried over from taxable year 1982.

(($115.000 − 80,000) − 33,650=$1,350). The remaining $4,493 ($5,843 − 1,350) of the housing cost amount deduction carried over from taxable year 1982 may not be deducted in 1983 or carried over to 1984.

*Example 8.* D is a U.S. citizen and a calendar year and cash basis taxpayer. D is a bona fide resident of and maintains his tax home in foreign country J for all of taxable year 1984. In 1984, D earns $80,000 of foreign earned income, $60,000 of which is an employer provided amount and $20,000 of which is a non-employer provided amount. D's total housing cost amount for 1984 is $25,000. D elects to exclude, under section 911(a)(2), the portion of his housing cost amount that is attributable to employer provided amounts. D's excludable housing cost amount is $18,750; that is the total housing cost amount ($25,000) multiplied by employer provided amounts for the taxable year ($60,000) over foreign earned income for the taxable year ($80,000). D also elects to exclude his foreign earned income under §1.911–3(d)(1). D's section 911(a)(1) limitation for 1984 is $61,250 (the lesser of $80,000 − $18,750 or $80,000×366/366). D's total exclusion for 1984 under section 911(a)(1) and (2) is $80,000. D cannot claim a housing cost amount deduction in 1984 because D has no foreign earned income in excess of his foreign earned income and housing cost amount excluded from gross income for the taxable year under §1.911–3 and this section. D may carry over his housing cost amount deduction of $6,250, the total housing cost amount less the portion attributable to employer provided amounts ($25,000 − 18,750), to taxable year 1985.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2970, Jan. 23, 1985]

### § 1.911–5 Special rules for married couples.

(a) *Married couples with two qualified individuals*—(1) *In general.* In the case in which a husband and wife both are qualified individuals under §1.911–2(a), each individual may make one or more elections under §1.911–7 and exclude

from gross income foreign earned income and exclude or deduct housing cost amounts subject to the rules of paragraphs (a)(2) and (3) of this section.

(2) *Computation of excluded foreign earned income.* The amount of excludable foreign earned income is determined separately for each spouse under the rule of §1.911–3 on the basis of the income attributable to the services of that spouse. If the spouses file separate returns each may exclude the amount of his or her foreign earned income attributable to his or her services subject to the limitations of §1.911–3(d)(2). If the spouses file a joint return, the sum of these foreign earned income amounts so determined for each spouse may be excluded. For example, H and W both qualify under §1.911–2(a)(2)(i) for the entire 1983 taxable year. During 1983 W earns $100,000 of foreign earned income and H earns $45,000 of foreign earned income. H and W file a joint return for 1983. On their joint return H and W may exclude from gross income a total of $125,000. That amount is determined by adding W's section 911(a)(1) limitation, $80,000 (the lesser of $80,000×365/365 or $100,000), and H's section 911(a)(1) limitation, $45,000 (the lesser of $80,000×365/365 or $45,000).

(3) *Computation of housing cost amount*—(i) *Spouses residing together.* If the spouses reside together, and file a joint return, they may compute their housing cost amount either jointly or separately. If the spouses reside together and file separate returns, they must compute their housing cost amounts separately. If the spouses compute their housing cost amounts separately, they may allocate the housing expenses to either of them or between them for the purpose of calculating separate housing cost amounts, but each spouse claiming a housing cost amount exclusion or deduction must use his or her full base housing amount in such computation. If the spouses compute their housing cost amount jointly, then only one of the spouses may claim the housing cost amount exclusion or deduction.

Either spouse may claim the housing cost amount exclusion or deduction; however, if the spouses have different periods of residence or presence and the spouse with the shorter period of residence or presence claims the exclusion or deduction, then only the expenses incurred in that shorter period may be claimed as housing expenses. The spouse claiming the exclusion or deduction may aggregate the couple's housing expenses, and subtract his or her base housing amount. For example, H and W reside together and file a joint return. H was a bona fide resident of and maintained his tax home in foreign country M from August 17, 1982, through December 31, 1983. W was a bona fide resident of and maintained her tax home in foreign country M from September 15, 1982, through December 31, 1983. During 1982, H and W earn and receive, respectively, $25,000 and $10,000 of foreign earned income. H paid $10,000 for qualified housing expenses in 1982, $7,500 of that was for qualified housing expenses incurred from September 15, 1982, through December 31, 1982. W paid $3,000 for qualified housing expenses in 1982 all of which were incurred during her period of residence. H and W may choose to compute their housing cost amount jointly. If they do so and H claims the housing cost amount exclusion his exclusion would be $10,617. H's housing expenses would be $13,000 ($10,000+$3,000) and his base housing amount would be $2,383 ((39,689×.16)×137/365=$2,383). If instead W claims the housing cost amount exclusion her exclusion would be $8,621. W's housing expenses would be $10,500 ($7,500+3,000) and her base housing amount would be $1,879 (($39,689×.16)×108/365=$1,879). If H and W file jointly and both claim a housing cost amount exclusion, then H's and W's housing cost amounts would be, respectively, $7,617 ($10,000 − 2,383) and $1,121 ($3,000 − 1,879).

(ii) *Spouses residing apart.* If the spouses reside apart, both spouses may exclude or deduct their housing cost amount if the spouses have different tax homes that are not within reasonable commuting distance (as defined in §1.119–1(d)(4)) of each other and neither spouse's residence is within a reasonable commuting distance of the other spouse's tax home. If the spouses' tax homes, or one spouse's residence and the other spouse's tax home, are within a reasonable commuting distance of

each other, only one spouse may exclude or deduct his or her housing cost amount. Regardless of whether the spouses file joint or separate returns, the amount of the housing cost amount exclusion or deduction must be determined separately for each spouse under the rules of §1.911–4. If both spouses claim a housing cost amount exclusion or deduction directly as qualified individuals, neither may claim any such exclusion or deduction under section 911(c)(2)(B)(ii), relating to a second foreign household maintained for the other spouse. If one spouse fails to claim a housing cost amount exclusion or deduction which that spouse could claim directly, the other spouse may claim such exclusion or deduction under section 911(c)(2)(B)(ii), relating to a second foreign household maintained for the first spouse, provided that all the requirements of that section are met. Spouses may not claim more than one second foreign household and the expenses of such household may only be claimed by one spouse. For example, if both H and W are qualified individuals and H's tax home is in London and W's tax home is in Paris, then both H and W may exclude or deduct their housing cost amounts; however, H and W must compute these amounts separately regardless of whether they file joint or separate returns. If instead of living in Paris, W lives in an area where there are adverse living conditions and W maintains H's home in London, then W may add those housing expenses to her housing expenses and compute one base housing amount. In that case H may not claim a housing cost amount exclusion or deduction.

(iii) *Housing cost amount attributable to employer provided amounts.* Each spouse claiming a housing cost amount exclusion or deduction shall compute the portion of the housing cost amount that is attributable to employer provided amounts separately, based on his or her separate foreign earned income, in accordance with §1.911–4(d)(3).

(b) *Married couples with community income.* The amount of excludable foreign earned income of a husband and wife with community income is determined separately for each spouse in accordance with paragraph (a) of this section on the basis of income attributable to that spouse's services without regard to community property laws. See sections 879 and 6013 (g) and (h) for special rules regarding treatment of community income of a nonresident alien individual married to a U.S. citizen or resident.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2972, Jan. 23, 1985]

### §1.911–6 Disallowance of deductions, exclusions, and credits.

(a) *In general.* No deduction or exclusion from gross income under subtitle A of the Code or credit against the tax imposed by chapter 1 of the Code shall be allowed to the extent the deduction, exclusion, or credit is properly allocable to or chargeable against amounts excluded from gross income under section 911(a). For purposes of the preceding sentence, deductions, exclusions, and credits which are definitely related (as provided in §1.861–8), in whole or in part, to earned income shall be allocated and apportioned to foreign earned income and U.S. source earned income in accordance with the rules contained in §1.861–8. Deductions, exclusions, and credits which are definitely related to all gross income under §1.861–8, including deductions for interest described in §1.861–8(e)(2)(ii), are definitely related, in whole or in part, to earned income. In the case of interest expense allocable, in whole or in part, to foreign earned income under §1.861–8(e)(2)(ii), the expense shall normally be apportioned under option one of the optional gross income methods of apportionment (§1.861–8(e)(2)(v)i(A)), but without regard to conditions (*1*) and (*2*) of subdivision (vi)(A) (the fifty percent conditions). Such interest expense shall not normally be apportioned under the asset method of §1.861–8(e)(2)(v). This is because, where section 911 is the operative section, the expense normally relates more closely to gross income generated from activities than to the amount of capital utilized or invested in activities or property. Deductions that are allocated and apportioned to foreign earned income must then be allocated and apportioned

to foreign earned income that is excluded under section 911(a). If an individual has foreign earned income from both self-employment and other employment, the amount excluded under section 911(a)(1) shall be deemed to include a pro rata amount of the self-employment income and the income from other employment; thus, a pro rata portion of deductible expenses attributable to self-employment income must be disallowed. For purposes of section 911 (d)(6) and this section only, deductions, exclusions, or credits which are not definitely related to any class of gross income shall not be allocable or chargeable to excluded amounts and are, therefore, deductible to the extent allowed by chapter 1 of the Code. Examples of deductions that are not definitely related to a class of gross income are personal and family medical expenses, qualified retirement contributions (but see section 219(b)(1)), real estate taxes and mortgage interest on a personal residence, charitable contributions, alimony payments, and deductions for personal exemptions. In addition, for purposes of this section, amounts excludable or deductible under section 911 or 119 shall not be allocable or chargeable to other amounts excluded under section 911(a). Thus, an individual's housing cost amount which is excludable or deductible under §1.911–4(d) for a taxable year is not apportioned in part to the individual's foreign earned income which is excluded for such year under §1.911–3(d). Therefore, the entire amount of such exclusion or deduction is allowed to the extent provided in §1.911–4. This section does not affect the time for claiming any deduction, exclusion, or credit that is not allocated or apportioned to excluded amounts.

(b) *Moving expenses*—(1) *In general.* No deduction shall be allowed for moving expenses under section 217 to the extent the deduction is properly allocable to or chargeable against amounts of foreign earned income excluded from gross income under section 911(a). If an individual's new principal place of work is in a foreign country, deductible moving expenses will be allocable to foreign earned income. If an individual treats a reimbursement from his employer for the expenses of a move from a foreign country to the United States as attributable to services performed in a foreign country under §1.911–3(e)(5)(i), then deductible moving expenses attributable to that move will be allocable to foreign earned income. If the individual is a qualified individual who elects to exclude foreign earned income under section 911(a), then some or all of such moving expenses must be disallowed as a deduction.

(2) *Attribution of moving expense deduction to taxable years in which services are performed.* If a moving expense deduction is properly allocable to foreign earned income, the deduction shall be considered attributable to services performed in the year of the move as long as the individual is a qualified individual under §1.911–2(a) for a period that includes 120 days in the year of the move. If the individual is not a qualified individual for such period, then the individual shall treat the deduction as attributable to services performed in both the year of the move and the succeeding taxable year, if the move is from the United States to the foreign country, or the prior taxable year, if the move is from a foreign country to the United States. Notwithstanding the preceding two sentences, storage expenses incurred after December 31, 1983 shall be treated as attributable to services performed in the year in which the expenses are incurred.

(3) *Formula for disallowance of moving expense deduction.* The portion of the moving expense deduction that is disallowed shall be determined by multiplying the moving expense deduction by a fraction the numerator of which is all amounts excluded under section 911(a) for the year or years to which the deduction is attributable (under paragraph (b)(2) of this section) and the denominator of which is foreign earned income (as defined in §1.911–3(a)) for that year or years.

(4) *Effect of disallowance based on attribution of deduction to subsequent year's income.* An individual may claim a moving expense deduction in the taxable year in which the amount of the expense is paid or incurred even if attributable, in part, to the succeeding year. However, at such time as the individual excludes income under section

911(a) for the year or years to which the deduction is attributable, the individual shall either—

(i) File an amended return for the year in which the deduction was claimed that does not claim the portion of the deduction that is disallowed because it is chargeable against excluded income, or

(ii) Include in income for the year following the year in which the deduction was claimed an amount equal to the amount of the deduction that is disallowed.

Any amount included in income under paragraph (b)(4)(ii) of this section is not foreign earned income.

(5) *Moves beginning before January 1, 1984.* Notwithstanding paragraphs (b)(1) through (3) of this section, the rules of this paragraph (b)(5) shall apply for moves beginning before January 1, 1984.

(i) *Individual qualifies for the entire taxable year of the move.* If the individual is a qualified individual for the entire taxable year of the move, then the amount of moving expense disallowed shall be determined by multiplying the moving expense deduction otherwise allowable by a fraction the numerator of which is the foreign earned income excluded under section 911(a) for the taxable year of the move and the denominator of which is the foreign earned income for the same taxable year.

(ii) *Individual qualifies for less than the entire taxable year of the move.* If the individual is a qualified individual for less than the entire taxable year of the move, then, for the purpose of determining the portion of the otherwise allowable moving expense deduction that is disallowed, the individual must attribute a portion of the otherwise allowable moving expense deduction either to the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The

portion of the moving expense deduction treated as attributable to services performed in the year of the move shall be determined by multiplying the otherwise allowable moving expense deduction by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in §1.911-3(d)(3) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

The portion of the moving expense deduction treated as attributable to the year succeeding or preceding the move shall be determined by subtracting the portion of the moving expense deduction that is attributable to the year of the move from the total moving expense deduction. The allocation of a portion of the moving expense deduction to a succeeding or preceding taxable year does not affect the time for claiming the allowable moving expense deduction. The portion of the moving expense deduction that is disallowed shall be determined by multiplying the moving expense deduction attributable to the year of the move or the succeeding or preceding year, as the case may be, by a fraction the numerator of which is amounts excluded under section 911(a) for that year and the denominator of which is foreign earned income for that year.

(c) *Foreign taxes*—(1) *Amount disallowed.* No deduction or credit is allowed for foreign income, war profits, or excess profits taxes paid or accrued with respect to amounts excluded from gross income under section 911. To determine the amount of disallowed foreign taxes, multiply the foreign tax imposed on foreign earned income (as defined in §1.911–3(a)) received or accrued during the taxable year by a fraction, the numerator of which is amounts excluded under section 911(a) in such taxable year less deductible expenses properly allocated to such amounts (see paragraphs (a) and (b) of this section), and the denominator of which is foreign earned income (as defined in §1.911–3(a)) received or accrued during

the taxable year less deductible expenses properly allocated or apportioned thereto. For the purpose of determining the extent to which foreign taxes are disallowed, the housing cost amount deduction is treated as definitely related to foreign earned income that is not excluded. If the foreign tax is imposed on foreign earned income and some other income (for example earned income from sources within the United States or an amount not subject to tax in the United States), and the taxes on the other amount cannot be segregated, then the denominator equals the total of the amounts subject to tax less deductible expenses allocable to all such amounts.

(2) *Definitions and special rules*—(i) *Taxable year.* For purposes of paragraph (c)(1) of this section, the term ''taxable year'' means the individual's taxable year for U.S. tax purposes. Such term includes the portion of any foreign taxable year within the individual's U.S. taxable year and excludes the portion of any foreign taxable year not within the individual's U.S. taxable year.

(ii) *Apportionment of foreign taxes.* For purposes of this paragraph (c), foreign taxes imposed on foreign earned income shall be deemed to accrue, on a pro rata basis, to income as the income is received or accrued. The taxes so accrued shall be apportioned to the taxable year during which the income is received or accrued. This rule applies for all individuals, regardless of their method of accounting.

(iii) *Effect of disallowance.* The disallowance of foreign taxes under this paragraph (c) shall not affect the time for claiming any deduction or credit for foreign taxes paid. Rather, the disallowance shall only affect the amount of taxes considered paid or accrued to any foreign country.

(iv) *Interest on foreign taxes.* Any interest expense incurred on a liability for foreign taxes is allocated and apportioned not under this paragraph (c) but under paragraph (a) of this section to foreign earned income and then to excluded foreign earned income and to that extent disallowed as a deduction under paragraph (a). In that regard, see also §1.861–8(e)(2) for the specific rules for allocation and apportionment of interest expense.

(d) *Examples.* The following examples illustrate the application of this section.

*Example 1.* In 1982 A, an architect, operates his business as a sole proprietorship in which capital is not a material income producing factor. A receives $1,000,000 in gross receipts, all of which is foreign source earned income, and incurs $500,000 of otherwise deductible business expenses definitely related to the foreign earned income. A elects to exclude $75,000 under section 911(a)(1). The expenses must be apportioned to excluded earned income as follows: $500,000×$75,000/1,000,000. Thus, $37,500 of the business expenses are not deductible.

*Example 2.* The facts are the same as in example 1, except that $100,000 of A's gross receipts is U.S. source earned income and $68,000 of A's business expenses are attributable to the U.S. source earned income. Thus, A has $900,000 of foreign earned income and $432,000 of deductions allocated to foreign earned income. The expenses apportioned to excluded earned income are $432,000×$75,000/$900,000, or $36,000, which are not deductible.

*Example 3.* B is a U.S. citizen, calendar year and cash basis taxpayer. B moves to foreign country N and maintains a tax home and is physically present there from July 1, 1984 through May 26, 1985. Among other possible periods, B is a qualified individual for 219 days in the year of the move. B pays $6,000 of otherwise deductible moving expenses in 1984. For 1984, B's foreign earned income is $60,000 and B excludes $47,869 ($80,000×219/366) under section 911(a). Under paragraph (b)(2) of this section, B's moving expenses are attributable to services performed in 1984. Under paragraph (b)(3) of this section, $6,000×$47,869/$60,000, or $4,789, of B's moving expense deduction is disallowed. B may deduct $1,211 of moving expenses on his 1984 return.

*Example 4.* The facts are the same as in example 3 except that B maintains a tax home and is physically present in foreign country N from October 9, 1984 through September 3, 1985. Among other possible periods, B is a qualified individual for no more than 119 days in 1984 and 281 days in 1985. B's foreign earned income for 1984 is $60,000. B's foreign earned income for 1985 is $150,000. Because B is a qualified individual for less than 120 days in the year of the move, under paragraph (b)(2) of this section, B's moving expenses are attributable to services performed in 1984 and 1985. At the close of 1984, B may either seek an extension of time to file under §1.911–7(c) or may file an income tax return without claiming the exclusions or deduction under section 911. B does not seek an extension and files without excluding foreign earned income; thus B may deduct his moving expenses in full. B later amends his 1984

return and excludes foreign earned income for that year. B excludes foreign earned income for 1985. B must determine the portion of the moving expense deduction that is disallowed. The portion of the moving expense deduction that is disallowed is determined by multiplying the otherwise allowable moving expense deduction by a fraction. The numerator of the fraction is the sum of amounts excluded under section 911(a) for 1984 and 1985, that is $26,082 or $80,000×119/365, plus $61,589, or $80,000×281/365, which totals $87,671. The denominator of the fraction is the sum of foreign earned income for 1984 and 1985, that is $60,000 plus $150,000, or $210,000. B's allowable moving expense deduction is $3,495, or $6,000−($6,000×$87,671/$210,000). If B does not file an amended 1984 return (and does not exclude foreign earned income for 1984), but excludes foreign earned income under section 911(a) for 1985, a portion of his moving expense deduction is disallowed, based on the same formula. The amount disallowed is $6,000×$61,589/$210,000, or $1,760. This amount may be recaptured either by filing an amended return for 1984 or by including it in income for 1985 (in which case it is not foreign earned income).

*Example 5.* C is a U.S. citizen, a self-employed individual, and a cash basis and calendar year taxpayer. For the entire 1982 taxable year C maintained his tax home and his bona fide residence in foreign country P. During 1982 C earned and received $120,000 of foreign earned income, none of which was attributable to employer provided amounts. C paid $40,000 of business expenses. C elected to exclude foreign earned income under section 911(a)(1) and claimed a housing cost amount deduction of $15,000. C received $10,000 of foreign source interest income which was included with C's earned income in a single tax base and taxed at graduated rates. For 1982, C paid $30,000 in income tax to foreign country P. The amount of C's business expenses that is properly apportioned to excluded amounts (and therefore, not deductible) equals $25,000, which is determined by multiplying the otherwise allowable deductions by C's excluded amounts over C's foreign earned income ($40,000×75,000/120,000). The amount of country P tax that is properly apportioned to excluded amounts (and therefore, not deductible or creditable) equals $20,000, which is determined by multiplying the tax of $30,000 by the following fraction:

$$\frac{\text{\$50,000 (\$75,000 excluded amounts less \$25,000 of deductible expenses allocable thereto)}}{\text{\$75,000 (((\$120,000 foreign earned income less \$40,000 of deductible expenses allocable thereto) less \$15,000 housing cost amount deduction allocable thereto) plus \$10,000 other taxable income).}}$$

*Example 6.* D is a U.S. citizen and an accrual basis and calendar year taxpayer for U.S. tax purposes. For the entire period from January 1, 1982 through December 31, 1983, D maintains his tax home and his bona fide residence in foreign country R. For purposes of R's income tax, D is a cash basis taxpayer and uses a fiscal year that begins on April 1 and ends on the following March 31. During his entire period of residence in R, D receives foreign earned income of $10,000 each month, all of which is attributable to employer provided amounts. For his foreign taxable year ending March 31, 1982, D pays $10,000 of income tax to R. For his foreign taxable year ending March 31, 1983, D pays $54,000 of income tax to R. Under paragraph (c)(2)(ii) of this section, all of the $10,000 of tax paid for this foreign taxable year ending March 31, 1982 is imposed on foreign earned income received in 1982, as is $40,500, or 9/12×$54,000, of tax paid for his foreign taxable year ending March 31, 1983. (D received $10,000 per month for the last 3 months of his foreign taxable year ending March 31, 1982, all of which are within his U.S. taxable year ending December 31, 1982 under paragraph (c)(2)(i) of this section, and $10,000 per month for each month of his foreign taxable year ending March 31, 1983, of which the first 9 months are within his U.S. taxable year ending December 31, 1982. Under paragraph (c)(2)(ii) of this section, foreign taxes are deemed to accrue on a pro rata basis to income as it is received or accrued. Thus, all of the $10,000 of foreign taxes imposed on the income received during D's foreign taxable year ending March 31, 1982 accrue to D's 1982 foreign earned income, as do 9/12 (or $90,000/120,000) of foreign taxes imposed on income received during D's foreign taxable year ending March 31, 1983, for purposes of determining the amount of D's foreign taxes that is disallowed.) For 1982, D has no deductible expenses, and elects to exclude his housing cost amount of $21,000 under section 911(a)(2) and foreign earned income of $75,000 under section 911(a)(1). The amount of D's foreign taxes disallowed for deduction or credit purposes for 1982 is $8,000 (that is, $10,000×$96,000/$120,000) of the taxes for his foreign taxable year ending March 31, 1982, plus $32,400 (that

is, $40,500×$96,000/$120,000) of the taxes for his foreign taxable year ending March 31, 1983, or $40,400. From 1982, D has $2,000 ($10,000 − $8,000) of deductible or creditable taxes accrued on March 31, 1982, and $8,100 ($40,500–$32,400) of deductible or creditable taxes accrued on March 31, 1983, after the disallowance based on his 1982 excluded income.

*Example 7.* E is a United States citizen, calendar year and cash basis taxpayer. E is physically present in and establishes his tax home in foreign country S on May 1, 1981. For purposes of country S, E's taxable year begins on April 1 and ends the following March 31. E receives foreign earned income of $15,000 each month beginning on May 1, 1981. At the end of his foreign taxable year ending on March 31, 1982, E pays $70,000 of income tax to S on $165,000 of foreign earned income. Under section 911, as in effect for taxable years beginning before January 1, 1982, E may not exclude any income that is earned or received during 1981. None of E's taxes paid in 1982 that are attributable to income earned or received in 1981 are subject to disallowance because, under paragraph (c)(2)(ii) of this section, the only taxes disallowed are those deemed to accrue on income earned and received after December 31, 1981, and excluded from gross income. The amount of E's taxes paid in 1982 that are attributable to 1981 is $50,909, or $70,000×$120,000/$165,000. E elects to exclude foreign earned income for 1982. The amount of E's taxes paid to S in 1982 that accrue to 1982 foreign earned income, and are therefore subject to disallowance based on excluded income, is $19,091, or $70,000×$45,000/$165,000.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2973, Jan. 23, 1985]

### § 1.911–7 Procedural rules.

(a) *Elections of a qualified individual*—(1) *In general.* In order to receive either exclusion provided by section 911(a), a qualified individual must elect, separately with respect to each exclusion, to exclude foreign earned income under section 911(a)(1) and the housing cost amount under section 911(a)(2). Any such elections may be made on Form 2555 or on a comparable form. Each election must be filed either with the income tax return, or with an amended return, for the first taxable year of the individual for which the election is to be effective. An election once made remains in effect for that year and all subsequent years unless revoked under paragraph (b) of this section. Each election shall contain information sufficient to determine whether the individual is a qualified individual as provided in §1.911–2. The statement shall include the following information:

(i) The individual's name, address, and social security number;

(ii) The name of the individual's employer;

(iii) Whether the individual claimed exclusions under section 911 for earlier years after 1981 and within the five preceding taxable years;

(iv) Whether the individual has revoked a previously made election and the taxable year for which such revocation was effective;

(v) The exclusion or exclusions the individual is electing;

(vi) The foreign country or countries in which the individual's tax home is located and the date when such tax home was established;

(vii) The status (either bona fide residence or physical presence) under which the individual claims the exclusion;

(viii) The individual's qualifying period of residence or presence;

(ix) The individual's foreign earned income for the taxable year including the fair market value of all noncash remuneration; and,

(x) If the individual elects to exclude the housing cost amount, the individual's housing expenses.

(2) *Requirement of a return*—(i) *In general.* In order to make a valid election under this paragraph (a), the election must be made:

(A) With an income tax return that is timely filed (including any extensions of time to file),

(B) With a later return filed within the period prescribed in section 6511(a) amending the foregoing timely filed income tax return,

(C) With an original income tax return that is filed within one year after the due date of the return (determined without regard to any extension of time to file); this one year period does not constitute an extension of time for any purpose—it is merely a period during which a valid election may be made on a late return, or

(D) With an income tax return filed after the period described in paragraphs (a)(2)(i)(A), (B), or (C) of this section provided—

(*1*) The taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached either before or after the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion; or

(*2*) The taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached before the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion.

(*3*) A taxpayer filing an income tax return pursuant to paragraph (a)(2)(i)(D)(*1*) or (*2*) of this section must type or legibly print the following statement at the top of the first page of the Form 1040: ''Filed Pursuant to Section 1.911–7(a)(2)(i)(D).''

(ii) *Election for 1982 and 1983 taxable years.* Solely for purposes of paragraph (a)(2)(i)(A) of this section, an income tax return for any taxable year beginning before January 1, 1984, shall be considered timely filed if it is filed on or before July 23, 1985.

(3) *Housing cost amount deduction.* An individual does not have to make an election in order to claim the housing cost amount deduction. However, such individual must provide the Commissioner with information sufficient to determine the individual's correct amount of tax. Such information shall include the following: The individual's name, address, and social security number; the name of the individual's employer; the foreign country in which the individual's tax home was established; the status under which the individual claims the deduction; the individual's qualifying period of residence or presence; the individual's foreign earned income for the taxable year; and the individual's housing expenses.

(4) *Effect of immaterial error or omission.* An inadvertent error or omission of information required to be provided to make an election under this paragraph (a) shall not render the election invalid if the error or omission is not material in determining whether the individual is a qualified individual or whether the individual intends to make the election.

(b) *Revocation of election*—(1) *In general.* An individual may revoke any election made under paragraph (a) of this section for any taxable year. A revocation must be made separately with respect to each election. The individual may revoke an election for any taxable year, including the first taxable year for which an election was effective, by filing a statement that the individual is revoking one or more of the previously made elections. The statement must be filed with the income tax return, or with an amended return, for the first taxable year of the individual for which the revocation is to be effective. A revocation once made is effective for that year and all subsequent years. If an election is revoked for any taxable year, including the first taxable year for which the election was effective, the individual may not, without the consent of the Commissioner, again make the same election until the sixth taxable year following the taxable year for which the revocation was first effective. For example, a qualified individual makes an election to exclude foreign earned income under section 911(a)(1) and files it with his 1982 income tax return. The individual files 1983 and 1984 income tax returns on which he excludes his foreign earned income. Then, within 3 years after filing his 1982 income tax return, the individual files an amended 1982 income tax return with a statement revoking his election to exclude foreign earned income under section 911(a)(1). The revocation of the election is effective for taxable years 1982, 1983, and 1984. The individual may not elect to exclude income under section 911(a)(1) for any taxable year before 1988, unless he obtains consent to reelect under paragraph (b)(2) of this section.

(2) *Reelection before sixth taxable year after revocation.* If an individual revoked an election under paragraph (b)(1) of this section and within five taxable years the individual wishes to reelect the same exclusion, then the individual may apply for consent to the reelection. The application for consent shall be made by requesting a ruling

from the Associate Chief Counsel (Technical), National Office, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. In determining whether to consent to reelection the Associate Chief Counsel or his delegate shall consider any facts and circumstances that may be relevant to the determination. Relevant facts and circumstances may include the following: a period of United States residence, a move from one foreign country to another foreign country with differing tax rates, a substantial change in the tax laws of the foreign country of residence or physical presence, and a change of employer.

(c) *Returns and extensions*—(1) *In general.* Any return filed before completion of the period necessary to qualify an individual for any exclusion of deduction provided by section 911 shall be filed without regard to any exclusion or deduction provided by that section. A claim for a credit or refund of any overpayment of tax may be filed, however, if the taxpayer subsequently qualifies for any exclusion or deduction under section 911. See section 6012(c) and §1.6012–1(a)(3), relating to returns to be filed and information to be furnished by individuals who qualify for any exclusion or deduction under section 911.

(2) *Extensions.* An individual desiring an extension of time (in addition to the automatic extension of time granted by §1.6081–2) for filing a return until after the completion of the qualifying period described in paragraph (c)(1) of this section for claiming any exclusion or deduction under section 911 may apply for an extension. An individual whose moving expense deduction is attributable to services performed in two years may apply for an extension of time for filing a return until after the end of the second year. The individual may make such application on Form 2350 or a comparable form. The application must be filed with the Director, Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The application must set forth the facts relied on to justify the extension of time requested and must include a statement as to the earliest date the individual expects to become entitled to any exclusion or deduction by reason of completion of the qualifying period.

(d) *Declaration of estimated tax.* In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, an individual is not required to take into account income which the individual reasonably believes will be excluded from gross income under the provisions of section 911. In computing estimated tax, however, the individual must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see §1.911–6(c)).

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2976, Jan. 23, 1985, as amended by T.D. 8480, 58 FR 34885, June 30, 1993]

### §1.911–8 Former deduction for certain expenses of living abroad.

For rules relating to the deduction for certain expenses of living abroad applicable to taxable years beginning before January 1, 1982, see 26 CFR 1.913–1 through 1.913–13 as they appeared in the Code of Federal Regulations revised as of April 1, 1982.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2977, Jan. 23, 1985]

## EARNED INCOME OF CITIZENS OF UNITED STATES

### §1.912–1 Exclusion of certain cost-of-living allowances.

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a ''living and quarters allowance'' would be excluded from gross income whether or not any other portion of

such allowance is excluded from gross income.

(b) For purposes of section 912(1), the term ''continental United States'' includes only the 48 States existing on February 25, 1944 (the date of the enactment of the Revenue Act of 1943 (58 Stat. 21)) and the District of Columbia.

### § 1.912–2 Exclusion of certain allowances of Foreign Service personnel.

Gross income does not include amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the provisions of chapter 9 of title I of the Foreign Service Act of 1980 or the provisions of section 28 of the State Department Basic Authorities Act (formerly section 914 of title IX of the Foreign Service Act of 1946).

[T.D. 8256, 54 FR 28620, July 6, 1989]

### § 1.921–1T Temporary regulations providing transition rules for DISCs and FSCs.

(a) *Termination of a DISC*—(1) *At end of 1984.*

*Q–1:* What is the effect of the termination on December 31, 1984, of a DISC's taxable year?

*A–1:* Without regard to the annual accounting period of the DISC, the last taxable year of each DISC beginning during 1984 shall be deemed to close on December 31, 1984. The corporation's DISC election also shall be deemed revoked at the close of business on December 31, 1984. (A DISC that does not elect to be an interest charge DISC as of January 1, 1985, in addition to a corporation described in section 992(a)(3), shall be referred to as a ''former DISC''.) A corporation which wishes to be treated as a FSC, a small FSC, or an interest charge DISC must make an election as provided under paragraph (b) (Q & A #1) of this section.

(2) *Deemed distributions for short taxable years.*

*Q–2:* If the termination of the DISC's taxable year on December 31, 1984, results in a short taxable year, how are the deemed distributions under section 995(b)(1)(E) determined?

*A–2:* The deemed distributions are determined on the basis of the DISC's taxable income for its short taxable year ending on December 31, 1984. In computing the incremental distribution under section 995(b)(1)(E), the export gross receipts for the short taxable year must be annualized.

(3) *Qualification as a DISC for 1984.*

*Q–3:* Must the DISC satisfy all the tests set forth in section 992(a)(1) for the DISC's taxable year ending December 31, 1984?

*A–3:* All of the tests under section 992(a)(1), except the qualified assets test under section 992(a)(1)(B), must be satisfied.

(4) *Commissions for 1984.*

*Q–4:* Must commissions be paid by a related supplier to a DISC with respect to the DISC's taxable year ending December 31, 1984?

*A–4:* No.

*Q–4A:* Must commissions which were earned prior to January 1, 1985, be paid by a related supplier if the last date payment is required (as set forth in §1.994–1(e)(3)) is after December 31, 1984?

*A–4A:* No.

(5) *Producer's loans of 1984.*

*Q–5:* Must the producer's loan rules under section 993(d) be satisfied with respect to the DISC's taxable year ending December 31, 1984?

*A–5:* Yes.

(6) *Accumulated DISC income.*

*Q–6.* Under what circumstances is any remaining accumulated DISC income treated as previously taxed income (and not taxed)?

*A–6.* The accumulated DISC income of a DISC (but not a DISC described in section 992(a)(3)) as of December 31, 1984, is treated as previously taxed income when actually distributed after December 31, 1984. Any amounts distributed by the former DISC (including a DISC which has elected to be an interest charge DISC) after December 31, 1984, shall be treated as made first out of current earnings and profits and then out of previously taxed income to the extent thereof. For purposes of the preceding sentence, amounts distributed before July 1, 1985, shall be treated as made first out of previously taxed income to the extent thereof. If property other than money is distributed and if such property was a qualified export asset within the meaning of section 993(b) on December 31, 1984, then for purposes of section 311, no gain or

loss will be recognized on the distribution and the distributee will have the same basis in the property as the distributor.

*Q–7:* May a DISC that was previously disqualified, but has requalified as of December 31, 1984, treat any accumulated DISC income as previously taxed income?

*A–7:* If a DISC was previously disqualified, but has requalified as of December 31, 1984, any accumulated DISC income previously required to be taken into income upon prior disqualification shall not be treated as previously taxed income. All accumulated DISC income derived since requalification, however, will be treated as previously taxed income.

(7) *Distribution of previously taxed income.*

*Q–8:* What effect will the distribution of previously taxed income have on the earnings and profits of corporate shareholders of the former DISC?

*A–8:* The earnings and profits of the corporate shareholders of the former DISC will be increased by the amount of money and the adjusted basis of any property which is distributed out of previously taxed income.

*Q–9:* Will the distribution of the former DISC's accumulated DISC income as previously taxed income after December 31, 1984, result in a reduction in the shareholder's basis of the stock of the former DISC and consequent taxation of the excess of the distribution over such basis as capital gain under section 996(d)?

*A–9:* No. This distribution will be treated both as amounts representing deemed distributions under section 995(b)(1) and as previously taxed income. Thus, no capital gain will arise.

(8) *Qualifying distributions.*

*Q–10:* How is a qualifying distribution to satisfy the qualified export receipts tests under section 992(c)(1)(A) which is made with respect to the DISC's taxable year ending on December 31, 1984, treated?

*A–10:* The distribution will not be treated as previously taxed income but will be taxed to the shareholder of the former DISC, as provided under section 992(c) and 996(a)(2) and the regulations thereunder, in the shareholder's taxable year in which the distribution is made.

(9) *Deficiency distributions.*

*Q–11:* With respect to an audit adjustment made after December 31, 1984, may a deficiency distribution be made, and if so, in what manner may it be made?

*A–11:* A deficiency distribution may be made notwithstanding the fact that after December 31, 1984, the former DISC is a taxable corporation under subchapter C, has elected to be treated as an interest charge DISC, or has been liquidated, reorganized or is otherwise no longer in existence. However, such deficiency distribution shall be treated as made out of accumulated DISC income which is not previously taxed income because it will be treated as distributed prior to December 31, 1984, to the DISC's shareholders.

*Q–11A:* Must a former DISC remain in existence in order for a former DISC shareholder to take advantage of the spread provided in section 995(b)(2) with respect to DISC disqualification?

*A–11A:* No. With respect to distributions deemed to be received by a former DISC shareholder under section 995(b)(2) for taxable years beginning after December 31, 1984, if the former DISC shareholder elects, the rules of section 995(b)(2)(B) shall apply even though the former DISC does not continue in existence. If the former DISC is no longer in existence, the former DISC's shareholders will be deemed to have received the distribution on the last day of their taxable years over the applicable period of time determined under section 995(b)(2) as if the former DISC had remained in existence.

(10) *Deemed distribution for 1984.*

*Q–12:* How is the deemed distribution to a shareholder for the DISC's taxable year ending December 31, 1984, taken into account?

*A–12* (i) If the taxable year of the DISC ending on December 31, 1984, (A) is the first taxable year of the DISC which begins in 1984, (B) begins after the date in 1984 on which the taxable year of the DISC's shareholder begins, and (C) if the DISC's shareholder makes an election under section 805(b)(3) of the Tax Reform Act of 1984, the deemed distribution under section 995(b) with respect to income derived

by the DISC for such taxable year of the DISC shall be treated as received by the shareholder in 10 equal installments (unless the shareholder elects to be treated as receiving the deemed distribution in income over a smaller number of equal installments). The first installment shall be treated as received by the shareholder on the last day of the shareholder's second taxable year beginning in 1984 (if any), or if the shareholder had only one taxable year which began in 1984, on the last day of the shareholder's first taxable year beginning in 1985. One installment shall be treated as received by the shareholder on the last day of each succeeding taxable year of the shareholder until the entire amount of the DISC's 1984 deemed distribution has been included in the shareholder's taxable income. To make the election under section 805(b)(3) of the Tax Reform Act of 1984, the DISC shareholder must attach a statement to its timely filed tax return (including extensions) for its taxable year which includes December 31, 1984, indicating the total amount of the shareholder's pro rata share of the DISC's deemed distribution for 1984 (determined under section 995(b) of the Code without regard to the election under section 805(b)(3) of the Tax Reform Act of 1984), and the number of equal installments, if less than 10, over which the shareholder wishes to spread its pro rata share of the deemed distribution for 1984. If the election under section 805(b)(3) of the Tax Reform Act of 1984 is made, it may not be changed or revoked. In determining estimated tax payments, the portion of the deemed distribution includible in the shareholder's taxable income for any taxable year under this subdivision (i) shall be treated as received by the shareholder on the last day of such taxable year.

(ii) Except as provided in subdivision (i), the deemed distribution under section 995(b) with respect to income derived by the DISC for its taxable year ending on December 31, 1984, shall be included in the shareholder's taxable income for its taxable year which includes December 31, 1984. Thus, if the taxable year of the DISC and the DISC's shareholder both begin on January 1, 1984, and end on December 31, 1984 (or, if the taxable year of the DISC beginning in 1984 begins before the taxable year of the DISC's shareholder), the deemed distribution with respect to the DISC's taxable year ending on December 31, 1984, will be included in the DISC shareholder's taxable year ending on (or including) December 31, 1984, and the election described in subdivision (i) may not be made.

(iii) The provisions of this Question and Answer-12 apply without regard to any existence of the DISC after December 31, 1984, as an interest charge DISC.

*Q–12A:* If under section 805(b)(3) of the Tax Reform Act of 1984 the shareholders of the DISC are permitted to make an election to treat the DISC's 1984 deemed distribution as received over a 10-year period, must the DISC distribute that amount to its shareholders ratably over the 10-year period?

*A–12A:* No. Under section 805(b)(3) of the Tax Reform Act of 1984, if the DISC's deemed distribution for its taxable year which ended on December 31, 1984, is a qualified distribution, the shareholders of the DISC are permitted to make an election to treat the distribution as received over a 10-year period. The 10-year treatment applies even though the amount of the deemed distribution is distributed to the DISC's shareholders prior to the period in which the distribution is taken into income by the shareholders. In addition, under section 996(e) of the Code, the shareholder's basis in the stock of the DISC will be considered as increased, as of the date of liquidation, by the shareholder's pro rata share of the amount of the undistributed qualified distribution even though that amount is treated as received by the shareholder in later years. Further, the actual distribution in liquidation of the former DISC after 1984 will increase the earnings and profits of a corporate distributee, and the amount actually distributed shall be treated under the rules of section 996.

(11) *Conformity of accounting period.*

*Q–13:* May a DISC be established or change its annual accounting period for taxable years beginning after March 21, 1984, and before January 1, 1985?

*A–13:* A DISC that is established or that changes its annual accounting period after March 21, 1984, must conform its annual accounting period to that of its principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)).

(12) *DISC gains and distributions from U.S. sources.*

*Q–14:* What is the effective date of the amendment to section 996(g), made by section 801(d)(10) of the Tax Reform Act of 1984, which treats certain DISC gains and distributions as derived from sources within the United States?

*A–14:* Under section 805(a)(3) of the Act, the amendment to section 996(g) shall apply to all gains referred to in section 995(c) and all distributions out of accumulated DISC income including deemed distributions made on or after June 22, 1984.

(b) *Establishing and electing status as a FSC, small FSC or interest charge DISC*—(1) *Ninety-day period.*

*Q–1:* How does a corporation elect to be treated as a FSC, a small FSC, or an interest charge DISC?

*A–1:* A corporation electing FSC or small FSC status must file Form 8279. A corporation electing interest charge DISC status must file Form 4876A. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for its first taxable year shall make its election within 90 days after the beginning of that year. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for any taxable year other than its first taxable year shall make its election during the 90-day period immediately preceding the first day of that taxable year. The election to be a FSC, small FSC, or interest charge DISC may be made by the corporation, however, during the first 90 days of a taxable year, even if that taxable year is not the corporation's first taxable year, if that taxable year begins before July 1, 1985. Likewise, the election to be a FSC (or a small FSC) may be made during the first 90 days of any taxable year of a corporation if the corporation had in a prior taxable year elected small FSC (or FSC) status and the corporation revokes the small FSC (or FSC) election within the 90 day period. A corporation which was a DISC for its taxable year ending December 31, 1984, which wishes to be treated as an interest charge DISC beginning with its first taxable year beginning after December 31, 1984, may make the election to be treated as an interest charge DISC by filing Form 4876A on or before July 1, 1987. Also, if a corporation which has elected FSC, small FSC or interest charge DISC status, or a shareholder of that corporation, is acquired in a qualified stock purchase under section 338(d)(3), and if an election under section 338(a) is effective with regard to that corporation, the corporation may re-elect FSC, small FSC or interest charge DISC status, (whichever is applicable) not later than the date of the election under section 338(a), see section 338(g)(i) and §1.338–2(d). This re-election is necessary because the original elections are deemed terminated if an election is made under section 338(a). The rules contained in §1.992–2 (a)(1), (b)(1) and (b)(3) shall apply to the manner of making the election and the manner and form of shareholder consent.

(2) *FSC incorporated in a possession.*

*Q–2:* Where does a FSC which is incorporated in a U.S. possession file its election?

*A–2:* The election is filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(3) *Information returns.*

*Q–3:* Must Form 5471 be filed with respect to the organization of a FSC pursuant to section 6046 or to provide information with respect to a FSC pursuant to section 6038?

*A–3:* A Form 5471 required under section 6046 need not be filed with respect to the organization of a FSC. The requirements of section 6046 shall be satisfied by the filing of a Form 8279 dealing with the election to be treated as a FSC or small FSC. However, a Form 5471 will be required with respect to a reorganization of a FSC (or small FSC) or an acquisition of stock of a FSC (or small FSC), as required under section 6046 and the regulations thereunder. Provided that a Form 1120 FSC is filed, a Form 5471 need not be filed to satisfy the requirements of section 6038.

(4) *Conformity of accounting period.*

*Q–4:* Since a FSC, small FSC, and interest charge DISC must use the same

annual accounting period as the principal shareholder, must such corporation delay the beginning of its first taxable year beyond January 1, 1985 if the principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)) is not a calendar year taxpayer?

*A–4:* No. Where the principal shareholder is not a calendar year taxpayer, a corporation may elect to be treated as a FFSC, small FSC, or interest charge DISC for a taxable year beginning January 1, 1985. However, such corporation must close its first taxable year and adopt the annual accounting period of its principal shareholder as of the first day of the principal shareholder's first taxable year beginning in 1985. A FSC, small FSC, or interest charge DISC need not obtain the consent of the Commissioner under section 442 to conform its annual accounting period to the annual accounting period of its principal shareholder.

(5) *Dollar limitations for short taxable years.*

*Q–5:* If a small FSC or an interest charge DISC has a short taxable year, how are the dollar limitations on foreign trading export gross receipts and qualified export gross receipts, respectively, determined for small FSCs and interest charge DISCs?

*A–5:* The dollar limitations are to be prorated on a daily basis. Thus, for example, if for its 1985 taxable year a small FSC has a short taxable year of 73 days, then in determining exempt foreign trade income, any foreign trading gross receipts that exceed $1 million (73/365 × $5 million) will not be taken into account.

(6) *Change of accounting period.*

*Q–6:* If the principal shareholder of a FSC, a small FSC, or an interest charge DISC (hereinafter referred to as a ''FSC'') changes its annual accounting period or is replaced by a new principal shareholder during a taxable year, is it necessary for the FSC to change its annual accounting period?

*A–6:* If the principal shareholder changes its annual accounting period, the FSC must also change its annual accounting period to conform to that of its principal shareholder. If the voting power of the principal shareholder is reduced by an amount equal to at least 10 percent of the total shares entitled to vote and such shareholder is no longer the principal shareholder, the FSC must conform its accounting period to that of its new principal shareholder. However, in determining whether a shareholder is a principal shareholder, the voting power of the shareholders is determined as of the beginning of the FSC's taxable year. Thus, for example, assume that for 1985 a FSC adopts a calendar year period as its annual accounting period to conform to that of its principal shareholder. Assume further than in March 1985 there is a 10 percent change in voting power and a different shareholder whose annual accounting period begins on July 1 becomes the new principal shareholder. The FSC will not be required to adopt the annual accounting period of its new principal shareholder until July 1, 1986. The FSC will have a short taxable year for the period January 1 to June 30, 1986.

(7) *Transition transfers.*

*Q–7.* Under what circumstances may a DISC or former DISC transfer its assets to a FSC or small FSC without incurring any tax liability on the transfer?

*A–7.* A DISC or former DISC will recognize no income, gain, or loss on a transfer of its qualified assets (as defined in section 993(b)) to a FSC or small FSC if all of the following conditions are met:

(i) The assets transferred were held by the DISC on August 4, 1983, and were transferred by the DISC or former DISC to the FSC or small FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer.

In addition, other provisions of subchapter C will apply to the transfer, such as section 358 (basis to shareholders), section 362 (basis to corporations), and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by a DISC to a FSC or small FSC qualifies for nonrecognition under subchapter C, a liquidation

of the assets of the DISC into a parent corporation followed by a transfer by the parent of those assets to the FSC or small FSC will be treated as a transaction described in section 368(a)(1)(D).

Notwithstanding the foregoing answer, a taxpayer which transfers a right to use its corporate name to a FSC in a transaction described in sections 332, 351, 354, 356 and 361 shall not be treated as having sold that right under section 367(d) or as having transferred that right to an entity that is not a corporation under section 367(a) provided that the corporate name is used only by the FSC and is not licensed or otherwise made available to others by the FSC.

(8) *Completed contract method.*

*Q–8:* Under what conditions is a taxpayer using the completed contract method of accounting as defined in §1.451–3(d) exempted from satisfying the foreign management and foreign economic process requirements of subsections (c) and (d) of section 924?

*A–8:* If the taxpayer has entered into a binding contract before March 16, 1984, or has on March 15, 1984, and at all times thereafter a firm plan, evidenced in writing, to enter the contract and enters into a binding contract by December 31, 1984, then the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, with respect to the transaction. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(9) *Long-term contract—before March 15, 1984.*

*Q–9:* Under what conditions is a taxpayer who enters into a binding long-term contract (*i.e.*, a contract which is not completed in the taxable year in which it is entered into) before March 15, 1984, but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924?

*A–9:* If a taxpayer enters into a binding contract before March 15, 1984, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, but only with respect to income attributable to such contracts that is recognized before December 31, 1986. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985, in order to use the transfer pricing rules under section 925.

(10) *Long-term contract—after March 15, 1984.*

*Q–10:* Under what conditions is a taxpayer who has a long-term contract (i.e., a contract which is not completed in the taxable year in which it is entered into) but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924 if such taxpayer enters into a binding contract after March 15, 1984 and before January 1, 1985?

*A–10:* If a taxpayer enters into a contract after March 15, 1984, and before January 1, 1985, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, but only with respect to income attributable to such contract that is recognized before December 31, 1985.

The FSC rules will apply to the income from the long-term contract if an election is made and the general requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(11) *Incomplete transactions.*

*Q–11:* In computing its foreign trade income, how should a FSC treat transfers of export property from a related supplier to a DISC which is subsequently resold by a FSC after the DISC's termination?

*A–11:* In applying the gross receipts and combined taxable income methods under section 925 (a)(1) and (a)(2), the transaction is treated as if the transfer of export property were made by the related supplier to the FSC except that the foreign management and economic processes tests under section 924 and the activities test under section 925(c) shall be deemed to be satisfied for purposes of the transaction.

(12) *Pre-effective date costs and activities.*

*Q–12:* Are costs incurred and activities performed prior to January 1, 1985 taken into account for purposes of satisfying the foreign management and foreign economic processes requirements of subsections (c) and (d) of section 924 and the activities test under section 925(c)?

*A–12:* For purposes of determining the costs incurred and the activities performed to be taken into account with respect to contracts entered into after December 31, 1984, only those costs incurred and activities performed after December 31, 1984, are taken into consideration. Costs incurred and activities performed by a related supplier prior to January 1, 1985 (or prior to the effective date of a corporation's election to be treated as a FSC if other than January 1, 1985) with respect to transactions occurring after January 1, 1985 (or after the effective date of a corporation's election to be treated as a FSC) need not be taken into account for purposes of computing the FSC's profit under section 925 but are treated for section 925(c) purposes as if they were performed on behalf of the FSC.

(13) *FSC and interest charge DISC.*

*Q–13:* Can a FSC and an interest charge DISC be members of the same controlled group?

*A–13:* A FSC and an interest charge DISC cannot be members of the same controlled group. If any controlled group of corporations of which an interest charge DISC is a member establishes a FSC, then any interest charge DISC which is a member of such group shall be treated as having terminated its status as an interest charge DISC.

(c) *Export Trade Corporations*—(1) *Previously taxed income.*

*Q–1:* Under what circumstances are earnings of an export trade corporation that have not been included in income under section 951 treated as previously taxed income previously included in the income of a U.S. shareholder for purposes of section 959 (and not taxed)?

*A–1:* A corporation which qualifies as an export trade corporation (ETC) with respect to its last taxable year beginning before January 1, 1985, and elects to discontinue operations as an ETC for all taxable years beginning after December 31, 1984, shall not be required to take into income earnings attributable to previously excluded export trade income, as defined in §1.970–1(b), derived with respect to taxable years beginning before January 1, 1985. However, any amounts distributed by the former ETC (*i.e.* a corporation which was an ETC for its last taxable year beginning before January 1, 1985) shall be treated as being made out of current earnings and profits and then out of previously taxed income. For purposes of determining the shareholder's basis in the ETC stock, distributions of previously excluded export trade income shall be treated as if made out of previously taxed income which has already been included in gross income under section 951(a)(1)(B). Thus, no basis adjustment under section 961 is necessary. In addition, upon the sale or exchange of the stock of such corporation in a transaction described in section 1248(a), the earnings and profits of the corporation attributable to such previously untaxed income shall not be subject to section 1248(a).

(2) *Qualification as an ETC for last year.*

*Q–2:* Must an ETC satisfy all of the tests set forth in section 971(a)(1) for the ETC's last taxable year beginning before January 1, 1985?

*A–2:* All of the tests in section 971(a)(1) must be satisfied, except that for purposes of the working capital requirements set forth in section 971(c)(1), the working capital of the ETC at the close of its last taxable

year beginning before January 1, 1985 shall be deemed reasonable.

(3) *Continuation of ETC status.*

*Q–3:* May a corporation which chooses to remain an ETC after December 31, 1984, continue to do so?

*A–3:* Yes. However, previously untaxed income of such ETC shall not be treated as previously taxed income in accordance with Q&A #1 of this section.

(4) *Discontinuation of ETC status.*

*Q–4:* How does an ETC make an election to discontinue its operation as an ETC?

*A–4:* The United States shareholders (as defined in section 951(b)) must file a statement of election on behalf of the ETC indicating the intent of the ETC to discontinue operations as an ETC for taxable years beginning after December 31, 1984. In addition, the statement of election must include the name, address, taxpayer identification number and stock interest of each United States shareholder. The statement must also indicate that the corporation on behalf of which the shareholders are making the election qualified as an ETC for its last taxable year beginning before January 1, 1985, and also the amount of earnings attributable to previously excluded export trade income. The statement must be jointly signed by each United States shareholder with each shareholder stating under penalties of perjury that he or she holds the stock interest specified for such shareholder in the statement of election. A copy of the statement of election must be attached to Form 5471 (information return with respect to a foreign corporation) filed with respect to the ETC's last taxable year beginning before January 1, 1985.

(5) *Transition transfers.*

*Q–5:* Under what circumstances may an electing ETC transfer its assets to a FSC without incurring any tax liability on the transfer?

*A–5:* An electing ETC will recognize no income, gain, or loss on a transfer of its assets to a FSC but only if all of the following conditions are met:

(i) The assets transferred were held by the ETC on August 4, 1983, and were transferred by the ETC to the FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer. In addition, other provisions of subchapter C will apply to the transfer such as section 358 (basis to shareholders), section 362 (basis to corporation) and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by an ETC to a FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the ETC into a parent corporation followed by a transfer by the parent of those assets to the FSC will be treated as a transaction described in section 368(a)(1)(D).

(Secs. 803 and 805 of the Tax Reform Act of 1984 (98 Stat. 1001) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805); sec. 805 (b)(3)(C) and (D) of the Tax Reform Act of 1984 (98 Stat. 1002), and sec. 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805); secs. 367, 927, and 7805 of the Internal Revenue Code of 1954 (98 Stat. 662, 26 U.S.C. 367; 98 Stat. 663, 26 U.S.C. 367; 98 Stat. 993, 26 U.S.C. 927; 98 Stat. 994, 26 U.S.C. 927; and 68A Stat. 917, 26 U.S.C. 7805); sec. 805 of the Tax Reform Act of 1984 (Pub. L. 98–69, 98 Stat. 1000))

[T.D. 7983, 49 FR 40013, Oct. 12, 1984, as amended by T.D. 7992, 49 FR 48283, Dec. 12, 1984; T.D. 7993, 49 FR 48291, Dec. 12, 1984; T.D. 7992, 49 FR 49450, Dec. 20, 1984; T.D. 8126, 52 FR 6434, 6435, Mar. 3, 1987; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

### § 1.921–2 Foreign Sales Corporation—general rules.

(a) *Definition of a FSC and the Effect of a FSC Election.*

*Q–1.* What is the definition of a Foreign Sales Corporation (hereinafter referred to as a ''FSC'' (All references to FSCs include small FSCs unless indicated otherwise))?

*A–1.* As defined in section 922(a), an FSC must satisfy the following eight requirements.

(i) The FSC must be a corporation organized or created under the laws of a foreign country that meets the requirements of section 927(e)(3) (a ''qualifying foreign country'') or a U.S. possession other than Puerto Rico (an ''eligible

possession''). See Q&As 3, 4, and 5 of §1.922–1.

(ii) A FSC may not have more than 25 shareholders at any time during the taxable year. See Q&A 6 of §1.922–1.

(iii) A FSC may not have any preferred stock outstanding during the taxable year. See Q&As 7 and 8 of §1.922–1.

(iv) A FSC must maintain an office outside of the United States in a qualifying foreign country or an eligible possession and maintain a set of permanent books of account (including invoices or summaries of invoices) at such office. See Q&As 9, 10, 11, 12, 13, 14, and 15 of §1.922–1.

(v) A FSC must maintain within the United States the records required under section 6001. See Q&A 16 of §1.922–1.

(vi) The FSC must have a board of directors which includes at least one individual who is not a resident of the United States at all times during the taxable year. See Q&As 17, 18, 19, 20, and 21 of §1.922–1.

(vii) A FSC may not be a member, at any time during the taxable year, of any controlled group of corporations of which an interest charge DISC is a member. See Q&A 2 of this section and Q&A 13, of §1.921–1T(b)(13).

(viii) A FSC must have made an election under section 927(f)(1) which is in effect for the taxable year. See Q&A 1 of §1.921–1T(b)(1) and §1.927(f)–1.

In addition, under section 441(h), the taxable year of a FSC must conform to the taxable year of its principal shareholder. See Q&A 4 of §1.921–1T(b)(4).

*Q–2.* Does the reference to a DISC under section 922(a)(1)(F) which provides that a FSC cannot be a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member refer solely to an interest charge DISC?

*A–2.* Yes.

(b) *Small FSC.*

*Q–3.* What is a small FSC?

*A–3.* A small FSC is a Foreign Sales Corporation which meets the requirements of section 922(a)(1) enumerated in Q&A 1 of this section as well as the requirements of section 922(b). Section 922(b) requires that a small FSC make a separate election to be treated as a small FSC. See Q&A 1 of §1.921–1T(b) and §1.927(f)–1. In addition, section 922(b) requires that the small FSC not be a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such FSC is a small FSC.

Q–4. What is the effect of an election as a small FSC?

A–4. Under section 924(b)(2), a small FSC need not meet the foreign management and economic processes tests of section 924(b)(1) in order to have foreign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts for the taxable year in excess of $5 million are not taken into account. If the foreign trading gross receipts of a small FSC for the taxable year exceed the $5 million limitation, the FSC may select the gross receipts to which the limitation is allocated. In order to use the administrative pricing rules under section 925(a), a small FSC must satisfy the activities test under section 925(c). In addition, under section 441(h), the taxable year of a small FSC must conform to the taxable year of its principal shareholder (defined in Q&A 4 of §1.921–1T(b)(4) as the shareholder with the highest percentage of its voting power).

Q–5. What is the effect on a small FSC (or FSC) (''target'') if it is acquired, directly or indirectly, by a corporation if that acquiring corporation (''acquiring''), or a member of the acquiring corporation's controlled group, is a FSC (or small FSC)?

A–5. Unless the corporations in the controlled group elect to terminate the FSC (or small (FSC) election of the acquiring corporation, the target's small FSC's (or FSC's) taxable year and election will terminate as of the day preceding the date the target small FSC and acquiring FSC became members of the same controlled group. The target small FSC will receive FSC benefits for the period prior to termination, but the $5 million small FSC limitation will be reduced to the amount which bears the same ratio to the $5 million as the number of days in the short year created by the termination bears to 365. The due date of the income tax return for the short taxable year created

by this provision will be the date prescribed by section 6072(b), including extensions, starting with the last day of the short taxable year. If the short taxable year created by this provision ends prior to March 3, 1987, the filing date of the tax return for the short taxable year will be automatically extended until the earlier of May 18, 1987 or the date under section 6072 (b) assuming a short taxable year had not been created by these regulations.

(c) *Comparison of FSC to DISC.*

Q–6. How does a FSC differ from a DISC?

A–6. A DISC is a domestic corporation which is not itself taxable while a FSC must be created or organized under the laws of a jurisdiction which is outside of the United States (including certain U.S. possessions) and may be taxable on its income except for its exempt foreign trade income. The DISC provisions enable a shareholder to obtain a partial deferral of tax on income from export sales and certain services, if 95 percent of its receipts and assets are export related. The FSC provisions contain no assets test, but a portion of income for export sales and certain services is exempt from U.S. taxes if the FSC satisfies certain foreign presence, foreign management, and foreign economic processes tests.

(d) *Organization of a FSC.*

Q–7. Under the laws of what countries may a FSC be organized?

A–7. A FSC may not be created or organized under the laws of the United States, a state, or other political subdivision. However, a FSC may be created or organized under the laws of a possession of the United States, including Guam. American Samoa, the Commonwealth of the Northern Mariana Islands and the Virgin Islands of the United States, but not Puerto Rico. These eligible possessions are located outside the U.S. customs territory. In addition, a FSC may incorporate under the laws of a foreign country that is a party to—

(i) An exchange of information agreement that meets the standards of the Caribbean Basin Economic Recovery Act of 1983 (Code section 274(h)(6)(C)), or

(ii) A bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purpose of the exchange of information requirements of the FSC legislation as set forth in section 927(e)(3), if the company is covered under the exchange of information program under subdivision (i) or (ii). The Secretary may terminate the certification. Any termination by the Secretary will be effective six months after the date of the publication of the notice of such termination in the FEDERAL REGISTER.

(e) *Foreign Trade Income.*

*Q–8.* How is foreign trade income defined?

*A–8.* Foreign trade income, defined in section 923(b), is gross income of an FSC attributable to foreign trading gross receipts. It includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products and services exported by others.

(f) *Investment Income and Carrying Charges.*

*Q–9.* What do the terms ''investment income'' and ''carrying charges'' mean?

*A–9.*

(i) Investment income means:

(A) Dividends,

(B) Interest,

(C) Royalties,

(D) Annuities,

(E) Rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States);

(F) Gains from the sale of stock or securities,

(G) Gains from future transactions in any commodity on, or subject to the rules of, a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others),

(H) Amounts includable in computing the taxable income of the corporation under part I of subchapter J, and

(I) Gains from the sale or other disposition of any interest in an estate or trust.

(ii) Carrying charges means:

(A) Charges that are imposed by a FSC or a related supplier and that are

identified as carrying charges, (''stated carrying charges'') and

(B)(*1*) Charges that are considered to be included in the price of the property or services sold by an FSC or a related supplier, as provided under Q&As 1 and 2 of §1.927(d)–1, and

(*2*) Any other unstated interest.

*Q–10*. How are investment income and carrying charges treated?

*A–10*. Investment income and carrying charges are not foreign trading gross receipts. Investment income and carrying charges are includable in the taxable income of an FSC, except in the case of a commission FSC where carrying charges are treated as income of the related supplier, and are treated as income effectively connected with a trade or business conducted through a permanent establishment within the United States. The source of investment income and carrying charges is determined under sections 861, 862, and 863 of the Code.

(g) *Small Businesses*.

*Q–11*. What options are available to small businesses engaged in exporting?

*A–11*. A small business may elect to be treated as either a small FSC or an interest charge DISC. See Q&As 3 & 4 of §1.921–2 relating to a small FSC. Rules with respect to interest charge DISCs are the subject of another regulations project.

[T.D. 8127, 52 FR 6469, Mar. 3, 1987]

### §1.921–3T Temporary regulations; Foreign sales corporation general rules.

(a) *Exclusion*—(1) *Classifications of income*. The extent to which income of a FSC (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise) is subject to the corporate income tax of section 11, or, in the alternative, section 1201(a), is dependent upon the allocation of the FSC's income to the following five categories:

(i) Exempt foreign trade income determined under section 923 and §1.923–1T;

(ii) Non-exempt foreign trade income determined with regard to the administrative pricing rules of section 925(a)(1) or (2);

(iii) Non-exempt foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2) (section 923(a)(2) non-exempt income as defined in section 927(d)(6));

(iv) Investment income and carrying charges; and

(v) Other non-foreign trade income.

(2) *Source and characterization of FSC income*—(i) *Exempt foreign trade income*. The exempt foreign trade income of a FSC determined under section 923 and §1.923–1T is treated as foreign source income which is not effectively connected with a United States trade or business. See §1.923–1T(a) for the definition of foreign trade income and §1.923–1T(b) for the definition of exempt foreign trade income.

(ii) *Non-exempt foreign trade income determined with regard to the administrative pricing rules*. The FSC's non-exempt foreign trade income with respect to a transaction or group of transactions will be treated as United States source income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the United States if either of the administrative pricing rules of section 925(a)(1) or (2) is used to determine the FSC's foreign trade income from a transaction or group of transactions. See §1.923–1T(b) for the definition of non-exempt foreign trade income.

(iii) *Non-exempt foreign trade income determined without regard to the administrative pricing rules*. The source and taxation of the FSC's non-exempt foreign trade income not classified in paragraph (a)(2)(ii) of this section will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. This type of income (section 923(a)(2) non-exempt income) includes both income that is not effectively connected with the conduct of a trade or business in the United States and income that is effectively connected.

(iv) *Investment income and carrying charges*. All of the FSC's investment income and carrying charges will be treated as income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the

United States. The source of that income will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. See §1.921–2(f) (Q & A9) for definition of investment income and carrying charges.

(v) *Non-foreign trade income (other than investment income and carrying charges).* The source and taxation of the FSC's non-foreign trade income (other than investment income and carrying charges) will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections.

(b) *Allocation and apportionment of deductions.* Expenses, losses and deductions incurred by the FSC shall be allocated and apportioned under the rules set forth in §1.861–8 to the FSC's foreign trade income and to the FSC's non-foreign trade income. Any deductions incurred by the FSC on a transaction, or group of transactions, which are allocated and apportioned to the FSC's foreign trade income from that transaction, or group of transactions, shall be allocated on a proportionate basis between exempt foreign trade income and non-exempt foreign trade income.

(c) *Net operating losses and capital losses*—(1) *General rule.* (i) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, exempt foreign trade income determined with regard to the administrative pricing rules,

(B) Second, non-exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, investment income and carrying charges, and

(D) Fourth, other non-foreign trade income.

(ii) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and net capital losses), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, investment income and carrying charges,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iii) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to investment income and carrying charges, that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, non-foreign trade income other than capital gains,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iv) Net capital losses will be available for carryback or carryover pursuant to paragraph (c)(2) of this section.

(v) Because the no-loss rules provide that a related supplier may always compensate the FSC for its expenses either as part of the commission payment or as part of the transfer price if the administrative pricing rules are used (see §1.925(a)–1T(e)(1)(i)), a FSC will not have a deficit in its earnings and profits relating to foreign trade income determined with regard to the administrative pricing rules. To determine the amount of any division of earnings and profits for the purpose of determining under §1.926(a)–1T (a) and (b) the treatment and order of distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316–2(b) for determining the

amount of earnings and profits available on the date of any distribution.

(2) *Carryback or carryover of net operating losses and capital losses to other taxable years of a FSC (or former FSC).* (i) The amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover, or under section 1212 for a capital loss carryback or carryover, shall be determined in the same manner as if the FSC were a foreign corporation which had not elected to be treated as a FSC. Thus, the amount of the deduction will be the same whether or not the corporation was a FSC in the year of the loss or in the year to which the loss is carried.

(ii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to transactions which give rise to foreign trade income shall be charged—

(A) First, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules,

(B) Second, to earnings and profits attributable to section 923(a)(2) non-exempt income,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to investment income and carrying charges (other than capital gain income), and

(F) Sixth, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income).

(iii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to non-foreign trade income (other than capital gain income) shall be charged—

(A) First, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income),

(B) Second, to earnings and profits attributable to investment income and carrying charges,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules, and

(F) Sixth, to earnings and profits attributable to section 923(a)(2) non-exempt income.

(iv) Any carryback or carryover of a net operating loss to a year in which the corporation was (or is) a FSC from a taxable year in which the corporation was not a FSC shall be applied in a manner consistent with subdivision (iii) of this paragraph.

(d) *Credits against tax*—(1) *General rule.* Notwithstanding any other provision of chapter 1, subtitle A, a FSC is allowed under section 921(c) as credits against tax only the following credits:

(i) The foreign tax credit, section 27(a);

(ii) The credit for tax withheld at source on foreign corporations, section 33; and

(iii) The certain uses of gasoline and special fuels credit, section 34.

(2) *Foreign tax credit.* (i) The direct foreign tax credit of section 901(b)(4) as determined under section 906 for income, war profits, and excess profits taxes (or taxes in lieu thereof) paid or accrued to any foreign country or possession of the United States is allowed a FSC only to the extent that those taxes are attributable to the FSC's foreign source non-foreign trade income which is effectively connected with its conduct of a trade or business within the United States. See section 906(b)(5).

(ii) The foreign tax credit for domestic corporate shareholders in foreign corporations (the deemed paid credit) provided under section 901(a) as determined under section 902 is allowed for income, war profits, and excess profits taxes deemed paid or accrued by a FSC (or former FSC) only to the extent those taxes are deemed paid or accrued with respect to the FSC's (or former

FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(iii) The foreign tax credit allowed by sections 901 and 903 for tax withheld at source is allowed only to the extent the dividends paid to the FSC's (or former FSC's) shareholder are attributable to the FSC's (or former FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(3) *Foreign tax credit limitation.* (i) For purposes of computation of the direct foreign tax credit of section 901(b)(4) as determined under section 906, the separate limitation of section 904(d)(1)(C) for the FSC's taxable income attributable to its foreign trade income will apply. The direct foreign tax credit is not allowed to a FSC with regard to taxes it paid which are attributable to its foreign trade income. Since the foreign tax credit is not allowed for that type of income, the effect of the separate limitation is to remove the FSC's foreign trade income from the numerator of the fraction used to compute the FSC's overall foreign tax credit limitation.

(ii) A separate limitation under section 904(d)(1)(D) is provided for distributions from a FSC (or former FSC) that arise through operation of the deemed paid credit of section 902 and are attributable to foreign trade income earned during the period when the distributing corporation was a FSC. This limitation is computed by multiplying the FSC's shareholder's tentative United States tax by a fraction the numerator of which is the foreign source dividend (determined with regard to section 78) attributable to the foreign trade income less dividends received deductions and other expenses allocated and apportioned under § 1.861–8 allowed to the shareholder and the denominator of which is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to the FSC's foreign trade income from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(iii) The separate limitation under section 904(d)(1)(D) also applies to the foreign tax credit allowed to a FSC shareholder by sections 901 and 903 for tax withheld at source on dividends paid by the FSC. The numerator of this fraction is the part of the dividend attributable to the FSC's foreign trade income and the denominator is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to foreign trade income of a FSC (or former FSC) from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(e) *Deduction for foreign income, war profits and excess profits taxes.* Under section 275(a)(4)(B), income, war profits and excess profits taxes imposed by a foreign country or possession of the United States may not be deducted by a FSC to the extent those taxes are paid or accrued with respect to its foreign trade income.

(f) *Payment of estimated tax.* Every FSC which is subject to tax under section 11 or 1201(a) and section 882 must make payment of its estimated tax in accordance with section 6154 and the regulations under that section. In determining the amount of the estimated tax, the FSC must treat the tax imposed by section 881 as though it were a tax imposed by section 11. See section 6154(g).

(g) *Accumulated earnings, personal holding company and foreign personal holding company.* The provisions covering the accumulated earnings tax (sections 531 through 537), personal holding companies (sections 541 through 547) and foreign personal holding companies (sections 551 through 558) apply to FSCs to the extent they would apply to foreign corporations that are not FSCs.

(h) *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 and of the increase in earnings invested in U.S. property of a FSC, see sections 951 through 964 and the regulations under those sections. However, the foreign trade income (other than section 923(a)(2) non-exempt income) and, generally, the investment income and carrying charges of a FSC and any deductions which are allocated and apportioned to those classes of income, are not taken into

account under sections 951 through 964. See sections 951(e) and 952(b).

(i) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend on the gain recognized on certain sales or exchanges of stock in a FSC, to the extent of certain earnings and profits attributable to the stock which were accumulated while the FSC was a controlled foreign corporation, see section 1248 and the regulations under that section. However, section 1248 and the regulations under that section do not apply to a FSC's earnings and profits attributable to foreign trade income, see section 1248(d)(6).

(j) *Limitations on certain multiple tax benefits.* The provisions of section 1561, Limitations on Certain Multiple Tax Benefits in the Case of Certain Controlled Corporations, and section 1563, Definitions and Special Rules, and the regulations under those sections apply to a FSC and its controlled group.

[T.D. 8126, 52 FR 6435, Mar. 3, 1987]

### § 1.922–1 Requirements that a corporation must satisfy to be a FSC or a small FSC.

(a) *FSC requirements.*

*Q–1.* What are the requirements that a corporation must satisfy to be an FSC?

*A–1.* A corporation must satisfy all of the requirements of section 922(a).

(b) *Small FSC requirements.*

*Q–2.* What are the requirements that a corporation must satisfy to be a small FSC?

*A–2.* A corporation must satisfy all of the requirements of sections 922(a)(1) and (b).

(c) *Definition of corporation.*

*Q–3.* What type of entity is considered a corporation for purposes of qualifying as an FSC or a small FSC under section 922?

*A–3.* A foreign entity that is classified as a corporation under section 7701(a)(3) (other than an insurance company) is considered a corporation for purposes of this requirement.

(d) *Eligible possession.*

*Q–4.* For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a possession of the United States?

*A–4.* For purposes of section 922(a)(1)(A), the possessions of the United States are Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States (''eligible possessions''). Puerto Rico, although a possession for certain tax purposes, does not qualify as a jurisdiction in which a FSC or small FSC may be incorporated.

(e) *Qualifying countries.*

*Q–5.* For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a foreign country and which foreign countries meet the requirements of section 927(e)(3)?

*A–5.* (i) A foreign country is a jurisdiction outside the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States. (ii) A list of the foreign countries that meet the requirements of section 927(e)(3) (''qualifying countries'') will be published from time to time in the FEDERAL REGISTER and the Internal Revenue Bulletin. A corporation is considered to be created or organized under the laws of a foreign country that meets the requirements of section 927(e)(3) only if the foreign country is a party to (A) an exchange of information agreement under the Caribbean Basin Economic Recovery Act (Code section 274(h)((6)(C)), or (B) a bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purposes of the exchange of information requirements of the FSC legislation as set forth in Code section 927(e)(3) and if the corporation is covered under exchange of information program under subdivision (A) or (B).

(f) *Number of shareholders.*

*Q–6.* Who is counted as a shareholder of a corporation for purposes of determining whether a corporation meets the limitation on the number of shareholders to no more than 25 under section 922(a)(1)(B)?

*A–6.* Solely for purposes of the limitation on the number of shareholders, the following rules apply:

(i) In general, an individual who owns an interest in stock of the corporation is counted as a shareholder. In the case

of joint owners, each joint owner is counted as a shareholder. A member of a corporation's board of directors who holds qualifying shares that are required to be owned by a resident of the country of incorporation is not counted as a shareholder.

(ii) A corporation that owns an interest in stock of the corporation is counted as a single shareholder.

(iii) An estate that owns an interest in stock of the corporation is counted as a single shareholder. If the limitation on number of shareholders is not satisfied by reason of the closing of an estate, the FSC will continue to qualify for the taxable year of the FSC in which the estate is closed.

(iv) A trust is not counted as a shareholder. In the case of a trust all of which is treated as owned by one or more persons under sections 671 through 679, those persons are counted as shareholders. In the case of all other trusts, a beneficiary is counted as a shareholder.

(v) A partnership is not counted as a shareholder. A general or limited partner is counted as a shareholder if it is a corporation, an individual, or an estate, under the rules contained in subdivisions (i) through (iii). A general or limited partner is not counted as a shareholder if it is a partnership or a trust; the rules contained in subdivision (iv) and this subdivision (v) apply to the determination of who is counted as a shareholder.

(g) *Class of stock.*

*Q–7.* What is preferred stock for purposes of determining whether a corporation satisfies the requirement under section 922(a)(1)(C) that no preferred stock be outstanding?

*A–7.* Preferred stock is stock that is limited and preferred as to dividends or distributions in liquidation.

*Q–8.* Can a corporation have outstanding more than one class of common stock?

*A–8.* Yes. However, the rights of a class of stock will be disregarded if the right has the effect of avoidance of Federal income tax. For instance, dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have met operating loss carryovers.

(h) *Office.*

*Q–9.* What is an office for purposes of determining whether a corporation satisfies the requirement of section 922(a)(1)(D)(i)?

*A–9.* An office is a place for the transaction of the business of the corporation. To be an office a place must meet all of the following requirements;

(i) *It must have a fixed location.* A transient location is not a fixed location.

(ii) *It must be a building or a portion of a building consisting of at least one room.* A room is a partitioned part of the inside of a building. The building or portion thereof used as the corporation's office must be large enough to accommodate the equipment required in subdivison (iii) of this answer 9 and the activity required in subdivision (iv) of this answer 9. However, an office is not limited to a room with communication equipment or an adjacent room. Noncontiguous space within the same building will also constitute an office if it is equipped for the retention of the documentation required to be stored by the FSC and if access to the necessary communication equipment is available for use by the FSC.

(iii) *It must be equipped for the performance of the corporation's business.* An office must be equipped for the communication and retention of information and must be supplied with communication services.

(iv) *It must be regularly used for some business activity of the corporation.* A corporation's business activities must include the maintenance of the documentation described in Q&A 12 of this section. These documents need not be prepared at the office. Any person, whether or not related to the corporation, may perform the business activities of the corporation at the office if the activity is performed pursuant to a contract, oral or written, for the performance of the activity on behalf of the corporation.

(v) *It must be operated, and owned or leased, by the corporation or by a person, whether or not related to the corporation, under contract to the corporation.*

(vi) *It must be maintained by the corporation or by a person, whether or not*

*related, to the corporation, under contract to the corporation at all times during the taxable year.* In the case of a corporation newly organized as a FSC, thirty days may elapse between the time the corporation is organized as a FSC (*i.e.*, the first day for which the FSC election is effective) and the time an office is maintained by the corporation or a person under contract with the corporation. A place that meets the requirements in subdivision (i) through (vi) of this answer 9 can also be used for activities that are unrelated to the business activity of the corporation.

*Q–10* Can a corporation locate an office in any foreign country if it has at least one office in a U.S. possession or in a foreign country that meets the requirements of section 927 (e)(3) as provided Q&A 5 of this section?

*A–10.* Yes.

*Q–11.* Must a corporation locate the office that is required under section 922(a)(1)(D)(i) in the country or possession of its incorporation?

*A–11.* No.

(i) *Documentation.*

*Q–12.* What documentation must be maintained at the corporation's office for purposes of section 922(a)(1)(D)(ii)?

*A–12.* At least the following documentation must be maintained at the corporation's office under section 922(a)(1)(D)(ii):

(i) The quarterly income statements, a final year-end income statement and a year-end balance sheet of the FSC; and

(ii) All final invoices (or a summary of them) or statements of account with respect to (A) sales by the FSC, and (B) sales by a related person if the FSC realizes income with respect to such sales. A final invoice is an invoice upon which payment is made by the customer. A invoice must contain, at a minimum, the customer's name or idenfitying number and, with respect to the transaction or transactions, the date, product or product code or service of service code, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit, as a receipt for payment, satisfies this definition. A single final invoice may cover more than one transaction with a customer.

(iii) A summary of final invoices may be in any reasonable form provided that the summary contains all substantive information from the invoices. All substantive information includes the customer's name or identifying number, the invoice number, date, product or product code, and amount owed. In the alternative, all substantive information includes a summary of the information that is included on documents considered to be final invoices under normal commercial practice. A statement of account is any summary statement forwarded to a customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account and the balance due (even if the balance due is zero) as of the last day of the accounting period covered by the statement of account. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practice if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. With regard to quarterly income statements, a reasonable estimate of the FSC's income and expense items will be acceptable. If the FSC is a commission FSC, 1.83% of the related supplier's gross receipts will be considered a reasonable estimate of the FSC's income. The documents required by this Q&A 12 need not be prepared by the FSC. In addition they need not be prepared at the FSC's office.

(iv) The FSC will satisfy the requirement that the documents be maintained at its office even if not all final invoices (or summaries) or statements of account or items to be included on statements of account are maintained at its office as long as it makes a good faith effort to do so and provided that any failure to maintain the required documents is cured within a reasonable time of discovery of the failure.

*Q–13.* If the required documents are not prepared at the FSC's office, by what date must the documents be maintained at its office?

*A–13.* With regard to the applicable quarters of years prior to March 3, 1987, the quarterly income statements, final invoices (or summaries), or statements of account and the year-end balance sheet must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year in which the period ends. With regard to the applicable quarters or years ending after March 3, 1987, the quarterly income statements for the first three quarters of the FSC year must be maintained at the FSC's office no later than 90 days after the end of the quarter. The quarterly income statement for the fourth quarter of the FSC year, the final year-end income statement, the year-end balance sheet, and the final invoices (or summaries) or statements of account must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year.

*Q–14.* In what form must the documentation required under section 922(a)(1)(D)(ii) be maintained?

*A–14.* The documentation required to be maintained by the office may be originals or duplicates and may be in any form that qualifies as a record under Rev. Rul. 71–20, 1971–1 C.B. 392. Therefore, documentation may be maintained in the form of punch cards, magnetic tapes, disks, and other machine-sensible media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's automatic data processing system. The corporation need not maintain at its office equipment capable of reading the machine-sensible media. That equipment, however, must be situated in a location that is readily accessible to the corporation. The equipment need not be owned by the corporation.

*Q–15.* How long must the documentation required under section 922(a)(1)(D)(ii) be maintained?

*A–15.* The documentation required under section 922(a)(1)(D)(ii) for a taxable year must be maintained at the FSC's office described in section 922(a)(1)(D)(i) until the period of limitations for assessment of tax for the taxable year has expired under section 6501.

*Q–16.* Under what circumstances will a coporation be considered to satisfy the requirement of section 922(a)(1)(D)(iii) that it maintain the records it is required to keep under section 6001 at a location within the United States?

*A–16.* A corporation will be considered to satify this requirement if the records required under section 6001 are kept by any person at any location in the United States provided that the records are retained in accordance with section 6001 and the regulations thereunder.

(j) *Board of directors.*

*Q–17.* What is a corporation's ''board of directors'' for purposes of the requirement under section 922(a)(1)(E) that, at all times during the taxable year, the corporation must have a board of directors which includes at least one individual who is not a resident of the United States?

*A–17.* The ''board of directors'' is the body that manages and directs the corporation according to the law of the qualifying country or eligible possession under the laws of which the corporation was created or organized.

*Q–18.* Can the member of the board of directors who is a nonresident of the United States be a citizen of the United States?

*A–18.* Yes. For purposes of meeting the requirement under section 922(a)(1)(E), the member of the board who cannot be a United States resident can be a United States citizen. The principles of section 7701(b) shall be used to determine whether a United States citizen is a United States resident.

*Q–19*. If the only member of the board of directors who is not a resident of the United States dies, or resigns, is removed from the board or becomes a resident of the United States will the corporation be considered to fail the requirement under section 922(a)(1)(E)?

*A–19*. If the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the death, resignation or removal of the former nonresident member, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E). Also, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E) if the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the corporation has knowledge, or reason to know, that the board's former nonresident member was in fact a resident of the United States.

*Q–20*. Is a nonresident alien individual who elects to be treated as a resident of the United States for a taxable year under section 6013(g) considered a nonresident of the United States for purposes of the requirement under section 922(a)(1)(E)?

*A–20*. Yes.

*Q–21*. Will the requirement that a FSC's board of directors have a nonresident member at all times during the taxable year be satisfied if the nonresident member is elected or appointed to the board of directors no later than 30 days after the first day for which the FSC election is effective?

*A–21*. Yes.

[T.D. 8127, 52 FR 6470, Mar. 3, 1987]

### § 1.923–1T Temporary regulations; exempt foreign trade income.

(a) *Foreign trade income*. Foreign trade income of a FSC is the FSC's gross income attributable to its foreign trading gross receipts. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) If the FSC is the principal on the sale of export property which it purchased from a related supplier, the FSC's gross income is determined by subtracting from its foreign trading gross receipts the transfer price determined under the transfer pricing methods of section 925(a). If the FSC is the commission agent on the sale of export property by its related supplier, the FSC's gross income is the commission paid or payable by the related supplier to the FSC with respect to the transactions that would have generated foreign trading gross receipts had the FSC been the principal on the transaction. See §1.925(a)–1T(f) *Examples 1* and *6* for illustrations of the computation of a FSC's foreign trade income, exempt foreign trade income and taxable income.

(b) *Exempt foreign trade income*—(1) *Determination*. (i) If a FSC uses either of the two administrative pricing rules, provided for by sections 925(a)(1) and (2), to determine its income from a transaction, or group of transactions, to which section 925 applies (see §1.925(a)–1T(b)(2) (ii) and (iii)), 15/23 of the foreign trade income that it earns from the transaction, or group of transactions, will be exempt foreign trade income. If a FSC has a non-corporate shareholder (shareholders), 16/23 of its foreign trade income attributable to the noncorporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(ii) If a FSC does not use the administrative pricing rules to determine its income from a transaction, or group of transactions, which gives rise to foreign trade income, 30 percent of its foreign trade income will be exempt foreign trade income. If a FSC has a non-corporate shareholder (shareholders), 32 percent of its foreign trade income attributable to the non-corporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(iii) Exempt foreign trade income so determined under subdivisions (1)(i) and (ii) of this paragraph is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. See section 921(a).

(2) *Special rule for foreign trade income allocable to a qualified cooperative*. (i) Pursuant to section 923(a)(4), if a qualified cooperative is a shareholder of a FSC, the FSC's non-exempt foreign

trade income determined by use of either of the administrative pricing methods of section 925(a)(1) or (2) which is allocable to the marketing of agricultural or horticultural products, or the providing of related services, for any taxable year will be treated as exempt foreign trade income to the extent that it is distributed to the qualified cooperative shareholder. A qualified cooperative is defined as any organization to which chapter 1, subchapter T, part 1 of the Code applies. See section 1381(a).

(ii) This special rule of section 923(a)(4) shall apply only if the distribution is made before the due date under section 6072(b), including extensions, for filing the FSC's income tax return for that year. Any distribution which satisfies this requirement will be treated as made on the last day of the FSC's taxable year. In addition, this special rule shall apply only if the income of the cooperative is based on arm's length transactions between the cooperative and its members or patrons.

(iii) Income attributable to the marketing of agricultural or horticultural products, or the providing of related services, shall be allocated to the FSC shareholders on a per share basis. See §1.926(a)–1T(b) for ordering rules for distributions from a FSC.

(3) *Special rule for military property.* (i) Under section 923(a)(5), the exempt foreign trade income of a FSC relating to the disposition of, or services relating to, military property shall be equal to 50 percent of the amount which, but for section 923(a)(5), would be treated as exempt foreign trade income under section 923(a)(2) or (3). The foreign trade income no longer treated as exempt because of this special rule of section 923(a)(5) will remain income of the FSC and will be treated as non-exempt foreign trade income.

(ii) The term ''military property'' is defined in section 995(b)(3)(B) and includes any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778) (which repealed and replaced the Military Security Act of 1954).

[T.D. 8126, 52 FR 6438, Mar. 3, 1987]

### §1.924(a)–1T Temporary regulations; definition of foreign trading gross receipts.

(a) *In general.* The term ''foreign trading gross receipts'' means any of the five amounts described in paragraphs (b) through (f) of this section, except to the extent that any of the five amounts is an excluded receipt within the meaning of paragraph (g) of this section. These amounts will not be foreign trading gross receipts if the FSC is not managed outside the United States, pursuant to section 924(c), or if the economic processes with regard to a transaction, or group of transactions, that are required of a FSC by section 924(d) do not take place outside the United States. The requirement that these activities take place outside the United States does not apply to a small FSC. The activities required by sections 924 (c) and (d) may be performed either by the FSC or by any person (whether or not related to the FSC) acting under contract with the FSC for the performance of the required activities. Sections 1.924(c)–1 and 1.924(d)–1 provide rules to determine whether these requirements have been met. For purposes of this section—

(1) *FSC.* All references to a FSC in this section mean a FSC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a FSC. All references to a FSC in this section shall include a small FSC unless indicated otherwise.

(2) *Sale and lease.* The term ''sale'' includes an exchange or other disposition and the term ''lease'' includes a rental or a sublease. The term ''license'' includes a sublicense. All rules under this section applicable to leases of export property apply in the same manner to licenses of export property. See §1.927(a)–1T(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term ''gross receipts'' is defined by section 927(b) and §1.927(b)–1T.

(4) *Export property*. The term ''export property'' is defined by section 927(a) and §1.927(a)–1T.

(5) *Controlled group*. The term ''controlled group'' is defined by paragraph (h) of this section.

(6) *Related supplier and related party*. The terms related supplier and related party are defined by §1.927(d)–2T.

(b) *Sales of export property*. Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by the FSC, or by any principal for whom the FSC acts as a commission agent (whether or not the principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by the FSC or by the principal at any time or by any other person and assigned to the FSC or the principal at any time prior to the shipment of the property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirements of this paragraph. Gross receipts from the sale of export property, whenever received, do not constitute foreign trading gross receipts unless the seller (or the corporation acting as commission agent for the seller) is a FSC at the time of the shipment of the property to the purchaser. For example, if a corporation which sells export property under the installment method is not a FSC for the taxable year in which the property is shipped to the purchaser, gross receipts from the sale do not constitute foreign trading gross receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general*. Foreign trading gross receipts of a FSC include gross receipts from the lease of export property provided that—

(i) The property is held by the FSC (or by a principal for whom the FSC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of the lease, and

(ii) The FSC qualified (or was treated) as a FSC for its taxable year in which the term of the lease began.

(2) *Prepayment of lease receipts*. If the gross receipts from a lease of export property are prepaid, then—

(i) All the prepaid gross receipts are foreign trading gross receipts of a FSC if it is reasonably expected at the time of the prepayment that, throughout the term of the lease, the lease will meet the requirements of this paragraph and the property will be export property; or

(ii) If it is reasonably expected at the time of the prepayment that the prepaid receipts would not be foreign trading gross receipts throughout the term of the lease if those receipts were not received as a prepayment, then only those prepaid receipts, for the taxable years of the FSC for which they would be foreign trading gross receipts, are foreign trading gross receipts. Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered foreign trading gross receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered foreign trading gross receipts.

(d) *Related and subsidiary services*—(1) *In general*. Foreign trading gross receipts of a FSC include gross receipts from services furnished by the FSC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by the FSC or with respect to which the FSC acts as a commission agent, provided that the FSC derives foreign trading gross receipts from the sale or lease. The services may be performed within or without the United States.

(2) *Services furnished by the FSC*. Services are considered to be furnished by a FSC for purposes of this paragraph if the services are provided by—

(i) The person who sold or leased the export property to which the services are related and subsidiary, provided that the FSC acts as a commission agent with respect to the sale or lease of the property and with respect to the services,

(ii) The FSC as principal, or any other person pursuant to a contract with the FSC, provided the FSC acted as principal or commission agent with

respect to the sale or lease of the property, or

(iii) A member of the same controlled group as the FSC if the sale or lease of the export property is made by another member of the controlled group provided, however, that the FSC acts as principal or commission agent with respect to the sale or lease and as commission agent with respect to the services.

(3) *Related services.* Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) will be related to a sale or lease of export property, if the cost of the transportation is included in the sale price or rental of the property or, if the cost is separately stated, is paid by the FSC (or its principal) which sold or leased the property to the person furnishing the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph. A service is related to a sale or lease of export property if—

(i) The service is of the type customarily and usually furnished with the type of transaction in the trade or business in which the sale or lease arose, and

(ii) The contract to furnish the service—

(A) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(B) Is entered into on or before the date which is 2 years after the date on which the contract under which the sale or lease was entered into, provided that the person described in paragraph (d)(2) of this section which is to furnish the service delivers to the purchaser or lessor a written offer or option to furnish the services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(C) Is a renewal of the services contract described in subdivisions (ii)(A) and (B) of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to the sale or lease only if it is reasonably expected at the time of the sale or lease that the gross receipts from all related services furnished by the FSC (as defined in this paragraph (d)(2)) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as described in this paragraph (d)(2)). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the 10-year period following the date of the sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the term of the lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to the sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to the services as determined under the facts and circumstances of each case without regard to whether—

(A) The services are furnished under a separate contract or under the same contract pursuant to which the sale or lease occurs, or

(B) The cost of the services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from the transaction and the total gross receipts from all services related to the transaction are each taken into account in determining whether the services are subsidiary to the transaction. However, the provisions of this subdivision apply only if the items could be included in the same product line, as determined under §1.925(a)–1T(c)(8).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, the contract is renewable within 10 years after a sale of export

property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to the sale or lease if it is reasonably expected at the time of the renewal that the gross receipts from all related services which have been and which are to be furnished by the FSC (as described in paragraph (d)(2) of this section) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this paragraph.

(v) *Parts used in services.* If a services contract described in paragraph (d)(3) of this section provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of the parts are not taken into account in determining whether under this paragraph (d)(4) the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts constitute foreign trading gross receipts. See §1.927(a)–1T (c)(2) and (e)(3) for rules regarding the treatment of the parts with respect to the manufacture of export property and the foreign content of the property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all the services which are to be performed before the end of the term of the lease, then the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this paragraph (d)(5) are foreign trading gross receipts. Thus, for example, if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be foreign trading gross receipts. However, any prepaid gross receipts for the services to be furnished in the second year cannot be foreign trading gross receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute foreign trading gross receipts does not depend upon whether services connected with the sale or lease are related and subsidiary to the sale or lease. Thus, for example, assume that a FSC receives gross receipts of $1,000 from the sale of export property and gross receipts of $1,100 from installation and maintenance services which are to be furnished by the FSC within 10 years after the sale and which are related to the sale. The $1,100 which the FSC receives for the services would not be foreign trading gross receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by the FSC. The $1,000 which the FSC receives from the sale of export property would, however, be foreign trading gross receipts if the sale met the requirements of paragraph (b) of this section.

(e) *Engineering and architectural services*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from engineering services (as described in paragraph (e)(5) of this section) or architectural services (as described in paragraph (e)(6) of this section) furnished by such FSC (as described in paragraph (e)(7) of this section) for a construction project (as defined in paragraph (e)(8) of this section) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for oil or gas, or

(ii) Technical assistance or know-how. For purposes of this paragraph, the term ''technical assistance or know-how'' includes activities or programs designed to enable business, commerce, industrial establishments,

and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute foreign trading gross receipts to the extent that the activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of paragraph (e)(8) of this section) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of paragraph (e)(8) of this section).

(7) *Definition of ''furnished by the FSC''.* For purposes of this paragraph, the term ''furnished by the FSC'' means architectural and engineering services furnished:

(i) By the FSC,

(ii) By another person (whether or not that person is a United States person) pursuant to a contract entered into with the FSC at any time prior to the furnishing of the services, provided that the FSC acts as principal, or

(iii) By another person (whether or not that person is a United States person) pursuant to a contract for the furnishing of the services entered into by, or assigned to, the person at any time, provided that the FSC acts as a commission agent for the furnishing of the services.

(8) *Definition of ''construction project''.* For purposes of this paragraph, the term ''construction project'' includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not foreign trading gross receipts unless the equipment is export property.

(f) *Managerial services*—(1) *In general.* Foreign trading gross receipts of a first FSC for its taxable year include gross receipts from the furnishing of managerial services provided for an unrelated FSC or unrelated interest charge DISC to aid the unrelated FSC or unrelated interest charge DISC in deriving foreign trading gross receipts or qualified export receipts, as the case may be, provided that at least 50 percent of the first FSC's gross receipts for such year consists of foreign trading gross receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services. For purposes of this paragraph, managerial services are considered furnished by a FSC if the services are provided—

(i) By the first FSC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by that person with the first FSC at any time prior to the furnishing of the services, provided that the first FSC acts as principal with respect to the furnishing of the services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of services entered into at any time prior to the furnishing of the services provided that the first FSC acts as commission agent with respect to those services.

(2) *Definition of ''managerial services''.* The term ''managerial services'' as used in this paragraph means activities

relating to the operation of an unrelated FSC or an unrelated interest charge DISC which derives foreign trading gross receipts or qualified export receipts as the case may be from the sale or lease of export property and from the furnishing of services related and subsidiary to those sales or leases. The term includes staffing and operational services necessary to operate the unrelated FSC or unrelated interest charge DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: conducting export market studies, making shipping arrangements, and contacting potential foreign purchasers.

(3) *Status of recipient of managerial services.* Foreign trading gross receipts of a first FSC include receipts from the furnishing of managerial services during any taxable year of a recipient of such services if the recipient qualifies as a FSC or interest charge DISC for the taxable year. For purposes of this paragraph, a recipient is deemed to qualify as a FSC or interest charge DISC for its taxable year if the first FSC obtains from the recipient a copy of the recipient's election to be treated as a FSC or interest charge DISC together with the recipient's sworn statement that an election has been timely filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a FSC or interest charge DISC before submitting it to the first FSC. The copy of the election and the sworn statement of the recipient must be received by the first FSC within six months after the first FSC furnishes managerial services for the recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first FSC for subsequent taxable years of the recipient. A recipient of managerial services is not treated as a FSC or interest charge DISC with respect to the services performed during a taxable year for which the recipient does not qualify as a FSC or interest charge DISC if the first FSC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing FSC's managerial relationship with such recipient FSC or interest charge DISC) at the beginning of such taxable year that the recipient will qualify as a FSC or an interest charge DISC for such taxable year.

(g) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (f) of this section, foreign trading gross receipts of a FSC do not include any of the six amounts described in paragraphs (g)(2) through (7) of this section.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See §1.927(a)–1T(d)(4) relating to determination of where the ultimate use of the property occurs. Thus, foreign trading gross receipts of a FSC described in paragraph (b) or (c) of this section do not include gross receipts of the FSC from the sale or lease of this property.

(3) *Sales or leases of export property and furnishing of services accomplished by subsidy.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraphs (b) through (f) of this section if the sale or lease of export property or the furnishing of services is accomplished by a subsidy granted by the United States or any instrumentality thereof, see section 924(f)(1)(B). Subsidies covered by section 924(f)(1)(B) are listed in subdivisions (i) through (vi) of this paragraph.

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151) unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale (or at the time of lease or at the time the services were rendered), the purchaser (or lessor or recipient of the services) had a reasonable opportunity to purchase (or lease or contract for services) on competitive terms and from a seller (or lessor or performer of services) who was not a U.S. person, goods (or services) which were substantially identical to such

property (or services) and which were not manufactured, produced, grown, or extracted in the United States (or performed by a U.S. person);

(ii) The Public Law 480 program authorized under Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701–1714);

(iii) The Export Payment program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f));

(iv) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c);

(v) The Export Sales program of Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM–4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities; and

(vi) The Foreign Military Sales direct credit program (22 U.S.C. 2763) or the Foreign Military Sales loan guaranty program (22 U.S.C. 2764) if—

(A) The borrowing country is released from its contractual liability to repay the United States government with respect to those credits or guaranteed loans;

(B) The repayment period exceeds twelve years; or

(C) The interest rate charged is less than the market rate of interest as defined in 22 U.S.C. 2763(c)(2)(B);

unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms from a seller who was not a U.S. person, goods which were substantially identical to this property and which were not manufactured, produced, grown, or extracted in the United States. Information regarding whether an export is financed, in whole or in part, with funds derived from the programs identified in this subdivision may be obtained from the Comptroller, Defense Security Assistance Agency, Department of Defense, Washington, DC 20301.

(4) *Sales or leases of export property and furnishing of architectural or engineering services for use by the United States*—(i) *In general.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraph (b), (c), or (e) of this section if a sale or lease of export property, or the furnishing of architectural or engineering services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of architectural or engineering services performed by a United States person. See section 924(f)(1)(A)(ii). For example, a sale by a FSC of export property to the Department of Defense for use outside the United States would not produce foreign trading gross receipts for the FSC if the Department of Defense purchased the property from appropriated funds subject to either any provision of the Department of Defense Federal Acquisition Regulations Supplement (48 CFR chapter 2) or any appropriations act for the Department of Defense for the applicable year if the regulations or appropriations act requires that the items purchased must have been grown, reprocessed, reused, or produced in the United States. The Department of Defense's regulations do not require that items purchased by the Department for resale in post or base exchanges and commissary stores located on United States military installations in foreign countries be items grown, reprocessed, reused or produced in the United States. Therefore, receipts arising from the sale by a FSC to those post or base exchanges and commissary stores will not be excluded from the definition of foreign trading gross receipts by this paragraph (g)(4).

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof if such property

is sold or leased by a FSC (or by a principal for whom the FSC acts as commission agent) to—

(A) A person who is a related person with respect to the FSC or such principal and who sells or leases the property for use by the United States or an instrumentality thereof, or

(B) A person who is not a related person with respect to the FSC or such principal if, at the time of the sale or lease, there is an agreement or understanding that the property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of the sale or lease that the property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after the sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (4)(i) and (ii) of this paragraph do not apply in the case of a purchase by the United States or an instrumentality thereof if the purchase is pursuant to—

(A) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the United States government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(B) A program (whether bilateral or multilateral) under which sales to the United States government are open to international competitive bidding.

(5) *Services.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts under this paragraph.

(6) *Receipts within controlled group.* (i) For purposes of the transfer pricing methods of section 925(a), gross receipts of a corporation do not constitute foreign trading gross receipts for any taxable year of the corporation if at the time of the sale, lease, or other transaction resulting in the gross receipts, the corporation and the person from whom the gross receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group, and either

(A) The corporation and the person each qualifies as a FSC (or if related FSCs are commission agents of each party to the transaction) for its taxable year in which its receipts arise, or

(B) With regard to sale transactions, a sale of export property to a FSC (or to a related person if the FSC is the commission agent of the related person) by a non-FSC within the same controlled group follows any sale of the export property to a FSC (or to a related person if the FSC is the commission agent of the related person) within the same controlled group if foreign trading gross receipts resulted from the sale. Thus for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are FSCs. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a FSC which is a member of the same controlled group as X, and thus will not result in foreign trading gross receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in foreign trading gross receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in foreign trading gross receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party may, however, constitute foreign trading gross receipts.

(ii) Section 1.927(a)–1T(f)(2) provides rules regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(7) *Factoring of receivables by a related supplier.* If an account receivable arising with respect to export property is transferred to any person for an amount reflecting a discount from the selling price of the export property,

then the gross receipts from the sale which are treated as foreign trading gross receipts for purposes of computing a FSC's profit under the administrative pricing methods of section 925(a)(1) and (2) shall be reduced by the amount of the discount. See §1.925(a)–1T(f) *Example 11* for illustration of how this special rule affects computation of combined taxable income of a FSC and its related supplier.

(h) *Definition of ''controlled group''.* For purposes of sections 921 through 927 and the regulations under those sections, the term ''controlled group'' has the same meaning as is assigned to the term ''controlled group of corporations'' by section 1563(a), except that (1) the phrase ''more than 50 percent'' is substituted for the phrase ''at least 80 percent'' each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 882 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(i) *FSC's entitlement to income*—(1) *Application of administrative pricing rules of section 925(a).* A corporation which meets the requirements of section 922(a) (or section 922(b) if the corporation elects small FSC status) and §1.921–2(a) (Q&A1) to be treated as a FSC (or small FSC) for a taxable year is entitled to income, and the administrative pricing rules of section 925(a)(1) or (2) apply, in the case of any transaction described in §1.925(a)–1T(b)(iii) between the FSC and its related supplier (as defined in §1.927(d)–2T(a)) as long as the FSC, or someone under contract to it, satisfies the requirements of section 925(c). The requirements of section 925(c) must be met by a commission FSC as well as by a buy-sell FSC. See §1.925 (a)–1T(a)(3)(i) and (b)(2)(ii).

(2) *Other transactions.* In the case of a transaction to which the provisions of paragraph (i)(1) of this section do not apply but from which a FSC derives gross receipts, the income to which the FSC is entitled as a result of the transaction is determined pursuant to the terms of the contract for the transaction and, if applicable, section 482 and the regulations under that section. For applicability of the section 482 transfer pricing method, see §1.925(a)–1T (a)(3)(ii) and (b)(2)(i).

(j) *Small FSC limitation*—(1) *In general.* Under section 924(b)(2)(B), in determining exempt foreign trade income of a small FSC, the foreign trading gross receipts of the small FSC for the taxable year which exceed $5 million are not taken into account. The foreign trading gross receipts of the small FSC not taken into account for purposes of computing the small FSC's exempt foreign trade income shall be taken into account in computing the small FSC's non-exempt foreign trade income. If the foreign trading gross receipts of the small FSC exceed the $5 million limitation, the small FSC may select the gross receipts to which the limitation is allocated. See section 922(b) and §1.921–2(b) (Q&A3) for a definition of a small FSC.

(2) *Members of a controlled group limited to one $5 million amount*—(i) *General rule.* All small FSCs which are members of a controlled group on a December 31, shall, for their taxable years which include that December 31, be limited to one $5 million amount. The $5 million amount shall be allocated equally among the member small FSCs of the controlled group for their taxable years including that December 31, unless all of the member small FSCs consent to an apportionment plan providing for an unequal allocation of the $5 million amount. The apportionment plan shall provide for the apportionment of a fixed dollar amount to one or more of the corporations, and the sum of the amounts so apportioned shall not exceed the $5 million amount. If the taxable year including the December 31 of any member small FSC is a short period (as defined in section 443), the portion of the $5 million amount allocated to that member small FSC for that short period under the preceding sentence shall be reduced to the amount which bears the same ratio to the amount so allocated as the number of days in such short period bears to 365. The consent of each member small FSC to the apportionment plan for the

taxable year shall be signified by completing the form (*i.e.*, Schedule O or any successor to that form) which satisfies the requirements of and is filed in the manner specified in §1.1561–3T. An apportionment plan may be amended in the manner prescribed in §1.1561–3T(a), except that an original or an amended plan may not be adopted with respect to a particular December 31 if at the time the original or amended plan is sought to be adopted, less than 12 full months remain in the statutory period (including extensions) for the assessment of a deficiency against any shareholder of a member small FSC the tax liability of which would change by the adoption of the original or amended plan. If less than 12 full months of the period remain with respect to any such shareholder, the director of the service center with which the shareholder files its income tax return will, upon request, enter into an agreement extending the statutory period for the limited purpose of assessing any deficiency against that shareholder attributable to the adoption of the original or amended apportionment plan.

(ii) *Membership determined under section 1563(b).* For purposes of this paragraph (j)(2), the determination of whether a small FSC is a member of a controlled group of corporations with respect to any taxable year shall be made in the manner prescribed in section 1563(b) and the regulations under that section.

(iii) *Certain short taxable years*—(A) *General rule.* If a small FSC has a short period (as defined in section 443) which does not include a December 31, and that small FSC is a member of a controlled group of corporations which includes one or more other small FSC's with respect to the short period, then the amount described in section 924(b)(2)(B) with respect to the short period of that small FSC shall be determined by—

(*1*) Dividing $5 million by the number of small FSCs which are members of that group on the last day of the short period, and

(*2*) Multiplying the result by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365.

For purposes of the preceding sentence, section 1563(b) shall be applied as if the last day of the short period were substituted for December 31. Except as provided in subdivision (2)(iii)(B) of this paragraph, the small FSC having a short period not including a December 31 may not enter into an apportionment plan with respect to the short period.

(B) *Exception.* If the short period not including a December 31 of two or more small FSCs begins on the same date and ends on the same date and those small FSCs are members of the same controlled group, those small FSCs may enter into an apportionment plan for such short period in the manner provided in subdivision (2)(i) of this paragraph with respect to the combined amount allowed to each of those small FSCs under subdivision (2)(iii)(A) of this paragraph.

[T.D. 8126, 52 FR 6438, Mar. 3, 1987, as amended by T.D. 9304, 71 FR 76907, Dec. 22, 2006]

### §1.924(c)–1 Requirement that a FSC be managed outside the United States.

(a) *In general.* Section 924(b)(1)(A) provides that a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of the FSC during the year takes place outside the United States, as provided in section 924(c). Section 924(c) and this section set forth the management activities that must take place outside the United States in order to satisfy the requirement of section 924(b)(1)(A). Paragraph (b) of this section provides rules for determining whether the requirements of section 924(c)(1) have been met. Section 924(c)(1) requires that all meetings of the board of directors of the FSC during the taxable year and all meetings of the shareholders of the FSC during the taxable year take place outside the United States. Paragraph (c) of this section provides rules for maintaining the FSC's principal bank account outside the United States as provided in section 924(c)(2). Paragraph (d) of this section provides rules for disbursements required by section 924(c)(3) to be made from bank accounts of the FSC maintained outside the United States.

(b) *Meetings of board of directors and meetings of shareholders must be outside the United States.* All meetings of the board of directors of the FSC and all meetings of the shareholders of the FSC that take place during a taxable year must take place outside the United States to meet the requirements of section 924(c)(1). Only meetings that are formally convened as meetings of the board of directors or as shareholder meetings will be taken into account in determining whether those requirements have been met. In addition, all such meetings must comply with the local laws of the foreign country or possession of the United States in which the FSC was created or organized. The local laws determine whether a meeting must be held, when and where it must be held (if it is held at all), who must be present, quorum requirements, use of proxies, and so on. Where the local law permits action by the board of directors or shareholders to be taken by written consent without a meeting, use of such procedure will not constitute a meeting for purposes of section 924(c)(1). Section 924(c)(1) and this section impose no other requirements except the requirement that meetings that are actually held take place outside the United States. If the participants in a meeting are not all physically present in the same location, the location of the meeting is determined by the location of the persons exercising a majority of the voting power (including proxies) participating in the meeting. For example, a FSC has five directors, and is organized in country A. Country A's law requires that a majority of the directors of a corporation must participate in a meeting to constitute a quorum (and, thus, a meeting), but there is no requirement that the meeting be held in country A or that the directors must be physically present to participate. One director is in country A, another director is in country B, and a third director is in the United States.

These three directors convene a meeting by telephone that constitutes a meeting under the law of country A. The meeting occurs outside the United States because the persons exercising a majority of the voting power participating in the meeting are located outside the United States.

(c) *Maintenance of the principal bank account outside the United States*—(1) *In general.* For purposes of section 924(c), the bank account that shall be regarded as the principal bank account of a FSC is the bank account from which the disbursements described in paragraph (d) of this section are made. A FSC may have more than one principal bank account. The bank account that is regarded as the principal bank account must be maintained in a foreign country which meets the requirements of section 927(e)(3), or in any possession of the United States (as defined in section 927(d)(5)), and it must be so maintained at all times during the taxable year. For taxable years beginning on or after February 19, 1987, a principal bank account or accounts must be designated on the annual return of the FSC by providing the bank name(s) and account number(s).

(2) *Maintenance of the account in a bank.* The bank account that is regarded as the principal bank account must be maintained in an institution that is engaged in the conduct of a banking, financing, or similar business, as defined in §1.954–2(d)(2)(ii) (without regard to whether it is a controlled foreign corporation). The institution may be a U.S. bank, provided that the account is maintained in a branch outside the United States.

(3) *Maintenance of an account outside the United States.* Maintenance of the principal bank account outside the United States means that the account regarded as the principal bank account must be an account maintained on the books of the banking institution at an office outside the United States, but does not require that access to the account may be made only outside the United States. Instructions providing for deposits into or disbursements from the account may originate in the United States without affecting the status of maintenance of the account outside the United States.

(4) *Maintenance of the account at all times during the taxable year.* The term ''at all times during the taxable year'' generally means for each day of the taxable year. In the case of a newly

created or organized corporation, thirty days may elapse between the effective date of the corporation's election to be treated as a FSC and the date a bank account is opened without causing the FSC to fail the requirement that it maintain its principal bank account outside the United States at all times during the taxable year. For example, if a corporation is created or organized prior to January 1, 1985, and makes an election to be treated as a FSC within the first 90 days of 1985, the election is effective as of January 1, 1985. Thus, the FSC must open a bank account within 30 days of January 1, or as of January 31, 1985, to satisfy this requirement. Also, a FSC shall be treated as satisfying this requirement if the account that is regarded as its principal bank account is terminated during the taxable year, provided that (i) such termination is the result of circumstances beyond the FSC's control, and (ii) the FSC establishes a new principal bank account within thirty days after such termination. A FSC may close its principal bank account and replace it with another account that qualifies under this paragraph (c) as a principal bank account at any time provided that no lapse of time occurs between the closing of the principal bank account and the opening of the replacement account.

(5) *Other accounts.* The FSC may maintain other bank accounts in addition to its principal bank account. Such other accounts may be located anywhere, without limitation. The mere existence of such other accounts will not cause the FSC to fail to satisfy the requirements of section 924(c).

(d) *Items includible as compensation.* For purposes of applying the limitations of section 415, except as otherwise provided in this section, the term *compensation* means remuneration for services of the following types—

(1) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan, to the extent that the amounts are includible in gross income (or to the extent amounts would have been received and includible in gross income but for an election under section 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b)). These amounts include, but are not limited to, commissions paid to salespersons, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan as described in §1.62–2(c).

(2) In the case of an employee who is an employee within the meaning of section 401(c)(1) and regulations promulgated under section 401(c)(1), the employee's earned income (as described in section 401(c)(2) and regulations promulgated under section 401(c)(2)), plus amounts deferred at the election of the employee that would be includible in gross income but for the rules of section 402(e)(3), 402(h)(1)(B), 402(k), or 457(b).

(3) Amounts described in section 104(a)(3), 105(a), or 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(4) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

(5) The value of a nonstatutory option (which is an option other than a statutory option as defined in §1.421–1(b)) granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.

(6) The amount includible in the gross income of an employee upon making the election described in section 83(b).

(7) Amounts that are includible in the gross income of an employee under the rules of section 409A or section 457(f)(1)(A) or because the amounts are constructively received by the employee.

(2) *Items not includible as compensation.* The term *compensation* does not include—

(i) Contributions (other than elective contributions described in section

402(e)(3), section 408(k)(6), section 408(p)(2)(A)(i), or section 457(b)) made by the employer to a plan of deferred compensation (including a simplified employee pension described in section 408(k) or a simple retirement account described in section 408(p), and whether or not qualified) to the extent that the contributions are not includible in the gross income of the employee for the taxable year in which contributed. In addition, any distributions from a plan of deferred compensation (whether or not qualified) are not considered as compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. However, if the plan so provides, any amounts received by an employee pursuant to a nonqualified unfunded deferred compensation plan are permitted to be considered as compensation for section 415 purposes in the year the amounts are actually received, but only to the extent such amounts are includible in the employee's gross income.

(ii) Amounts realized from the exercise of a nonstatutory option (which is an option other than a statutory option as defined in §1.421–1(b)), or when restricted stock or other property held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see section 83 and regulations promulgated under section 83).

(iii) Amounts realized from the sale, exchange, or other disposition of stock acquired under a statutory stock option (as defined in §1.421–1(b)).

(iv) Other amounts that receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee and are not salary reduction amounts that are described in section 125).

(v) Other items of remuneration that are similar to any of the items listed in paragraphs (c)(1) through (c)(4) of this section.

(3) *Good faith exception.* If, after the FSC has filed its tax return, a determination is made by the Commissioner that all or a part of the legal or accounting fees, salaries of officers, and salaries or fees of directors of the FSC were paid by a related person without receiving reimbursement, the FSC may, nonetheless, satisfy the requirements of section 924(c)(3) if the fees and salaries were paid by the related person in good faith, and the FSC reimburses the related person for the fees and salaries paid within 90 days after the determination. The reimbursement shall be treated as made as of the end of the taxable year of the FSC for which the reimbursement is made.

(4) *Dividends*—(i) *Definition.* For purposes of section 924(c) and this section only, the term ''dividends'' refers solely to cash dividends (including a dividend paid in a foreign functional currency) actually paid pursuant to a declaration or authorization by the FSC. Accordingly, a ''dividend'' will not include a constructive dividend that is deemed to be paid (regardless of the source of such constructive dividend) or a distribution of property that is a dividend under section 316 other than a distribution of U.S. dollars or a foreign functional currency.

(ii) *Offset accounting entries.* Payment of dividends by the FSC to its related supplier may be in the form of an accounting entry offsetting an amount payable to the related supplier for the dividend against an existing debt owed to the FSC. The offset accounting entries must be clearly identified in the books of account of both the related supplier and the FSC.

(5) *Legal and accounting fees.* For purposes of this section, legal and accounting fees do not include salaries paid to legal and accounting employees of the FSC (or a related person). Legal and accounting fees are limited to fees paid to independent persons performing legal or accounting services for or with respect to the FSC.

(6) *Salaries of officers and directors.* For purposes of this section, salaries of officers and salaries or fees of directors are only those salaries or fees paid for services as officers or directors of the FSC. Salaries do not include reimbursed travel and entertainment expenses. If an individual officer, director, or employee of a related person is also an officer or director of a FSC and receives additional compensation for services performed for the FSC, the portion of the compensation paid to

the individual which is for services performed for the FSC is required to be disbursed out of the FSC's principal bank account. For purposes of this section, the term ''compensation'' is defined as set forth §1.415(c)–2(b) and (c).

[T.D. 8125, 52 FR 5089, Feb. 19, 1987, as amended by T.D. 9319, 72 FR 16894, Apr. 5, 2007]

### § 1.924(d)–1 Requirement that economic processes take place outside the United States.

(a) *In general.* Section 924(b)(1)(B) provides that a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as provided in section 924(d). Section 924(d) and this section set forth the rules for determining whether a sufficient amount of the economic processes of a transaction take place outside the United States. Generally, a transaction will qualify if the FSC satisfies two different requirements: Participation outside the United States in the sales portion of the transaction, and satisfaction of either the 50-percent or the 85-percent foreign direct cost test. The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC. (All references to ''FSC'' in §§1.924(d)–1 and 1.924(e)–1 shall mean the FSC or, if applicable, the person performing the relevant activity under contract on behalf of the FSC.) The FSC may act upon standing instructions from another person in the performance of any activity, whether a sales activity under paragraph (c) of this section or an activity relating to the disposition of export property under paragraph (d) of this section and §1.924(e)–1. The identity of the FSC as a separate entity is not required to be disclosed in the performance of any of the activities comprising the economic processes. Except as otherwise provided, the location of any activity is determined by the place where the activity is initiated by the FSC, and not by the location of any person transmitting instructions to the FSC.

(b) *Activities performed by another person*—(1) *In general.* Any person, whether domestic or foreign, and whether related or unrelated to the FSC, may perform any activity required to satisfy this section, provided that the activity is performed pursuant to a contract for the performance of that activity on behalf of the FSC. Such a contract may be any oral or written agreement which constitutes a contract at law. The person performing the activity is not required to enter into a contract directly with the FSC and, thus, may be a direct or indirect subcontractor of a person under contract with the FSC. For example, assume that a buy-sell FSC enters into an agreement with its related supplier in which the related supplier agrees to perform on behalf of the FSC all sales activities with respect to the FSC's transactions with its foreign customers. Through its existing agreements with a domestic unrelated person, the related supplier subcontracts the performance of these activities to the domestic unrelated person, who, in turn, subcontracts the performance of the sales activities to foreign sales agents. The sales activities performed by the foreign sales agents are considered to be performed on behalf of the FSC for purposes of meeting the requirements of section 924(d)(1)(A).

(2) *Proof of compliance.* If the FSC does not perform the activity itself, it must maintain records adequate to establish, with respect to each transaction or group of transactions, that the activity was performed and that the performance of such activity took place outside the United States. If the person who performed the activity on behalf of the FSC is an independent contractor, the FSC may rely upon a written declaration from that person stating that the activities were performed by that person on behalf of the FSC, and were performed outside the United States. An invoice or a receipt for payment will be considered to be such a written declaration if it specifies that the activities were performed outside the United States or specifies a particular place outside the United States where the activities were performed. If the person performing the activities on behalf of the FSC is a related person, the FSC must maintain records adequate to establish that the activities were actually performed and where the activities were performed.

Such records may be stored with the related person provided that the FSC makes such records available to the Commissioner upon request.

(c) *Participation outside the United States in the sales portion of the transaction*—(1) *In general.* The requirement of section 924(d)(1)(A) is met with respect to the gross receipts of a FSC derived from any transaction if the FSC has participated outside the United States in the solicitation, the negotiation, or the making of the contract relating to such transaction (hereinafter described as ''sales activities''), as provided in this paragraph (c). A sale need not occur in order that the solicitation or negotiation tests be satisfied. Once the FSC has participated outside the United States in an activity that constitutes the solicitation, negotiation, or the making of the contract with respect to a transaction, any prior or subsequent activity by the FSC with respect to such transaction that would otherwise constitute the sales activity will be disregarded for purposes of determining whether the FSC has met the requirements of section 924(d)(1)(A). For example, if a FSC sells a product to a foreign customer by first meeting with the customer in New York to discuss the product and then by mailing to it from outside the United States a brochure describing the product, the prior meeting is disregarded and only the mailing is considered in determining whether there was solicitation outside the United States by the FSC with respect to the transaction which has occurred.

(2) *Solicitation (other than advertising).* For purposes of this paragraph (c), ''solicitation'' refers to any communication (by any method, including, but not limited to, telephone, telegraph, mail, or in person) by the FSC, at any time during the 12 month period (measured from the date the communication is mailed or transmitted) immediately preceding the execution of a contract relating to the transaction to a specific, targeted customer or potential customer, that specifically addresses the customer's attention to the product or service which is the subject of the transaction. For purposes of paragraph (c)(2) of this section, communication by mail means depositing the communication in a mailbox. Except as provided in §1.924(e)–1(a)(1) with respect to second mailings, activities that would otherwise constitute advertising (such as sending sales literature to a customer or potential customer) will be considered solicitation if the activities are directed at a specific, targeted customer or potential customer, and the costs of the activity are not taken into account as advertising under the foreign direct cost tests. Activities that would otherwise constitute sales promotion (such as a promotional meeting in person with a customer) will be considered to be solicitation if the activities are directed at a specific, targeted customer or potential customer, and the costs of the activity are not taken into account as sales promotion under the foreign direct cost tests. Except as provided in §1.924(e)–1(a)(1) with respect to second mailings, the same or similar activities cannot be considered both solicitation and advertising, or both solicitation and sales promotion, with respect to the same customer. Solicitation, however, may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(3) *Negotiation.* For purposes of this paragraph (c), ''negotiation'' refers to any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery. For purposes of this paragraph (c)(3), communication by mail has the same meaning as provided in paragraph (c)(2) of this section. Negotiation does not include the mere receipt of a communication from a customer (such as an order) that includes terms of a sale. Negotiation may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(4) *Making of a contract.* For purposes of this paragraph (c), ''making of a contract'' refers to performance by the FSC of any of the elements necessary

to complete a sale, such as making an offer or accepting an offer. A requirements contract is considered an open offer to be accepted from time to time when the customer submits an order for a specified quantity. Thus, the acceptance of such an order will be considered the making of a contract. The written confirmation by the FSC to the customer of the acceptance of the open order will also be considered the making of a contract. Acceptance of an unsolicited bid or order is considered the ''making of a contract'' even if no solicitation or negotiation occurred with respect to the transaction. The written confirmation by the FSC to the customer of an oral or written agreement which confirms variable contract terms, such as price, credit terms, quantity, or time or manner of delivery, or specifies (directly or by cross-reference) additional contract terms will be considered the making of a contract. A written confirmation is any confirmation expressed in writing, including a telegram, telex, or other similar written communication. The making of a contract may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(5) *Grouping transactions.* Generally, the sales activities under this paragraph (c) are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, any of the sales activities may be applied on the basis of a group as set forth in this paragraph (c)(5). Any groupings used must be supported by adequate documentation of performance of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC, however, may amend its tax return to group in a manner different from that elected on its original return before the expiration of the statute of limitations.

(i) *Standards of groups.* A determination by a FSC as to a grouping will be accepted by a district director if such determination conforms to any of the following standards:

(A) *Product or product line groupings.* A product or product line grouping may be based upon either a recognized trade or industry usage, or upon a two digit major group (or on any inferior classification or combination of inferior classifications within a major group) of the Standard lndustrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. For taxable years beginning on or before February 19, 1987, any sales activity that is performed outside the United States with respect to any transaction covered by the product or product line grouping during the FSC's taxable year shall apply to all transactions covered by the product or product line. However, for taxable years beginning after February 19, 1987, the requirement of section 924(d)(1)(A) is met with respect to all transactions covered by the product or product line grouping only if the sales activities are performed outside the United States with respect to customers with sales representing either:

(i) 20 percent or more of the foreign trading gross receipts of the product or product line grouping during the current year or

(ii) 50 percent or more of the foreign trading gross receipts of the product or product line grouping for the prior year irrespective of whether any sales occurred within the current year to the prior year customers.

If during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may use the 50 percent rule with respect to the preceding DISC or interest charge DISC year, substituting qualified export receipts for foreign trading gross receipts. A corporation which has not been treated in the prior year as a FSC, interest charge DISC, or DISC does not have to meet either the 20 percent test or the 50 percent test for the first year in which it is treated as a FSC.

(B) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction with the customer

during the taxable year shall apply to all transactions within the customer grouping.

(C) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract for a taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction under the contract will apply to all transactions under the contract for such taxable year. For long-term contracts between unrelated parties, the sales activities tests need be satisfied only once for the life of the contract. With respect to requirements contracts and long-term contracts between related parties, the sales activities test must be satisfied annually.

(D) *Product or product line groupings within customer or contract groupings.* Groupings may be based upon product or product line groupings within customer or contract groupings. If, however, the primary grouping is a customer or contract grouping, the 20 percent test set forth in subdivision (A) of this paragraph relating to product or product line grouping will not be applicable.

(ii) *Transactions included in a grouping.* A choice by a FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The choice of a grouping, however, applies only to transactions covered by the grouping and, for transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, a FSC may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC applies sales activity rules on the basis of other types of groupings, such as all sales to a particular customer, transactions included in those other groupings shall be excluded from product groupings.

(iii) *Different groupings allowed for different purposes.* A choice by the FSC to group transactions may be made separately for each of the sales activities under section 924(d)(1)(A). Groupings used for purposes of section 924(d)(1)(A) will have no relationship to groupings used for other purposes, such as satisfying the foreign direct cost tests. This paragraph (c)(5) does not apply for purposes of section 925.

(6) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples:

*Example 1.* In November, a calendar year FSC mailed from its foreign office its catalog to a potential foreign customer. The catalog displayed numerous products along with a brief description and the price of each. In February of the following year, the FSC sold to the customer a product displayed in the catalog. Since the FSC communicated with the customer during the 12-month period prior to the sale, although during the previous taxable year, the FSC participated outside the United States in the solicitation relating to the transaction.

*Example 2.* A FSC with a taxable year ending April 30, 1986, solicits customer X during that taxable year with respect to Product A. In the previous taxable year, the FSC sold product A to customers V, W, X, Y, Z, none of whom were customers in the taxable year ending April 30, 1986. The sales proceeds from sales to customer X represented 50 percent of the foreign trading gross receipts for the previous FSC year. The FSC meets the 50 percent test for product or product line grouping for the taxable year ending April 30, 1986. If the facts were changed so that there was not a FSC, DISC or interest charge DISC in the same controlled group in the previous taxable year, the single solicitation directed to any customer would qualify all transactions within the product group as meeting the solicitation requirement for that taxable year. For subsequent taxable years, the 50 percent test or the 20 percent test would be applicable.

*Example 3.* A FSC earns commissions on the sale of export property by its domestic related supplier to United States wholesalers for final sale to foreign customers. The related supplier receives an order from one of its United States wholesalers. The related supplier telephones the United States wholesaler to inform it of the new price and the probability of another price increase soon. The United States wholesaler orally agrees to the new price and the related supplier instructs the FSC to telex the wholesaler from its foreign office a confirmation that the product will be sold at the current new price. The written confirmation by the FSC of an oral agreement on a variable contract term constitutes the making of a contract. Thus, the requirements of section 924(d)(1)(A) are met with respect to the transaction relating to the product.

(d) *Satisfaction of either the 50-percent or the 85-percent foreign direct cost test—*

(1) *In general.* Section 924(d)(1)(B) requires, in order for the gross receipts of a transaction to qualify as foreign trading gross receipts, that the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to the transaction. The direct costs are those costs attributable to activities described in the five categories of section 924(e). Section 924(d)(2) provides that, instead of satisfying the 50-percent foreign direct cost test of section 924(d)(1)(B), the FSC may incur foreign direct costs attributable to activities described in each of two of those categories that equal or exceed 85 percent of the total direct costs incurred by the FSC attributable to the activity described in each of the two categories. If no direct costs are incurred by the FSC in a particular category, that category shall not be taken into account for purposes of determining satisfaction of either the 50-percent or the 85-percent foreign direct cost test. If any amount of direct costs is incurred in a particular category, that category shall be taken into account for purposes of the foreign direct costs tests.

(2) *Direct costs*—(i) *Definition of direct costs.* For purposes of section 924 (d), direct costs are those costs which are incident to and necessary for the performance of any activity described in section 924(e). Direct costs include the cost of materials which are consumed in the performance of the activity, and the cost of labor which can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits). Direct costs also include the allowable depreciation deduction for equipment or facilities (or the rental cost for use thereof) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by a contractor. If costs of services or the use of facilities are only incidentally related to the performance of an activity described in section 924(e), only the incremental cost is considered to be identified directly with the activity. For example, supervisory, administrative, and general overhead expenses, such as telephone service, normally are not identified directly with particular activities described in section 924(e). The cost of a long distance telephone call made to arrange for delivery of export property, however, is identified directly with the activities described in section 924(e)(2). Direct costs for purposes of section 924(d) do not necessarily include all of the expenses taken into account for purposes of determining the taxable income of the FSC or the combined taxable income of the FSC and its related supplier.

(ii) *Allocation of direct costs.* For purposes of this section only, if costs are identified with more than one activity (whether or not all of the activities are described in section 924(e)), the portion of the costs attributable to each activity shall be determined by allocating the costs among the activities in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing each activity independently. If costs of an activity are attributable to more than one transaction or grouping of transactions, the portion of the costs attributable to each transaction or grouping shall be determined by allocating the costs among the transactions or groupings in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing the activity independently with respect to each transaction or grouping.

(3) *Total direct costs.* The term ''total direct costs'' means all of the direct costs of any transaction attributable to activities described in any paragraph of section 924(e). For purposes of the 50-percent foreign direct cost test of section 924(d)(1)(B), total direct costs are determined based on the direct costs of all activities described in all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test of section 924(d)(2), however, the total direct costs are determined separately for each paragraph of section 924(e). If more than one activity is included within a paragraph of

section 924(e), direct costs must be incurred with respect to at least one activity listed in the paragraph. If costs are incurred with respect to more than one activity, all direct costs must be considered for purposes of satisfying the direct costs test.

(4) *Foreign direct costs.* The term ''foreign direct costs'' means the portion of the total direct costs of any transaction which is attributable to activities performed outside the United States. For purposes of the 50-percent foreign direct cost test, foreign direct costs are determined based on the direct costs of all activities described in all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test, however, foreign direct costs are determined separately for each paragraph of section 924(e).

(5) *Fifty percent foreign direct cost test.* To satisfy the requirement of section 924(d)(1)(B), the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs attributable to the transaction. This test looks to the cost of the activities described in section 924(e) on an aggregate basis; therefore, it is not necessary that the foreign direct costs of each activity, or of each paragraph of section 924(e), equal or exceed 50 percent of the total direct costs of that activity or paragraph.

(6) *Eighty-five percent foreign direct cost test*—(i) *General rule.* To satisfy the requirement of section 924(d)(2), the foreign direct costs of a transaction incurred by the FSC attributable to activities described in each of at least two paragraphs of section 924(e) must equal or exceed 85 percent of the total direct costs attributable to activities described in that paragraph. This test looks to costs of the activities on a paragraph-by-paragraph basis (but not on an activity-by-activity basis). As an example, the foreign direct costs of advertising and sales promotion are aggregated with each other for this purpose, but they are not aggregated with the foreign direct costs of transportation.

(ii) *Satisfaction of the 85-percent test.* If, after the FSC files its tax return indicating that it has satisfied the 85-percent foreign direct cost test with respect to each of at least two paragraphs of subsection 924(e) and a determination is made by the Commissioner that the foreign direct costs attributable to one or both of the two paragraphs of section 924(e) specified on the return did not equal or exceed 85 percent of the total direct costs attributable to such activities, the FSC may, nonetheless, satisfy the 85-percent foreign direct cost test if the foreign direct costs attributable to any two paragraphs of section 924 (e) equal or exceed 85 percent of the total direct costs attributable to those other paragraphs.

(e) *Grouping transactions.* Generally, the foreign direct cost tests under paragraph (d) of this section are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, the foreign direct cost tests may be applied on a customer, contract or product or product line grouping basis. Any groupings used must be supported by adequate documentation of performance of activities and costs of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC may, however, amend its tax return before the expiration of the statute of limitations under section 6501 of the Code to group in a manner different from that elected on its original return.

(1) *Standards for groupings.* A determination by a FSC as to a grouping will be accepted by the district director if such determination conforms to any of the following standards:

(i) *Product or product line groupings.* A product or product line grouping may be based either on a recognized trade or industry usage, or on a two digit major grouping (or on any inferior classification or combination of inferior classifications within a major grouping) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(ii) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year.

(iii) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract, including a requirements contract. The tests will be applied to all transactions within a contract grouping during each taxable year of the FSC; however, by election of the FSC, all transactions under a contract that occur in the first or the last year of the contract may be included with, respectively, the next succeeding or the immediately preceding taxable year in applying these tests. For example, if with respect to transactions during the first calendar year of a 5-year contract, a calendar year FSC incurs direct costs attributable to the transactions of $100X for advertising, all of which are foreign direct costs, and $10X for processing of customers orders and for arranging for delivery, $9X (or 90 percent of the total direct costs) of which are foreign direct costs, the FSC has satisfied the 85-percent foreign direct cost test with respect to those transactions for the taxable year. If with respect to transactions during the second year of the contract, the FSC only incurs $18X of direct costs for processing of customer orders and arranging for delivery, $15X (83.3 percent of the total direct costs) of which are foreign direct costs, the FSC may include the transactions from the first year of the contract to meet the 85-percent foreign direct cost test in the second taxable year. Thus, with respect to the transactions in the second year, the FSC satisfies the foreign direct costs test for advertising (because the entire $100X of direct costs are foreign direct costs) and for processing of customer orders and arranging for delivery (because of the $28X of direct costs, $24X or 85.7 percent of the total direct costs are foreign direct costs). If, however, with respect to transactions in the third year, the FSC satisfies the foreign direct costs test, those transactions cannot be included with the transactions in the fourth year. The FSC may aggregate the direct costs in the fourth and fifth years in the same manner as for the first and second years as described above in order to satisfy the 85 percent foreign direct costs test.

(iv) *Product or product line groupings within customer or contract groupings.* Groupings may be based on product or product line groupings within customer or contract groupings.

(2) *Transactions included in a grouping.* An election by the FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The election of a grouping, however, applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, the FSC may elect a product grouping with respect to one product and elect the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC is permitted to apply either the 50-percent or the 85-percent foreign direct cost test on the basis of other types of groupings, such as all transactions with respect to a particular customer, transactions included in those other groupings shall be excluded from product groupings.

(3) *Different groupings allowed for different purposes.* An election by the FSC to group transactions may be made separately for each of the activities relating to disposition of export property under section 924(d)(1)(B) or section 924(d)(2). Groupings used for purposes of section 924 will have no bearing on groupings for other purposes. This paragraph (e) does not apply for purposes of section 925.

(f) *Exception for foreign military property*—(1) *General rule.* The requirements of this section do not apply to any activities performed in connection with foreign military sales except those activities described in section 924(e). The FSC is deemed to have satisfied the requirements of section 924(d)(1)(A).

(2) *Example.* The principles of paragraph (f)(1) of this section may be illustrated by the following example:

*Example.* A FSC earns commissions on foreign military sales by its related supplier. All solicitation, negotiation, and contract making activities occur in the United States solely between the related supplier and the United States government. The property is delivered, title passes, and payment is made in the United States in accordance with standard United States government practices. The FSC incurs direct costs in the amount of $155X to process the government's

orders and arrange for delivery of the goods, all of which are foreign direct costs. In addition, it incurs foreign direct costs in the amount of $250X for assembling and transmitting its final invoice to the government from outside the U.S. and foreign direct costs of $200X associated with receiving payment from the related supplier in accordance with the rules of §1.924(e)–1(d)(2)(iii). No other activities occur with respect to the foreign military sales. The FSC has satisfied the 85-percent foreign direct cost test and thus has foreign trading gross receipts with respect to the foreign military sales. The fact that the FSC did not participate outside the United States in any of the sales activities has no bearing on the qualification of the receipts since the FSC is deemed to have met the requirements of section 924(d)(1)(A).

[T.D. 8125, 52 FR 5090, Feb. 19, 1987]

### § 1.924(e)–1 Activities relating to the disposition of export property.

(a) *Advertising and sales promotion.* For purposes of section 924(e), advertising and sales promotion are defined as follows.

(1) *Advertising*—(i) *Advertising defined*—(A) *General rule.* Advertising means the announcement or description of property or services described in section 924(a), in some medium of mass communication (such as radio, television, newspaper, trade journals, mass mailings, or billboards), in order to induce multiple customers or potential customers to buy or rent the property or services from the FSC or related supplier. Advertising is not required to be directed to the general public, but may be focused toward any group of export customers or potential export customers. Advertising except for the advertising described in §1.924(e)–1(a)(1)(B) must describe one or more specific products or product lines (or services) and identify the product as a product offered by the FSC or related supplier. Advertising intended solely to build a favorable image of a company or group of companies is not included in this definition of advertising. Additionally, advertising primarily directed at customers or potential customers in the United States is not included in this definition of advertising, nor is advertising related to property or services not described in section 924(a).

(B) *Special rules for sales to distributors.* If the customer is a distributor (whether domestic or foreign, related or unrelated to the FSC), an expense that is incurred by the distributor and charged to the FSC or related supplier as a reduction in the purchase price or as a separate charge for an announcement or description described in paragraph (a)(1)(A) of this section to induce the distributor's customers, potential customers, or the ultimate users to buy or rent the property or services is advertising for these purposes (i) if the FSC incurs 20 percent or more of the total advertising costs of the distributor or (ii) if the FSC pays the total charge of an advertisement either directly or indirectly. For these purposes, a distributor is anyone other than an end user or a final consumer. A FSC may incur direct advertising costs to a foreign end consumer even though the FSC sells to a U.S. distributor.

(ii) *Direct costs of advertising.* Direct costs of advertising include costs of transmitting, displaying, or distributing the advertising to customers or potential customers and the costs of printing in the case of sales literature, but do not include fees paid to an independent advertising agency to develop the announcement or description, translation costs, or costs of preparing the announcement or description for potential use as advertising. Direct costs of sending sales literature to customers or potential customers may be taken into account as advertising costs as long as the activity is not taken into account for purposes of the sales activity requirements of §1.924(d)–1(c).

(iii) *Location of advertising*—(A) *General rule.* The location of advertising activity is the place to which the advertising is transmitted, displayed, distributed, mailed, or otherwise conveyed to the customers or potential customers (or in the case of advertising described in paragraph (a)(i)(B) of this section, the distributor's customers, or the ultimate users). For example, a television advertisement that is broadcast to a foreign country constitutes advertising activity outside the United States even though the broadcast signal originates in the United States. Therefore, the cost of that advertising activity is a foreign cost. The FSC may rely upon the distribution statistics of the publisher of print media or the

broadcaster of broadcast media through which the advertising is distributed. If the distribution statistics show that 85 percent or more of the readership, radio listeners, or viewership are outside the United States, all direct costs of advertising are considered foreign direct costs of advertising.

(B) *Foreign editions of journals, magazines, etc.* Costs related to advertising in foreign English editions of U.S. publications as well as advertising in any publication in a foreign language are foreign direct costs.

(C) *United States editions.* Costs related to advertising in United States publications are not treated as direct costs even if the publication also has a foreign edition in English.

(iv) *Second mailings.* In general, direct costs of sending sales literature to customers may be treated as solicitation or advertising, but not both. A distinction may be made, however, between a first and second mailing so that one may be treated as advertising and the other may be treated as solicitation. To qualify under this second mailing rule, the two mailings must be generically different items such as a price list and a description of the product itself. An amended price list would not be distinguishable from an original price list and would, therefore, not constitute a second mailing.

(v) *Examples.* The principles of paragraph (a)(1) of this section may be illustrated by the following examples:

*Example 1.* The related supplier, under contract with a buy-sell FSC to advertise export product D on the ''FSC's'' behalf to its foreign unrelated customers, engaged a French advertising agency to develop an advertising campaign to induce French customers to buy the product. As a part of the advertising campaign, the agency places a one-page advertisement in a relevant French trade journal. The advertisement constitutes advertising within the meaning of paragraph (a)(1) of this section.

*Example 2.* A United States weekly magazine publishes, in addition to its United States edition, a Canadian edition in English and a Mexican edition in Spanish. A FSC incurs costs of $200 X for a one-page display in each of the three editions for a total advertising cost of $600 X. The $200 X cost relating to the advertising in the United States edition is not a direct cost because it relates to United States sales. The total costs of $400 X relating to advertising in the English language Canadian edition and the Spanish language Mexican edition are foreign direct costs.

*Example 3.* A FSC earns commissions on the sale of export product E by its domestic related supplier to United States distributors for resale to Canadian retail customers. The related supplier, under contract with the FSC to advertise product E, pays an amount equal to 1 percent of its annual gross receipts with respect to product E under a cooperative advertising arrangement with the distributor. The amount, which represents 20 percent of the total advertising costs for product E, is reimbursed by the FSC. The 20-percent amount represents a significant portion of the total advertising costs and thus constitutes advertising within the meaning of paragraph (a)(1)(i) of this section.

*Example 4.* A FSC mails two items to each customer on its customer list within one taxable year. The first mailing consists of a price list which merely lists the various products by name and provides a price next to each product name. The second mailing consists of a brochure which fully describes and illustrates each product. The two mailings are generically different. Therefore, one mailing may be counted as advertising while the other mailing may be counted as solicitation.

(2) *Sales promotion*—(i) *Sales promotion defined.* Sales promotion means an appeal made in person to an export customer or potential export customer for the sale or rental of property or services described in section 924(a), made in the context of a trade show or customer meeting. A customer meeting means a periodic meeting (*e.g.*, quarterly, semi-annual, or annual) in which 10 or more customers or potential customers are reasonably expected to attend. However, for taxable years beginning before February 19, 1987, a customer meeting may, at the option of the taxpayer, mean any meeting with a customer or potential customer regardless of the frequency of the meetings or the number of customers or potential customers in attendance. A meeting, show or event in the United States that is primarily aimed at the export of goods or services described in section 924(a) constitutes sales promotion. Sales promotion does not include an appeal made in the context of any meeting, show or event primarily aimed at U.S. customers or an appeal for the sale or rental of property or services not described in section 924(a).

Whether any meeting, show or event is primarily aimed at U.S. customers or at the export of goods or services described in section 924(a) shall be determined by all of the facts and circumstances including the announced objective of the meeting, show or event; the attendees; the location of the meeting, show or event; and the product or special feature of the product.

(ii) *Direct costs of sales promotion.* Direct costs of sales promotion include costs such as rental of space at trade shows, payments to organizers or other persons hired for the event, rental of display equipment and decorations for the event, and costs of maintaining a showroom. Direct costs of sales promotion also include costs for travel, meals, and lodging for direct sales people attending the event if these costs are paid by the FSC or related supplier. In the case of a customer meeting, direct costs of sales promotion include the costs of materials printed specifically for the meeting and the costs of travel, lodging, and food for both the direct sales people and customers or potential customers attending the meeting. Direct costs of sales promotion do not include the cost of salaries and commissions of direct sales people or the cost of discount coupons, samples of the product, or printed advertising materials that are used for general advertising as well as sales promotion.

(iii) *Location of sales promotion.* The location of sales promotion activity is the place where the trade show or customer meeting is held.

(iv) *Examples.* The principles of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

*Example 1.* The related supplier sells various export products described in section 924(a) to its foreign customers. As a commission agent for the related supplier with respect to such sales, the FSC performs sales promotion. It contracts with the related supplier to serve as its agent for such purposes. To stimulate the sale of its export products, the related supplier conducts semi-annual meetings with the purchasing agents of its customers at its Kansas City headquarters. Ten or more purchasing agents are reasonably expected to attend each meeting. At such meetings, the purchasing agents see the related supplier's manufacturing facilities, visit with its executives, attend technical updates, and see new export products. These semi-annual customer meetings constitute sales promotion within the meaning of paragraph (a)(2)(i) of this section. Direct costs incurred with respect to the customer meetings are U.S. direct costs because the sales promotion activities occur within the United States.

*Example 2.* Assume the same facts as in *Example 1*, except that the related supplier exhibits products that only operate on 220 volts at a trade show in the United States. According to the trade show sponsors, the purpose of the show is to increase sales abroad of United States-manufactured products. Since the products exhibited are designed for operation in foreign countries and the purpose of the trade show is to boost sales in those countries, the trade show held in the United States is primarily aimed at the export products described in section 924(a) and not at United States customers. Thus, the trade show constitutes sales promotion within the meaning of paragraph (a)(2)(i) of this section and the direct costs incurred in connection with the trade show are treated as United States direct costs.

(b) *Processing of customer orders and arranging for delivery of the export property.* For purposes of section 924(e), the processing of customer orders and the arranging for delivery of the export property are defined in paragraph (b)(1) and paragraph (b)(2), respectively, of this section. For taxable years beginning after February 19, 1987, if the FSC performs the activities of processing of customer orders and arranging for delivery of the export property and elects to group its transactions, it is considered to have performed the activities with respect to all transactions in the grouping elected by the FSC under §1.924(d)–1(e) during the taxable year if it performs the activities of processing of customer orders and arranging for delivery of the export property with respect to customers generating 20 percent or more of foreign trading gross receipts within the elected grouping.

(1) *Processing of customer orders*—(i) *Processing of customer orders defined.* The processing of customer orders means notification by the FSC to the related supplier of the order and of the requirements for delivery. The related supplier may have independent knowledge of the order and requirements for delivery. If the FSC does not have a related supplier, the processing of customer orders means communication

with the customer by any method such as telephone, telegram, or mail to acknowledge receipt of the order and requirements for delivery. Once the related supplier has been notified by the FSC, or the customer has received an acknowledgement from the FSC, of the order and requirements for delivery, subsequent or prior communications with respect to an order (such as changes in quantity or prospective delivery date) are not included in the definition of processing of customer orders.

(ii) *Direct costs of processing customer orders.* Direct costs of processing of customer orders include salaries of clerical personnel and costs of telephone, telegram, mail, or other communication media (including the costs of operating transmission equipment).

(iii) *Location of processing of customer orders.* The location of this activity is the place where the communication is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(1) of this section may be illustrated by the following examples:

*Example 1.* A domestic related supplier, using a FSC as its commission agent on the sale of export property to foreign customers, receives an order from one of its foreign customers. Information concerning the receipt of such order and its requirements for delivery are transmitted to the FSC. The FSC from its office outside the United States notifies the related supplier of the order and the requirements for delivery by telex. This notification by the FSC to the related supplier constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section. In addition, its direct costs of processing the customer's order are foreign direct costs because the communication is initiated by the FSC from outside the United States.

*Example 2.* A domestic unrelated supplier manufactures a product which it sells to a buy-sell FSC located in Germany for resale to the FSC's German customers. Upon receiving an order from one of its customers, the FSC telephones the customer from its German office to acknowledge receipt of the order and the requirements for delivery. The acknowledgement constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section and the direct costs attributable thereto are foreign direct costs.

(2) *Arranging for delivery*—(i) *Arranging for delivery defined.* The arranging for delivery of export property means the taking of necessary steps to have the export property delivered to the customer in accordance with the requirements of the order. Arranging for delivery does not include preparation of shipping documents (*e.g.*, bill of lading) or the property for shipment (*i.e.*, packaging or crating), or shipment of property (*i.e.*, transportation). Arranging for delivery does include communications with a carrier or freight forwarder to provide transportation (as defined in §1.924(e)–1(c)(1), but without regard to when the commission relationship for purposes of transportation begins) for the export property from the FSC or related supplier to the place where the customer takes possession of the property. Arranging for delivery also includes communications with the customer to notify the customer of the time and place of delivery. The carrier or freight forwarder and the customer may already have knowledge of the information communicated. If the FSC has communicated with the carrier or freight forwarder, where applicable, and the customer to notify it of the time and place of delivery, prior or subsequent communications to either about delivery are not included in the definition of arranging for delivery.

(ii) *Direct costs of arranging for delivery.* The direct costs of arranging for delivery include salaries of clerical personnel and costs of telephone, telegraph, mail, and other communications media, but do not include any actual shipping costs.

(iii) *Location of arranging for delivery.* The location of arranging for delivery activity is the place where the activity is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(2)(i) of this section may be illustrated by the following examples:

*Example 1.* A FSC earns commissions on the sale of export property by its domestic related supplier to foreign customers. The shipment term of all of the related supplier's sales is F.O.B. (Free on Board) its manufacturing plant in Gary, Indiana. Thus, there is no transportation as defined in §1.924(e)–1(c)(1) with respect to its sales. From its shipping department at the plant, the related supplier telephones carriers to arrange for delivery. It also notifies the FSC by mail

of the time and place of delivery of the customer's orders. The FSC from its office outside the United States transmits the received information to the customers. Because there is no transportation to be arranged, this communication alone by the FSC to the customers to notify them of the time and place of delivery constitutes arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

*Example 2.* Assume the same facts as in *Example 1*, except that the shipment term of all of the related supplier's sales is C.I.F. (Cost, Insurance, Freight) and that the commission relationship for transportation begins after the export property leaves the United States customs territory. The related supplier telephones a trucking firm and an overseas carrier from its plant in Gary, Indiana to ascertain information on transporting its property by truck to the docks, and by overseas carrier from the docks to the place where the customer takes possession. Upon receiving the necessary information, the related supplier electronically transmits to the FSC the shipping information and the time and place of delivery to the customer. In addition, it instructs the FSC to communicate the necessary shipping information to the carriers to ensure shipment and to notify the customer of the time and place of delivery. The FSC does both from its office located outside of the United States. The communications by the FSC to the carriers and the customer constitute arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

(c) *Transportation*—(1) *Transportation defined.* For purposes of section 924(e), transportation means moving or shipping the export property during the period when the FSC owns or is responsible for the property, or, if the FSC is acting as a commission agent, during the period when the related supplier owns or is responsible for the property but after the commission relationship for purposes of transportation begins (even if the relationship begins after the property leaves the U.S. customs territory). The FSC or related supplier is treated as responsible for the property when it either has title, bears the risk of loss, or insures the property during shipment. Since a commission FSC will not generally have title or bear the risk of loss, it will, nevertheless, satisfy the transportation test if the related supplier has either title, bears the risk of loss, or insures the property during shipment. Examples of methods of shipping which would qualify as transportation include F.O.B. (Free on Board) destination, C.I.F. (Cost, Insurance, Freight), Ex Ship, and Ex Quay, but do not include C. & F. (Cost and Freight) or F.O.B. shipping point.

(2) *Direct costs of transportation.* The direct costs of transportation include the expenses of shipping, such as fees paid to carriers and freight forwarders, costs of freight insurance, and documentation fees. With respect to fungible commodities, direct costs include only those costs incurred after the goods have been identified to a contract. Transportation costs do not include any of the costs of arranging for delivery. The FSC is considered to engage in transportation activity whenever it pays the costs of shipping the export property and the property is shipped during the period when the FSC owns or is responsible for the property as provided in paragraph (c)(1) of this section. If the customer pays the shipping costs directly, the FSC is not considered to engage in transportation activity. If, however, the FSC pays the shipping costs, the ultimate transfer of those costs to the customer will not disqualify the FSC from engaging in transportation for purposes of section 924(e) regardless of whether the costs are included in the sale price of the export property or separately stated.

(3) *Location of transportation.* The location of transportation activity is the area over which the property is transported. Thus, the portion of total direct costs of transportation treated as foreign direct costs is the portion attributable to transportation outside the United States, determined on the basis of the ratio of mileage outside the U.S. customs territory to total mileage. For purposes of determining mileage outside U.S. customs territory, goods are treated as leaving U.S. customs territory when they have been tendered to an international carrier for shipment to a foreign location, as long as they are not removed from the custody of the carrier before they reach a point outside U.S. customs territory. The same rule for determining mileage outside the U.S. customs territory will apply to freight forwarders if (i) the forwarder has the risk of loss or is an insurer of the goods, and (ii) the property is shipped on a single bill of lading

issued to the FSC or its agent as the shipper.

(4) *Examples.* The principles of paragraph (c) of this section may be illustrated by the following examples:

*Example 1.* A buy-sell FSC sells export property to a customer located in Canada. The contract between the FSC and the customer requires that the property be shipped F.O.B. its Canadian destination. Under this shipment term, the FSC holds title and bears the risk of loss until the property is tendered at its Canadian destination. Thus, it is responsible for the property during shipment. The FSC instructs its related supplier to ship the property from its manufacturing facilities in St. Louis. The related supplier negotiates two contracts, one for domestic transportation and the second for foreign transportation. A domestic trucking firm transports the property to the Canadian border where a Canadian trucking company is used to transport the property to its Canadian destination. The documentation fees and the fees for the two trucking firms are paid by the FSC. Because the FSC paid the costs of shipping and the property was shipped during the period when the FSC was responsible for the property, the FSC has engaged in transportation activity, the direct costs of which are the fees paid by the FSC. If 70 percent of the mileage from St. Louis to the Canadian destination is associated with the transportation from the Canadian border to the Canadian destination, 70 percent of the FSC's direct transportation costs are foreign direct costs. If, instead of using two trucking firms, the FSC had tendered the goods to a freight forwarder for shipment to a foreign location and the freight forwarder assumed the risk of loss for the goods and issued a single bill of lading, all of the fees paid by the FSC to the freight forwarder would be foreign direct costs.

*Example 2.* A related supplier sells export property to its foreign customer in Liverpool, England. The contract between the related supplier and the customer requires that the property be shipped C.I.F. Liverpool. The related supplier engages the FSC as its commission agent with respect to its sales to the customer, requiring the FSC to provide transportation to the customer. The FSC contracts with the related supplier to provide the transportation on behalf of the FSC. The commission agreement between the related supplier and the FSC provides that the FSC's responsibilities with respect to transportation of the export property begins after the property leaves the U.S. customs territory. The related supplier hires a domestic trucking firm to transport the shipment to a New York City port where it is loaded on a cargo ship destined for Liverpool at a total cost of $3,000X, $2,750X of which is allocable to mileage from the U.S. customs territory to Liverpool, England. Because the related supplier insures the property during shipment under C.I.F., the property is shipped during the period when the related supplier is treated as responsible for the property. Thus, the FSC, as the related supplier's commission agent, has satisfied the transportation test. In addition, because the FSC's responsibilities with respect to transportation begins when the property leaves U.S. customs territory, the FSC's payment of $2,750X is a foreign direct cost of transportation. The remaining $250X is not a direct cost of transportation to the FSC because the amount was expended before the commission relationship between the FSC and related supplier began.

*Example 3.* A FSC earns commissions on sales by the related supplier of export property, all of which falls within a single two-digit SIC group. The related supplier is under contract to the FSC to perform on the FSC's behalf all of the section 924(e) activities attributable to the sales. Of all of the sales made during the year, the FSC has no transportation costs with respect to the sales to customer R because the shipment term is F.O.B. the related supplier's Chicago plant. With respect to the sales to customer S, the FSC ships the property F.O.B. its destination and pays 100 percent of the transportation costs, all of which are foreign direct costs because the commission relationship for transportation begins outside the U.S. customs territory. For purposes of determining whether the FSC has satisfied the 85-percent foreign direct cost test for transportation, the FSC groups the sales by product. Because the transportation costs for sales to customer S are 100-percent foreign direct costs and because there are no transportation costs on sales to customer R, the FSC is considered to have met the 85-percent foreign direct cost test for transportation for all the sales in the single two-digit SIC group.

(d) *Determination and transmittal of a final invoice or statement of account and receipt of payment.* For purposes of section 924(e), the determination and transmittal of a final invoice or statement of account and the receipt of payment are defined as follows.

(1) *Determination and transmittal of a final invoice or statement of account*—(i) *Definitions*—(A) *In general.* The determination and transmittal of a final invoice or statement of account means the assembly of either a final invoice or statement of account and the forwarding of that document to the customer. A FSC may elect to send either final invoices or statements of account

and disregard any costs of the alternative not elected. For taxable years beginning after February 19, 1987, a special grouping rule is provided. If the FSC assembles and forwards either a statement of account or a final invoice from outside the United States to customers with sales representing 50 percent of the current year foreign trading gross receipts within a product or product line grouping or to customers with sales representing 50 percent of the prior year foreign trading gross receipts within a product or product line grouping utilized for the current year, all other U.S. costs will be disregarded and the FSC will be deemed to have no U.S. costs with respect to the determination and transmittal of a final invoice or statement of account. If, during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may apply the 50 percent rule by taking into account the customers and sales of the DISC or interest charge DISC for the preceding taxable year. If no foreign trading gross receipts (or qualified export receipts for DISC purposes) were received in the prior year either by the FSC or by a DISC or interest charge DISC within the controlled group of which the FSC is a member, the FSC must apply the 50 percent rule taking into account customers and foreign trading gross receipts for the current year. In the event that the 50 percent rule is not satisfied, all costs associated with assembly and forwarding of the selected documents (invoices or statements of account) must be included in the costs attributable to activities described in section 924(e)(4).

(B) *Final invoice defined.* A final invoice is an invoice upon which payment is made by the customer. A final invoice must contain the customer's name or identifying number and, with respect to the transaction or transactions, the date, product or service, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit as a receipt for payment satisfies this definition.

(C) *Statement of account defined.* A statement of account is any summary statement forwarded to a customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account as of the last day of the accounting period covered by the statement of account and the balance due (even if the balance due is zero). A single final invoice or statement of account can cover more than one transaction with one customer. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practices if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. Additional information may be sent separately, such as summary statements forwarded to a related party for purposes of reconciling intercompany accounts for financial reporting requirements. If the information is sent separately, the direct costs associated with the assembly and forwarding of that information are not considered for purposes of section 924(d).

(D) *Assembly and forwarding defined.* Assembly means folding the documents (where applicable), filling envelopes, and addressing envelopes (if window envelopes are not used). Forwarding means mailing or delivery.

(ii) *Direct costs of determination and transmittal of final invoice or statement of account.* Direct costs of this activity include costs of office supplies, office equipment, clerical salaries and costs of mailing or other delivery services, if the costs can be identified or associated directly with the assembly and

transmittal of a final invoice or statement of account. Costs of establishing a price, or of communicating prices or other billing information between the FSC and a related supplier are not direct costs of this activity. In addition, the costs of preparing and mailing the final invoices or statements of account to the FSC and the costs of accumulating and formatting data for invoicing or statements of account on computer discs, tapes, or some other storage media along with the costs of transmitting or transporting this data to the FSC are not direct costs of this activity.

(iii) *Location of determination and transmittal of a final invoice or statement of account.* For taxable years beginning before February 19, 1987, the location of this activity is the place where the final invoice or statement of account is assembled for forwarding to the customer or the place from which it is forwarded to the customer. Thus, the forwarding of the final invoice or statement of account from outside the United States is sufficient to source this activity outside the United States. For all other taxable years, the location of this activity is the place where the final invoice or statement of account is both assembled and forwarded to the customer.

(iv) *Examples.* The principles of paragraph (d)(1) of this section may be illustrated by the following examples, all of which apply to taxable years beginning on or after February 19, 1987.

*Example 1.* A related supplier sells export property to its foreign customers. The related supplier engages the FSC as its commission agent with respect to the sales, requiring the FSC to determine and transmit final invoices or statements of account to the customers with respect to the sales. Annually, the FSC assembles and forwards statements of account to customers representing 40 percent of current year export sales and 35 percent of prior year sales. The statements are sent from its office outside of the United States. The remaining statements of account are sent from the Albany, New York office of the related supplier. The statements are recognized in its industry as a statement of account. Although the statement does not contain all of the information described in §1.924(e)–1(d)(1)(i), it is sent to both domestic and foreign customers of the related supplier to inform the customer of the status of its transactions with the related supplier. The document qualifies as a statement of account under §1.924(e)–1(d)(1)(i); however, the 50 percent test set forth in §1.924(e)–1(d)–1(d)(1)(i)(A) is not satisfied. Therefore, the FSC must take into account all domestic direct costs attributable to assembly and forwarding of statements of account from its domestic office in determining whether the FSC has satisfied the direct costs test with respect to section 924(e)(4) and §924 (e)–1(d).

*Example 2.* Employees of a FSC, in the FSC's foreign office, fold and place in envelopes the sheet or sheets that constitute the final invoices provided by the related supplier. In addition, the employees address, affix postage to, and mail the envelopes. These activities constitute the determination and transmittal of the final invoices within the meaning of paragraph (d)(1)(i) of this section and, because the final invoices are assembled and forwarded to the customers from outside the United States, all the direct costs of the activities are foreign direct costs.

*Example 3.* The related supplier sends to the FSC's foreign office a computer tape to be used to prepare a statement of account. A management company, working under contract with the FSC, transcribes the data to a piece of paper which is a statement of account for purposes of §1.924(d)(1)(i), folds the document, and fills, affixes postage to, and mails the envelopes. Only the costs performed by the management company under contract with the FSC that constitute the assembly and forwarding of a statement of account under §1.924(e)–1(d)(1)(i)(D) are direct costs. Therefore, the costs attributable to transcribing the data to a piece of paper are not direct costs for purposes of section 924(e)(4).

(2) *Receipt of payment*—(i) *Receipt of payment defined.* Receipt of payment means the crediting of the FSC's bank account by an amount which is not less than 1.83 percent of the gross receipts (''gross receipts amount'') associated with the transaction. The FSC's bank account is not credited unless the FSC has the authority to withdraw the amount deposited. Where sales proceeds are factored or where payments from related foreign subsidiaries are netted against amounts owed to these foreign subsidiaries in an intercompany account, crediting of the FSC's bank account with no less than the gross receipts amount of the factoring proceeds or the proceeds, net of offsets, respectively, qualifies as receipt of payment. In addition, where a FSC is precluded from receiving a portion of

the proceeds of the export transaction, the FSC may satisfy receipt of payment by receiving no less than the gross receipts amount of the remaining portion of the proceeds in its bank account. In the case of advance or progress payments, each payment constitutes a payment for receipt of payment purposes.

(ii) *Direct costs of receipt of payment.* Direct costs of receiving payment include the expenses of maintaining a bank account of the FSC in which payment is deposited, any fees or service charges incurred for converting the payment into U.S. currency, and any transfer fees incurred with respect to the transfer of funds into and out of the FSC's bank account in accordance with the 35 calendar day rule in paragraph (d)(2)(iii) of this section. The transfer fees and the fees or service charges incurred for currency conversion are considered to be foreign direct costs of receiving payment; however, exchange losses are not costs of receiving payment.

(iii) *Location of receipt of payment.* The location of this activity is the office of the banking institution at which the account is maintained. If payment is made by the purchaser directly to the FSC or the related supplier in the United States, and the FSC or related supplier transfers the gross receipts amount associated with the transaction to a bank account of the FSC outside the United States after receipt of payment (i.e., cash, check, wire transfer, etc.), but no later than 35 calendar days after receipt of good funds (i.e., the clearance of the check) the FSC is considered to have received payment outside the United States. Therefore, all transfer fees and the costs of the foreign bank account are treated as foreign direct costs. The United States bank costs are disregarded. If, however, the related supplier does not transfer the gross receipts amount within 35 calendar days, United States bank costs are not disregarded and are domestic direct costs. In either case, the transfer costs, currency conversion charges, and foreign bank costs remain foreign direct costs. The preceding rules apply both to commission FSCs and buy-sell FSCs.

(iv) *Examples.* The principles of paragraph (d)(2) of this section may be illustrated by the following examples:

*Example 1.* A FSC earns commissions on sales of export property by its related supplier. The related supplier manufactures and sells its export property to its foreign subsidiaries for resale in their respective countries. From time to time, the foreign subsidiaries will return products to the related supplier for credit and, from time to time, the foreign subsidiaries purchase products in their respective countries and sell such products to the related supplier. These transactions result in various amounts being owed to the foreign subsidiaries. Each month the various inter-company obligations are reviewed. The result of such review of intercompany indebtedness is a netting out of the various intercompany liabilities on the books, to the extent possible, and a flow of funds for the net obligation. Due to the nature of these transactions, the amounts owed by the foreign subsidiaries exceed the amounts which the related supplier owes to the foreign subsidiaries. The gross receipts amount (*i.e.,* 1.83 percent of this net amount) is credited to the FSC's bank account. This constitutes receipt of payment for purposes of paragraph (d)(2)(i) of this section.

*Example 2.* In a leveraged lease transaction, a FSC-lessor obtains purchase financing from a lending institution. The lending institution retains a security interest in the proceeds and requires that a portion of each rental payment be paid by the lessee directly to the lending institution. Since the FSC is precluded from receiving a portion of the proceeds of the export transaction, the FSC may satisfy the receipt of payment requirement by receiving the gross receipts amount with respect to the remaining proceeds.

*Example 3.* A buy-sell FSC sells its export property to a foreign customer and is paid by means of a ''draw-down'' letter of credit. Over a substantial period of time prior to delivery of the export property, amounts are advanced to the FSC under the letter of credit. At delivery, the remaining amount available is paid. Each payment made to the FSC constitutes a payment for receipt of payment purposes and thus the gross receipts amount related to each payment must be credited to the FSC's bank account.

*Example 4.* An FSC earns commissions on sales of export property by its related supplier. The related supplier regularly collects payments from its foreign customers in a San Francisco bank account and, after the San Francisco bank has collected on the checks, transfers, within 35 calendar days, the gross receipts amounts from its New York bank account to the FSC's bank account located outside the United States. The FSC incurred transfer fees of $160X in addition to a fee of $35X for the maintenance of

the FSC's bank account outside the United States during the 35 calendar day period. The maintenance fee relating to the United States bank account for the 35 calendar day period is $45X. The receipt of payment test is met because the gross receipts amounts are transferred after payment but within 35 calendar days to the FSC's bank account located outside the United States. The transfer fees of $160X and the maintenance fee of $35X relating to the FSC's foreign bank account are foreign direct costs. The $45X maintenance fee related to the United States bank account is not a direct cost. If the gross receipts amounts had not been transferred to the FSC's foreign bank account within 35 calendar days, the $45X maintenance fee related to the United States bank account would be considered a United States direct cost. The transfer fee of $160X and the maintenance fee of $35X relating to the FSC's foreign bank account, however, would, nonetheless, be considered as foreign direct costs. The same funds received in San Francisco need not be transferred to the FSC's foreign bank account because money is fungible. For the same reason, the gross receipts amounts need not be transferred from the same bank account in which the payments are received.

(e) *Assumption of credit risk*—(1) *Assumption of credit risk defined.* For purposes of section 924(e), the assumption of credit risk means bearing the economic risk of nonpayment with respect to a transaction. If the FSC is acting as a commission agent for the related supplier, this risk is borne by the FSC if the commission contract transfers the costs of the economic risk of nonpayment with respect to the transaction from the related supplier to the FSC. The FSC may elect on its annual return to bear the economic risk of nonpayment with respect to its transactions during a taxable year by either—

(i) Assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section,

(ii) Obtaining insurance to cover nonpayment,

(iii) Investigating credit of a customer or a potential customer,

(iv) Factoring trade receivables, or

(v) Selling by means of letters of credit or banker's acceptances.

Only the alternative elected to be performed by the FSC during a taxable year is relevant for purposes of section 924(d). For example, if a buy-sell FSC elects to bear the economic risk of nonpayment with respect to its transaction during a taxable year by assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section, and also factors the transaction's trade receivables, only the direct costs of assuming the risk of a bad debt are relevant for purposes of section 924(d). For purposes of this paragraph, a potential customer is an unrelated person who is engaged in the purchase or sale of export property on whom an investigation is performed, but with whom no export sales contract is executed.

(2) *Direct costs of assumption of credit risk.* (i) With respect to assuming the risk of a bad debt, the direct costs of the assumption of credit risk in the case of a buy-sell FSC include debts that become uncollectible and charges taken into account in determining additions to bad debt reserves of the FSC. In the case of a commission FSC, the direct costs of the assumption of credit risk include the assumption of the debts and charges of the related supplier attributable to export sales that are allowed as deductions under section 166.

(ii) With respect to insurance, the direct costs of the assumption of credit risk are the costs of obtaining insurance against the risk of nonpayment. Qualifying insurance must be obtained from an unrelated insurer and must cover the risk of nonpayment due to default and bankruptcy by the purchaser. Insurance obtained from a related insurer, or insurance that covers default and bankruptcy due to risks of war or political unrest without covering ordinary default or bankruptcy is not sufficient.

(iii) With respect to investigating credit, the direct costs of assumption of credit risk are the external costs of investigating credit for customers or potential customers, including costs of membership in a credit agency or association for that purpose (but not the costs of approving credit by an internal credit agency).

(iv) With respect to factoring trade receivables, the direct costs of assumption of credit risk are the costs of factoring trade receivables of related and unrelated customers (*e.g.* the amount of the discount and the fees relating to factoring).

(v) With respect to letters of credit or banker's acceptances, the direct costs of assumption of credit risk are the costs of letters of credit or banker's acceptances and the documentary collection costs.

(3) *Location of assumption of credit risk.* The location of the activity of assumption of credit risk is the location of the customer or obligor whose payment is at risk, except that the location of investigating credit is the location of the credit agency or association performing the investigation. A foreign branch of a United States corporation and a foreign office of the United States government are not foreign obligors for purposes of this test. A foreign branch of a United States credit investigation agency or association, however, is treated as located outside the United States.

(4) *Special rules*—(i) *Assuming the risk of a bad debt*—(A) *In general.* If a FSC chooses to bear the economic risk of nonpayment by assuming the risk of a bad debt with respect to a transaction or grouping of transactions and an actual bad debt loss on a foreign trading gross receipt is not incurred in any three consecutive years, the FSC will be deemed to have performed this activity during the first two years of the three year period. For the third year, the FSC will not be deemed to have performed this activity and must satisfy the 85 percent foreign direct costs test by satisfying any two paragraphs included within section 924(e) other than assumption of credit risk activity under section 924(e)(5). An actual bad debt loss will only satisfy the activity test with respect to a single three consecutive year period.

(B) *Example.* The principles of this paragraph may be illustrated by the following example:

*Example.* In year 1, a related supplier of a commission FSC incurs a bad debt with respect to foreign trading gross receipts owed by a foreign obligor. This expense is the only bad debt incurred with respect to foreign trading gross receipts in year 1. Therefore, the direct costs for the bearing of the economic risk of nonpayment for year 1 are all foreign direct costs and the 85-percent test is satisfied. In year 2, the FSC incurs a bad debt with respect to a U.S. broker/consolidator. The direct costs for year 2 are U.S. direct costs and, therefore, the 85-percent test is not satisfied. No bad debt is incurred in year 3. Because a bad debt with respect to a foreign obligor is incurred in year 1, the FSC is deemed to have satisfied the economic risk of nonpayment for each of years 1, 2 and 3.

(ii) *Grouping with respect to other risk activities.* For taxable years beginning after February 19, 1987, if a FSC elects to bear the economic risk of nonpayment by performing one of the activities described in paragraph (e) of this section and elects to group transactions, it is considered to have performed the elected activity with respect to all transactions within the group during the taxable year if it performs the activity in accordance with the following rules. If a FSC elects to factor trade receivables, at least 20 percent of the face amount of a group's receivables must be factored. If a FSC elects to sell by means of letters of credit or banker's acceptances, a fee must be incurred with respect to 20 percent of the foreign trading gross receipts attributable to sales within the group. If the FSC elects to obtain insurance to cover nonpayment, 20 percent of the face amount of receivables attributable to sales included in the §1.924(d)–1(e) grouping elected by the FSC must be insured. If a FSC elects to investigate credit of customers or potential customers, 20 percent of new or potential customers for which a credit investigation is performed must be investigated.

[T.D. 8125, 52 FR 5094, Feb. 19, 1987]

### § 1.925(a)–1 Transfer pricing rules for FSCs.

(a)–(c)(7) [Reserved]. For further guidance, see §1.925(a)–1T(a) through (c)(7).

(c)(8) *Grouping transactions.* (i) The determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines. The election to group transactions shall be evidenced on Schedule P of the FSC's U.S. income tax return for the taxable year. No untimely or amended returns filed later than one

year after the due date of the FSC's timely filed (including extensions) U.S. income tax return will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis (collectively ''grouping redeterminations''). The rule of the previous sentence is applicable to taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000. Notwithstanding the time limits for filing grouping redeterminations otherwise specified in the previous three sentences, a grouping redetermination may be made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. In addition, any grouping redeterminations made under this paragraph must meet the requirements under §1.925(a)–1T(e)(4) with respect to redeterminations other than grouping. The language ''or grouping of transactions'' is removed from the fourth sentence of §1.925(a)–1T(e)(4), applicable to taxable years beginning after December 31, 1997. See also §1.925(b)–1T(b)(3)(i).

(c)(8)(ii)–(f) [Reserved]. For further guidance, see §1.925(a)–1T(c)(8)(ii) through (f).

(g) *Effective date.* The provisions of this section apply on or after March 2, 2001.

[T.D. 8944, 66 FR 13428, Mar. 6, 2001]

### § 1.925(a)–1T Temporary regulations; transfer pricing rules for FSCs.

(a) *Scope*—(1) *Transfer pricing rules.* In the case of a transaction described in paragraph (b) of this section, section 925 permits a related party to a FSC to determine the allowable transfer price charged the FSC (or commission paid to the FSC) by its choice of the three transfer pricing methods described in paragraphs (c)(2), (3), and (4) of this section: The ''1.83 percent'' gross receipts method and the ''23 percent'' combined taxable income method (the administrative pricing rules) of section 925(a)(1) and (2), respectively, and the section 482 method of section 925(a)(3). (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) Subject to the special no-loss rule of §1.925(a)–1T(e)(1)(iii), any, or all, of the transfer pricing methods may be used in the same taxable year of the FSC for separate transactions (or separate groups of transactions). If either of the administrative pricing methods (the gross receipts method or combined taxable income method) is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations under that section. The transfer price charged the FSC (or the commission paid to the FSC) on a transaction with a person that is not a related party to the FSC may be determined in any manner agreed to by the FSC and that person. However, the Commissioner will use special scrutiny to determine whether a person selling export property to a FSC (or paying a commission to a FSC) is a related party to the FSC with respect to a transaction if the FSC earns a profit on the transaction in excess of the profit it would have earned had the administrative pricing rules applied to the transaction.

(2) *Special rules.* For rules as to certain ''incomplete transactions'' and for computing full costing combined taxable income, see paragraphs (c)(5) and (6) of this section. For a special rule as to cooperatives and computation of their combined taxable incomes, see paragraph (c)(7) of this section. Grouping of transactions for purposes of applying the administrative pricing method chosen is provided for by paragraph (c)(8) of this section.

The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a FSC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For a rule providing for the recovery of the FSC's costs in an overall loss situation, see

paragraph (e)(1)(i) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the FSC to related persons or to sales between related persons prior to the sale to the FSC. Paragraph (e)(3) of this section provides for the creation of receivables if the transfer price, rental payment, commission or payment for services rendered is not paid by the due date of the FSC's income tax return for the taxable year under section 6072(b), including extensions provided for by section 6081. Provisions for the subsequent determination and further adjustment to the relevant amounts are set forth in paragraphs (e)(4) and (5) of this section. Paragraph (f) of this section has several examples illustrating the provisions of this section. Section 1.925(b)–1T prescribes the marginal costing rules authorized by section 925(b)(2). Section 1.927(d)–2T provides definitions of related supplier and related party.

(3) *Performance of substantial economic functions*—(i) *Administrative pricing methods.* The application of the administrative pricing methods of section 925 (a)(1) and (2) does not depend on the extent to which the FSC performs substantial economic functions beyond those required by section 925(c). See paragraph (b)(2)(ii) of this section and §1.924(a)–1T(i)(1).

(ii) *Section 482 method.* In order to apply the section 482 method of section 925(a)(3), the arm's length standards of section 482 and the regulations under that section must be satisfied. In applying the standards of section 482, all of the rules of section 482 will apply. Thus, if the FSC would not be recognized as a separate entity, it would also not be recognized on application of the section 482 method. Similarly, if a FSC performs no substantial economic function with respect to a transaction, no income will be allocable to the FSC under the section 482 method. See §1.924(a)–1T(i)(2). If a related supplier performs services under contract with a FSC, the FSC will not be deemed to have performed substantial economic functions for purposes of the section 482 method unless it compensates the related supplier under the provisions of §1.482–2(b)(1) through (7). See §1.925(a)–1T(c)(6)(ii) for the applicability of the regulations under section 482 in determination of the FSC's profit under the administrative pricing methods.

(b) *Transactions to which section 925 applies*—(1) *In general.* The transfer pricing methods of section 925 (the administrative pricing methods and the section 482 method) will apply, generally, only if a transaction, or group of transactions, gives rise to foreign trading gross receipts (within the meaning of section 924(a) and §1.924(a)–1T) to the FSC (or small FSC, as defined in section 922(b) and §1.921–2(b) (Q&A3)). However, the transfer pricing methods will apply as well if the FSC is acting as commission agent for a related supplier with regard to a transaction, or group of transactions, on which the related supplier is the principal if the transaction, or group of transactions, would have resulted in foreign trading gross receipts had the FSC been the principal.

(2) *Application of the transfer pricing rules*—(i) *Section 482 method.* The section 482 transfer pricing method may be applied to any transaction between a related supplier and a FSC if the requirements of paragraph (a)(3)(ii) of this section have been met.

(ii) *Administrative pricing methods.* The administrative pricing methods may be applied in situations in which the FSC is either the principal or commission agent on the transaction, or group of transactions, only if the requirements of section 925(c) are met. Section 925(c) requires that the FSC performs all the activities described in subsections (d)(1)(A) and (e) of section 924 that are attributable to a particular transaction, or group of transactions. The FSC need not perform any activities with respect to a particular transaction merely to comply with section 925(c) if that activity would not have been performed but for the requirements of that subsection. The FSC need not perform all of the activities outside the United States. None of the activities need be performed outside the United States by a small FSC. Rather than the FSC itself performing the activities required by section 925(c), another person under contract, written or oral, directly or indirectly,

with the FSC may perform the activities (see §1.924(d)–1(b)). If a related supplier is performing the required activities on behalf of the FSC with regard to a transaction, or group of transactions, the requirements of section 925(c) will be met if the FSC pays the related supplier an amount equal to the direct and indirect expenses related to the required activities. See paragraph (c)(6)(ii) of this section for the amount of compensation due the related supplier. The payment made to the related supplier must be reflected on the FSC's books and must be taken into account in computing the FSC's and related supplier's combined taxable income. If it is determined that the related supplier was not compensated for all the expenses related to the required activities or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. At the election of the FSC and related supplier, the requirements of section 925(c) will be deemed to have been met if the related supplier is paid by the FSC an amount equal to all of the costs under paragraph (c)(6)(iii)(D) of this section (limited by paragraph (c)(6)(ii) of this section) related to the export sale, other than expenses relating to activities performed directly by the FSC or by a person other than the related supplier, and if that payment is reflected on the FSC's books and in computing the FSC's and related supplier's combined taxable income on the transaction, or group of transactions. If it is determined that the related supplier was not compensated for all its expenses or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. All activities that are performed in connection with foreign military sales are considered to be performed by the FSC, or under contract with the FSC, if they are performed by the United States government even though the United States government has not contracted for the performance of those activities. All actual costs incurred by the FSC and related supplier in connection with the performance of those activities must be taken into account, however, in determining the combined taxable income of the FSC and related supplier.

(iii) *Allowable transactions for purposes of the administrative pricing methods.* If the required performance of activities has been met, the administrative pricing methods may be applied to a transaction between a related supplier and a FSC only in the following circumstances.

(A) The related supplier sells export property (as defined in section 927(a) and §1.927(a)–1T) to the FSC for resale or the FSC acts as a commission agent for the related supplier on sales by the related supplier of export property to third parties, whether or not related parties. For purposes of this section, references to sales include references to exchanges or other dispositions.

(B) The related supplier leases export property to the FSC for sublease for a comparable period with comparable terms of payment, or the FSC acts as commission agent for the related supplier on leases of export property by the related supplier, to third parties whether or not related parties.

(C) Services are furnished by a FSC as principal or by a related supplier if a FSC is a commission agent for the related supplier which are related and subsidiary to any sale or lease by the FSC, acting as principal or commission agent, of export property under subdivision (iii)(A) and (B) of this paragraph.

(D) Engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by the FSC if the FSC is acting as principal, or by the related supplier if the FSC is a commission agent for the related supplier, with respect to the furnishing of the services to a third party whether or not a related party.

(E) The FSC acting as principal, or the related supplier where the FSC is a

commission agent, furnishes managerial services in furtherance of the production of foreign trading gross receipts of an unrelated FSC or the production of qualified export receipts of an unrelated interest charge DISC.

This subdivision (iii)(E) shall not apply for any taxable year unless at least 50 percent of the gross receipts for such taxable year of the FSC or of the related supplier, whichever party furnishes the managerial services, is derived from activities described in subdivision (iii)(A), (B), or (C) of this paragraph.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a FSC in the case of a sale, described in paragraph (b)(2)(iii)(A) of this section, of export property.

(2) *The ''1.83 percent'' gross receipts method.* Under the gross receipts method of pricing, described in section 925(a)(1), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. Pursuant to section 925(d), the amount of profit derived by the FSC under this method may not exceed twice the amount of profit determined under, at the related supplier's election, either the combined taxable income method of §1.925(a)–1T(c)(3) or the marginal costing rules of §1.925(b)–1T. For FSC taxable years beginning after December 31, 1986, if the related supplier elects to determine twice the profit determined under the combined taxable income method using the marginal costing rules, because of the no-loss rule of §1.925(a)–1T(e)(1)(i), the profit that may be earned by the FSC is limited to 100% of the full costing combined taxable income as determined under §1.925(a)–1T(c)(3) and (6). Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(3) *The ''23 percent'' combined taxable income method.* Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

(4) *Section 482 method.* If the methods of paragraph (c)(2) and (3) of this section are inapplicable to a sale or if the related supplier does not choose to use them, the transfer price for a sale by the related supplier to the FSC is to be determined on the basis of the sales price actually charged but subject to the rules provided by section 482 and the regulations for that section and by §1.925(a)–1T(a)(3)(ii).

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, if export property which the FSC purchased from the related supplier is not resold by the FSC before the close of either the FSC's taxable year or the taxable year of the related supplier during which the export property was purchased by the FSC from the related supplier, then—

(A) The transfer price of the export property sold by the FSC during that year shall be computed separately from the transfer price of the export property not sold by the FSC during that year.

(B) With respect to the export property not sold by the FSC during that year, the transfer price paid by the FSC for that year shall be the related supplier's cost of goods sold (see paragraph (c)(6)(iii)(C) of this section) with respect to the property.

(C) For the subsequent taxable year during which the export property is resold by the FSC, an additional amount shall be paid by the FSC (to be treated as income for the later year in which it is received or accrued by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the FSC by the related supplier and the resale by the FSC taken place during the taxable year of the FSC during which it resold the property over the amount already paid under subdivision (B) of this paragraph.

(D) The time and manner of payment of transfer prices required by subdivisions (i)(B) and (C) of this paragraph shall be determined under paragraphs (e)(3), (4) and (5) of this section.

(ii) For purposes of this paragraph, a FSC may determine the year in which it received property from a related supplier and the year in which it resells property in accordance with the method of identifying goods in its inventory properly used under section 471 or section 472 (relating respectively to the general rule for inventories and to the rule for LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this paragraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see paragraph (c)(6)(iii)(C) of this section).

(6) *Full costing combined taxable income*—(i) *In general.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see §1.471–11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of §1.482–2(b) (1) through (6). Section 1.482–2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (*i.e.*, the related supplier) or the member receiving the benefit of the services (*i.e.*, the FSC), shall not apply if the administrative pricing methods of section 925(a)(1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482–2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See §1.925(a)–1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs.* In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii)(A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and §1.924(a)–1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of §1.61–3. See sections 471 and 472

and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631–1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in §1.861–8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) *Cooperatives and combined taxable income method.* If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382 (b) and (c) for patronage dividends, per-unit retain allocations and nonpatronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) [Reserved]. For further guidance, see §1.925(a)–1(c)(8)(i).

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and §1.923–1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923(a)(4) increases the amount of the FSC's exempt foreign trade income with regard to sales of these products, see §1.923–1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping

rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see §1.924(d)–1(e)).

(d) *Rules under section 925(a)(1) and (2) for transactions other than sales by a FSC.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales by a FSC.

(1) *Leases.* In the case of a lease of export property by a related supplier to a FSC for sublease by the FSC, the amount of rent the FSC must pay to the related supplier shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. Transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(8) of this section as to combine in any one group of transactions both lease transactions and sale transactions.

(2) *Commissions.* If any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC and if commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly then—

(i) The administrative pricing methods of section 925(a)(1) and (2) may be used to determine the FSC's commission income only if the requirements of section 925(c) (relating to activities that must be performed in order to use the administrative pricing methods) are met, see §1.925(a)–1T(b)(2)(ii).

(ii) The amount of the income that may be earned by the FSC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method if the related supplier had sold (or leased) the property or service to the FSC and the FSC had in turn sold (or subleased) to a third party, whether or not a related party.

(iii) The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see §1.471–11(c)(2)(ii)) which relate to the gross receipts from the transaction. The related supplier's gross receipts for purposes of the administrative pricing methods shall be reduced by carrying charges, if any, as computed under §1.927(d)–1(a)(Q&A2). These carrying charges shall remain income of the related supplier.

(iv) The maximum commission the FSC may charge the related supplier is the amount of income determined under subdivisions (ii) and (iii) of this paragraph plus the FSC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(2)(iii)(C) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between

the FSC and its related supplier and the accounting method otherwise employed by the FSC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* Income from the performance of related and subsidiary services will be treated as a separate type of income if subdivision (i) of this paragraph does not apply. Income from the performance of engineering and architectural services and certain managerial services, as defined in paragraphs (b)(2)(iii)(D) and (E), respectively, of this section, will in all situations be treated as separate types of income. If this subdivision (ii) applies, the amount of taxable income which the FSC may derive for any taxable year shall be determined under the arrangement between the FSC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the transfer pricing rules of section 925. Related and subsidiary services to which the above subdivision (i) of this paragraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(8) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the products or product lines were sold or in which payment for the services is received or accrued. Grouping of transactions shall not be allowed with respect to the determination of taxable income which the FSC may derive from services described in paragraph (b)(2)(iii)(D) or (E) of this section whether performed by the FSC or by the related supplier. Those determinations shall be made only on a transaction-by-transaction basis.

(e) *Special rules for applying paragraphs (c) and (d) of this section*—(1) *Limitation on FSC income (''no loss'' rules).* (i) If there is a combined loss on a transaction or group of transactions, a FSC may not earn a profit under either the combined taxable income method or the gross receipts method. Also, for FSC taxable years beginning after December 31, 1986, in applying the gross receipts method, the FSC's profit may not exceed 100% of full costing combined taxable income determined under the full costing method of §1.925(a)–1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. The related supplier may in all situations set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its costs, if any, even if to do so would create, or increase, a loss in the related supplier.

(ii) For purposes of determining whether a combined loss exists, the basis for grouping transactions chosen by the related supplier under paragraph (c)(8) of this section for the taxable year shall apply.

(iii) If a FSC recognizes income while the related supplier recognizes a loss on a sale transaction under the section 482 method, neither the combined taxable income method nor the gross receipts method may be used by the FSC and related supplier (or by a FSC in the same controlled group and the related supplier) for any other sale transaction, or group of sale transactions, during a year which fall within the same three digit Standard Industrial Classification as the subject sale transaction. The reason for this rule is to prevent the segregation of transactions for the purposes of allowing the related supplier to recognize a loss on the subject transactions, while allowing the FSC to earn a profit under the administrative pricing methods on other transactions within the same three digit Standard Industrial Classification.

(2) *Relationship to section 482.* In applying the administrative pricing methods, it may be necessary to first take into account the price of a transfer (or other transaction) between the related supplier (or FSC) and a related party which is subject to the arm's length standard of section 482. Thus, for example, if a related supplier sells to a FSC export property which the related supplier purchased from related parties, the costs taken into account in

computing the combined taxable income of the FSC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a FSC to a related party, the parties are treated as if they were a single entity carrying on all the functions performed by the FSC and the related supplier with respect to the transaction. The FSC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no FSC.

(3) *Creation of receivables.* (i) If the amount of the transfer price or rental payment actually charged by a related supplier to a FSC or the sales commission actually charged by a FSC to a related supplier has not been paid, an account receivable and payable will be deemed created as of the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC during which a transaction to which section 925 is applicable occurs. The receivable and payable will be in an amount equal to the difference between the amount of the transfer price or rental payment or commission determined under section 925 and this section and the amount (if any) actually paid or received. For example, a calendar year FSC's related supplier paid the FSC on July 1, 1985, a commission of $50 on the sale of export property. On September 15, 1986, the extended due date of the FSC's income tax return for taxable year 1985, the related supplier determined that the commission should have been $60. The additional $10 of commission had not been paid. Accordingly, an interest-bearing payable to the FSC from the related supplier in the amount of $10 was created as of September 15, 1986. A $10 interest bearing receivable was also created on the FSC's books.

(ii) An indebtedness arising under the above subdivision (i) shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2), from the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC in which the transaction occurred which gave rise to the indebtedness to the date of payment of the indebtedness. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid if that person is an accrual basis taxpayer or when the interest is paid if a cash basis taxpayer. Because the transactions covered by this subdivision are between the related supplier and FSC, the carrying charges provisions of §1.927(d)–1(a) do not apply.

(iii) Payment of dividends, transfer prices, rents, commissions, service fees, receivables, or payables may be in the form of money, property, sales discount, or an accounting entry offsetting the amount due the related supplier, or FSC, whichever applies, against an existing debt of the other party to the transaction. This provision does not eliminate the requirement that actual cash payments be made by the related supplier to a commission FSC if the receipt of payment test of section 924(e)(4) is used to meet the foreign economic process requirements of section 924(d). The offset accounting entries must be clearly identified in both the related supplier's and FSC's books of account.

(4) *Subsequent determination of transfer price, rental income or commission.* The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the Commissioner may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and §1.861–8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the FSC and related supplier if their taxable years are still open under the statute of limitations for making

claims for refund under section 6511 if they determine that a different transfer pricing method may be more beneficial. Also, the FSC and related supplier may redetermine the amount of foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the FSC and the related supplier. The FSC and the related suppler may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa.

(5) *Procedure for adjustments to redeterminations.* (i) If a redetermination under paragraph (e)(4) of this section is made of the transfer price, rental payment or commission for a transaction, or group of transactions, the person who was underpaid under this redetermination shall establish (or be deemed to have established), at the date of the redetermination, an account receivable from the person with whom it engaged in the transaction equal to the difference between the amounts as redetermined and the amounts (if any) previously paid and received, plus the amount (if any) of the account receivable determined under paragraph (e)(3) of this section that remains unpaid. A corresponding account payable will be established by the person who underpaid the amount due.

(ii) An account receivable established in accordance with the above subdivision (5)(i) of this paragraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2), from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxable income for each taxable year during which the account receivable is outstanding of an accrual basis taxpayer or when paid if a cash basis taxpayer.

(iii) In lieu of establishing an account receivable in accordance with the above subdivision (5)(i) of this paragraph for all or part of an amount due a related supplier, the related supplier and FSC are permitted to treat all or part of any current or prior distribution which was made by the FSC as an additional payment of transfer price or rental payment or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the redetermination due the related supplier after this treatment shall be represented by an account receivable established under the above subdivision (5)(i) of this paragraph. To the extent that a distribution is so treated under this subdivision (5)(iii), it shall cease to qualify as a distribution for any Federal income tax purpose. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (5)(iii), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. The Commissioner may prescribe by Revenue Procedure conditions and procedures that must be met in order to obtain the relief provided by this subdivision (5)(iii).

(iv) The procedure for adjustments to transfer price provided by this paragraph does not apply to incomplete transactions described in paragraph (c)(5) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

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

*Example 1.* In 1985, F, a FSC, purchases export property from R, a domestic manufacturer of export property A. R is F's related supplier. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section 925. F resells property A in 1985 to an unrelated purchaser for $1,000. The terms of the sales contract between F and the unrelated purchaser provide that payment of the $1,000 sales price will be made within 90 days after sale. The purchaser pays the entire sales price within 60 days. F incurs indirect and direct expenses in the amount of $260 attributable to the sale which relate to the activities and functions referred to in section 924 (c), (d) and (e). In addition, F incurs additional expenses attributable to the sale in the amount of $35. R's cost of goods sold attributable to the export

property is $550. R incurred direct selling expenses in connection with the sale of $50. R's deductible general and administrative expenses allocable to all gross income are $200. Apportionment of those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is $17,550 resulting in total gross income of R and F (excluding the transfer price paid by F) of $18,000 ($450 plus $17,550). For purposes of this example, it is assumed that if R sold the export property to F for $690, the price could be justified as satisfying the standards of section 482. Under these facts, F may earn, under the combined taxable income method, the more favorable of the three transfer pricing rules, a profit of $23 on the sale. (Unless otherwise indicated, all examples in this section assume that the marginal costing method of §1.925(b)–1T does not result in a higher profit than the profit under the full costing combined taxable income method of paragraphs (c)(3) and (6) of this section.) F's profit and the transfer price to F from the transaction, using the administrative pricing methods, and F's profit if the transfer price is determined under section 482, would be as follows:

| | |
|---|---|
| Combined taxable income: | |
| F's foreign trading gross receipts | $1,000.00 |
| R's cost of goods sold | (550.00) |
| Combined gross income | 450.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| F's expenses | 295.00 |
| Apportionment of R's general and administrative expenses: | |
| R's total G/A expenses | 200.00 |
| Combined gross income | 450.00 |
| R's and F's total gross income (foreign and domestic) | 18,000.00 |
| Apportionment of G/A expenses: $200×$450/$18,000 | 5.00 |
| Total | (350.00) |
| Combined taxable income | 100.00 |
| The section 482 method—Transfer price to F and F's profit: | |
| Transfer price to F | $690.00 |
| F's profit: | |
| F's foreign trading gross receipts | 1,000.00 |
| Less: | |
| F's cost of goods sold | 690.00 |
| F's expenses | 295.00 |
| Total | (985.00) |
| F's profit | 15.00 |

| | |
|---|---|
| The gross receipts method— | |
| F's profit and transfer price to F: | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts ($18.30) or two times F's profit under the combined taxable income method ($46.00) (See below) (Unless otherwise indicated, all examples in this section assume that the marginal costing method of §1.925(b)–1T does not result in a higher profit than the profit under the full costing combined taxable income method) | 18.30 |
| Transfer price to F: | |
| F's foreign trading gross receipts | 1,000.00 |
| Less: | |
| F's expenses | 295.00 |
| F's profit | 18.30 |
| Total | (313.30) |
| Transfer price | 686.70 |
| The combined taxable income method—F's profit and transfer price to F: | |
| F's profit—23% of combined taxable income ($100) | $23.00 |
| Transfer price to F: | |
| F's foreign trading gross receipts | 1,000.00 |
| Less: | |
| F's expenses | 295.00 |
| F's profit | 23.00 |
| Total | (318.00) |
| Transfer price | 682.00 |

With a profit of $23 under the most favorable of the transfer pricing methods, F's exempt foreign trade income under section 923 would be $207.39, computed as follows:

| | |
|---|---|
| F's foreign trading gross receipts | $1,000.00 |
| F's costs of purchases (transfer price) | (682.00) |
| F's foreign trade income | 318.00 |
| F's exempt foreign trade income $318×15/23 | 207.39 |
| F's taxable income would be $8.00, computed as follows: | |
| F's foreign trade income | $318.00 |
| F's exempt foreign trade income | (207.39) |
| F's non-exempt foreign trade income | 110.61 |
| Less: | |
| F's expenses allocable to non-exempt foreign trade income $295×$110.61/$318 | (102.61) |
| F's taxable income | 8.00 |

Of F's total expenses, $192.39 ($295×$207.39/$318) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

*Example 2.* Assume the same facts as in *Example 1* except that the purchaser pays the entire sales price 96 days after delivery, well beyond the 60 day period in which payment

must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of $1,000 includes $10 of carrying charges, assuming a discount rate of 10%. See §1.927(d)–1(a) (Q & A2) for computation method for determining amount of carrying charges. Under these facts, F may earn, under the combined taxable income method, the most favorable of the three transfer pricing rules, a profit of $20.73 on the sale. F's profit and the transfer price to F under the transfer pricing rules, assuming that a carrying charge is incurred, would be as follows:

| | |
|---|---|
| Combined taxable income: | |
| F's foreign trading gross receipts | $990.00 |
| R's cost of goods sold | (550.00) |
| Combined gross income | 440.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| R's apportioned G/A expenses: | |
| $200×$440/$18,000 | 4.89 |
| F's expenses | 295.00 |
| Total | (349.89) |
| Combined taxable income | 90.11 |
| The combined taxable income method—F's profit and transfer price to F: | |
| F's profit—23% of combined taxable income ($90.11) | $20.73 |
| Transfer price to F: | |
| F's foreign trading gross receipts | 990.00 |
| Less: | |
| F's expenses | 295.00 |
| F's profit | 20.73 |
| Total | (315.73) |
| Transfer price | 674.27 |
| The gross receipts method—F's profit and transfer price to F: | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts ($18.12) or two times F's profit under the combined taxable income method ($41.46) | $18.12 |
| Transfer price to F: F's foreign trading gross receipts | 990.00 |
| Less: | |
| F's expenses | 295.00 |
| F's profit | 18.12 |
| Total | (313.12) |
| Transfer price | 676.88 |
| The section 482 method—Transfer price to F and F's profit: | |
| Transfer price to F | 690.00 |
| F's profit: | |
| F's foreign trading gross receipts | 990.00 |
| Less: | |
| F's cost of goods sold | 690.00 |
| F's expenses | 295.00 |
| Total | (985.00) |
| F's profit | 5.00 |

*Example 3.* R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells a product line of export property to F for $157, a price which can be justified as satisfying the arm's length price standard of section 482. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section 925. F resells the export property for $200. R's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.*, $200 minus $115). R incurs $18 in direct selling expenses in connection with the sale of the property. R's deductible general and administrative expenses allocable to all gross income are $120. R's direct selling and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is $5,015 resulting in total gross income of R and F (excluding the transfer price paid by F) of $5,100 (*i.e.*, $85 plus $5,015). F incurs $50 in direct and indirect expenses attributable to resale of the export property. Of those expenses, $45 relate to activities and functions referred to in section 924 (c), (d) and (e). The maximum profit which F may earn with respect to the product line is $3.66, computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| F's foreign trading gross receipts | $200.00 |
| R's cost of goods sold | (115.00) |
| Combined gross income | 85.00 |
| Less: | |
| R's direct selling expenses | 18.00 |
| R's apportioned G/A expenses: | |
| $120×$85/$5,100 | 2.00 |
| F's expenses | 50.00 |
| Total | (70.00) |
| Combined taxable income | 15.00 |
| *The combined taxable income method—F's profit:* | |
| F's profit—23% of combined taxable income ($15) | $ 3.45 |
| *The gross receipts method—F's profit:* | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts ($3.66) or two times F's profit under the combined taxable income method ($6.90) | $3.66 |
| *The section 482 method—F's profit:* | |
| F's foreign trading gross receipts | 200.00 |
| Less: | |
| F's cost of goods sold | 157.00 |

| | |
|---|---|
| F's expenses | 50.00 |
| Total | (207.00) |
| F's profit (loss) | (7.00) |

Since the gross receipts method results in a greater profit to F ($3.66) than does either the combined taxable income method ($3.45) or the section 482 method (a loss of $7), and does not exceed twice the profit under the combined taxable income method, F may earn a maximum profit of $3.66. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below $146.34, computed as follows:

| | |
|---|---|
| *Transfer price to F:* | |
| F's foreign trading gross receipts | $ 200.00 |
| Less: | |
| F's expenses | 50.00 |
| F's profit | 3.66 |
| Total | (53.66) |
| Transfer price | 146.34 |

*Example 4*. R and F are fiscal year May 31 year-end taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During August of 1987, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the transfer pricing rules of section 925. Thereafter, the 100 units are resold for export by F for $950. R's cost of goods sold attributable to the 100 units is $650. R incurs costs, both direct and indirect, in the amount of $270 with regard to activities and functions referred to in section 924 (c), (d) and (e) which it was under contract with F to perform for F. R's direct selling expenses are $40. Those expenses were not required to be incurred by F. For purposes of this example, assume that R has no general and administrative expenses other than those relating to the section 924 (c), (d) and (e) activities and functions. F incurs expenses in the amount of $290 attributable to the resale which relate to the activities and functions referred to in section 924 (c), (d) and (e). Of that amount, $270 was paid to R under contract to perform the activities in section 924. The remaining $20 was paid to independent contractors. R chooses not to apply the section 482 transfer pricing method to determine F's profit on the transaction. F may not earn any income under either the gross receipts (see the special no-loss rule of paragraph (e)(1)(i) of this section) or the combined taxable income administrative pricing methods with respect to resale of the 100 units because there is a combined loss of $(30) on the transaction, computed as follows:

| | |
|---|---|
| *Combined taxable income:* | |
| F's foreign trading gross receipts | $ 950.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 300.00 |
| Less: | |
| R's direct selling expenses | 40.00 |
| F's expenses | 290.00 |
| Total | (330.00) |
| Combined taxable income (loss) | (30.00) |

Under paragraph (e)(1)(i) of this section, F is permitted to recover its expenses attributable to the sale ($290) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below $660, computed as follows:

| | |
|---|---|
| Transfer price to F: | |
| F's foreign trading gross receipts | $950.00 |
| Less: | |
| F's expenses | (290.00) |
| Transfer price | 660.00 |

*Example 5*. Assume the same facts as in *Example 4* except that F performs the section 924 (c), (d) and (e) activities and functions and that R chooses to apply the section 482 transfer pricing method. Under the standards of section 482, a transfer price from R to F of $650 is an arm's length price. Accordingly, the transfer price to F and F's profit on the subsequent resale of product A ($10) are as follows:

| | |
|---|---|
| The section 482 method—Transfer price to F and F's profit: | |
| Transfer price to F | $650.00 |
| F's profit: | |
| F's foreign trading gross receipts | 950.00 |
| F's cost of purchases | (650.00) |
| F's gross income | 300.00 |
| Less: | |
| F's expenses | (290.00) |
| F's profit | 10.00 |

This sale of product A results in a loss to R of $40 (transfer price of $650 less R's cost of goods sold of $650 and direct selling expenses of $40). Since R chose to use the section 482 transfer pricing method on this loss transaction, under the special no loss rule of paragraph (e)(1)(iii) of this section, the administrative pricing methods of section 925(a)(1) and (2) may not be used for any other sale transactions, or group of sale transactions, during the same year of other products which fall within the same three digit Standard Industrial Classification as product A. F's profit, if any, on these sales must be

computed under the section 482 transfer pricing method.

*Example 6.* R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures 100 units of export property A. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export property A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925 (a)(1) and (2). Thereafter, the 100 units are sold for export by R for $1,000. The total sales price of $1,000 was paid by the purchaser to R within 60 days of the sales transaction. The entire $1,000 would have been foreign trading gross receipts had F been the principal on the sale. R's cost of goods sold attributable to the 100 units is $650. R's direct selling expenses so attributable are $50. R's deductible general and administrative expenses, other than those attributable to the section 924 (c), (d) and (e) activities and functions, allocable to all gross income are $200. Apportionment of those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and the portion of the general and administrative expenses not relating to the activities and functions referred to in section 924 (c), (d) and (e) were not required to be incurred by F. R's gross income from sources other than the transaction is $17,650 resulting in total gross income of $18,000 ($350 plus $17,650). R and a related person perform on F's behalf the activities and functions referred to in section 924 (c), (d) and (e). In performing these activities, R and the related person incurred expenses, both direct and indirect, of $200 and $45, respectively. F pays $200 to R under contract and $50 to the related person. The maximum profit which F may earn under the franchise pursuant to the administrative pricing rules is $18.30, computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| F's expenses | 250.00 |
| Apportionment of R's general and administrative expenses: | |
| R's total G/A expenses | 200.00 |
| Combined gross income | 350.00 |
| R's and F's total gross income (foreign and domestic) | 18,000.00 |
| Apportionment of G/A expenses: | |
| $200×$350/$18,000 | 3.89 |
| Total | (303.89) |
| Combined taxable income | 46.11 |

As reflected in the above computation, F included on its books $200 of expenses related to the section 924 activities and performed by R on behalf of F. R incurred $253.89 of expenses. These expenses were reflected on its books. Under paragraph (b)(2)(ii) of this section, R and F may elect to include all of the expenses related to the export sales on F's books. This will satisfy the requirements of section 925(c) without requiring an allocation of the expenses between R and F. Under this election, as reflected in the following computation, combined taxable income will still be $46.11 but, as reflected in a later part of this example, the commission due F will be increased by $253.89:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: | |
| F's expenses | (303.89) |
| Combined taxable income | 46.11 |
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income ($46.11) | $10.61 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income method ($21.22) | $18.30 |

If the election provided for in paragraph (b)(2)(ii) of this section is not made, F may receive a commission from R in the amount of $268.30, computed as follows:

| | |
|---|---|
| F's expenses | $250.00 |
| F's profit | 18.30 |
| F's commission | 268.30 |

This $268.30 is F's foreign trade income. F's exempt foreign trade income is $174.98 ($268.30×15/23). F's taxable income is $6.37, computed as follows:

| | |
|---|---|
| F's foreign trade income | $268.30 |
| F's exempt foreign trade income | (174.98) |
| F's non-exempt foreign trade income | 93.32 |
| Less: | |
| F's expenses allocable to non-exempt foreign trade income $250×$93.32/$268.30 | (86.95) |
| F's taxable income | 6.37 |

Of F's total expenses, $163.05 ($250×$174.98/$268.30) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

If R and F make the election provided for in paragraph (b)(2)(ii) of this section, F may receive a commission from R in the amount of $322.19, computed as follows:

| | |
|---|---|
| F's expenses | $303.89 |
| F's profit | 18.30 |
| F's commission | 322.19 |

With this election, this $322.19 is F's foreign trade income. F's exempt foreign trade income is $210.12 ($322.19×15/23). F's taxable income is still $6.37, computed as follows:

| | |
|---|---|
| F's foreign trade income | $322.19 |
| F's exempt foreign trade income | (210.12) |
| F's non-exempt foreign trade income | 112.07 |
| Less: | |
| F's expenses allocable to non-exempt foreign trade income $303.89×$112.07/$322.19 | (105.70) |
| F's taxable income | 6.37 |

Of F's total expenses, $198.19 ($303.89×$210.12/$322.19) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

*Example 7.* Assume the same facts as in *Example 6* except that R's direct selling expenses are $60. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $16.62, computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: | |
| R's direct selling expenses | 60.00 |
| R's apportioned G/A expenses | 3.89 |
| F's expenses | 250.00 |
| | (313.89) |
| Combined taxable income | 36.11 |
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income ($36.11) | 8.31 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts ($ 18.30) or two times F's profit under the combined taxable income method ($16.62) | 16.62 |

F may receive a commission from R in the amount of $266.62, computed as follows:

| | |
|---|---|
| F's expenses | $250.00 |
| F's profit | 16.62 |
| F's commission | 266.62 |

If the election provided for in paragraph (b)(2)(ii) of this section is made by R and F, the profit which F may earn under the franchise pursuant to the administrative pricing rules will remain at $16.62 but will be computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: F's expenses | (313.89) |
| Combined taxable income | 36.11 |
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income ($36.11) | 8.31 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income method ($16.62) | 16.62 |

F may receive a commission from R in the amount of $330.51, computed as follows:

| | |
|---|---|
| F's expenses | 313.89 |
| F's profit | 16.62 |
| F's commission | 330.51 |

As illustrated by *Example 6*, F's exempt taxable income and taxable income will be the same regardless of which method is used to compute F's commission.

*Example 8.* Assume the same facts as in *Example 6* except that F's expenses are $300. With this assumption, there is a combined loss of $(3.89) on the transaction under the full costing combined taxable income method, computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| R's apportioned G/A expenses | 3.89 |
| F's expenses | 300.00 |
| | (353.89) |
| Combined taxable income (loss) | (3.89) |

Since there is a combined loss, F will not have a profit under the full costing combined taxable income method. However, for purposes of this example, it is assumed that under the marginal costing rules of §1.925(b)–1T the maximum combined taxable income is $75 and the overall profit percentage limitation is $30. Accordingly, F's profit would be $6.90 (23% of $30) under the marginal costing rules. F's profit under the gross receipts method will be $13.80 (1.83% of $1,000 limited by section 925(d) to two times the profit determined under marginal costing). The commission F may receive from R is $313.80. Had all of the expenses been reflected on F's books pursuant to the election of paragraph

(b)(2)(ii) of this section, F's commission would have been $367.69.

*Example 9.* Assume the same facts as in *Example 6* except that F's expenses are $300 and that the transaction occurred in 1987. F will not earn a profit under the sales franchise pursuant to the administrative pricing rules. This is shown by the following computation:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 350.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| R's apportioned G/A expenses | 3.89 |
| F's expenses | 300.00 |
| | (353.89) |
| Combined taxable income (loss) | (3.89) |

F will not have a profit under the full costing combined taxable income method since there is a combined loss of $(3.89). Also, F will not have a profit under the gross receipts method due to section 925(d) and the special no loss rule of paragraph (e)(1)(i) of this section. In addition, F will not have a profit under the marginal costing rules because the profit may not exceed full costing combined taxable income, see §1.925 (b)–1T(b)(4). Although F may not earn a profit, it is entitled to recoup its expenses. Therefore, the commission F may receive from R is $300.00. R will bear the entire loss. Had all of the expenses been reflected on F's books pursuant to the election of paragraph (b)(2)(ii) of this section, F's commission would have been $353.89.

*Example 10.* Assume the same facts as in *Example 6* except that R receives total payment of the sale price of $1,000 on the 96th day after delivery, well beyond the 60 day period in which payment must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of $1,000 includes $10 of carrying charges, assuming a discount rate of 10%. See §1.927(d)–1 (a) (Q & A2) for computation method for determining amount of carrying charges. This $10 of carrying charges is R's income. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $16.66, computed as follows (the election of paragraph (b)(2)(ii) of this section is not made by R and F):

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $990.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 340.00 |
| Less: | |
| R's direct selling expenses | 50.00 |
| R's apportioned G/A expenses: $200×$340/$18,000 | 3.78 |
| F's expenses | 250.00 |
| Total | (303.78) |
| Combined taxable income | 36.22 |
| The combined taxable income method—F's profit: F's profit—23% of combined taxable income ($36.22) | $8.33 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts ($18.12) or two times F's profit under the combined taxable income method ($16.66) | $16.66 |
| F may receive a commission from R in the amount of $266.66, computed as follows: | |
| F's expenses | $250.00 |
| F's profit | 16.66 |
| F's commission | 266.66 |

*Example 11.* Assume the same facts as in *Example 6*. In addition, assume that R also manufactures products K, L, M, N, and P all of which are export property as defined in section 927(a). Product K is military property as defined in section 923(a)(5) and §1.923–1T(b)(3)(ii). Assume further that products A, L, and P are included within product line X and that products K, L, M, and N are included within product line W. R has entered into a written agreement with F under which F is granted a sales franchise with respect to exporting the products. Under this agreement, F will receive commissions with respect to those exports equal to the maximum amount permitted to be received under the administrative pricing rules. The table set forth below details F's foreign trading gross receipts, R's cost of goods sold and R's and F's expenses allocable and apportioned under §1.861–8 to the sale of products A, L, M, N, and P. For purposes of this example, it is assumed that R does not incur any general and administrative expenses. Because of the special grouping rule of paragraph (c)(8)(ii) of this section, product L may be included for purposes of the administrative pricing rules in only one product line, at the option of R. Also for these purposes, product K, which is military property, may not be grouped with products L, M, and N. See paragraph (c)(8)(iv) of this section. Under these facts, F will have profits under the franchise agreement from the sale of products A, L, M, N, and P and may receive commissions from R relating to the sale of those products, assuming the election of paragraph (b)(2)(ii) of this section is not made, in the following amounts:

| | Profit | F's Expenses | Commissions |
|---|---|---|---|
| Product Line X (products A and P) | $36.34 | $490.00 | $526.34 |

| | Profit | F's Expenses | Commissions |
|---|---|---|---|
| Product Line W (products L, M, and N) | $40.48 | $421.00 | $461.48 |

On the sale of product K, R received gross receipts of $150. R's cost of goods sold was $130. R's and F's expenses allocable to product K totaled $10 ($7 of R's expenses and $3 of F's). Under the gross receipts method, F earned a profit of $2.75 (1.83% of $150) and $2.30 under the combined taxable income method. F may receive a commission, assuming the election of paragraph (b)(2)(ii) of this section is made by R and F, from R in the amount of $12.75, computed as follows:

| | |
|---|---|
| F's expenses | $10.00 |
| F's profit | 2.75 |
| F's commission | $12.75 |

| | Product A | Product L | Product M | Product N | Product P | Total |
|---|---|---|---|---|---|---|
| Product Line X | | | | | | |
| Combined Taxable Income | | | | | | |
| R's GR From sale | $1,000 | | | | $1,000 | $2,000 |
| R's cost of goods sold | (650) | | | | (650) | (1,300) |
| Combined gross income | 350 | | | | 350 | 700 |
| Less: | | | | | | |
| R's expenses | 50 | | | | 81 | 131 |
| F's expenses | 250 | | | | 240 | 490 |
| Total | (300) | | | | (321) | (621) |
| Combined taxable income (loss) | $50 | | | | $29 | $79 |
| 23% of CTI | $11.50 | | | | $6.67 | $18.17 |
| 1.83% of GR from sale | $18.30 | | | | $13.34 | $36.34 |
| Product Line W | | | | | | |
| Combined Taxable Income | | | | | | |
| R's GR from sale | | $1,000 | $625 | $1,800 | | $3,425 |
| R's cost of goods sold | | (650) | (445) | (1,600) | | (2,695) |
| Combined gross income | | 350 | 180 | 200 | | 730 |
| Less: | | | | | | |
| R's expenses | | 81 | 70 | 70 | | 221 |
| F's expenses | | 230 | 60 | 131 | | 421 |
| Total | | (311) | (130) | (201) | | (642) |
| Combined taxable income (loss) | | $39 | $50 | $(1) | | $88 |
| 23% of CTI | | $8.97 | $11.50 | $0 | | $20.24 |
| 1.83% of GR From sale | | $17.94 | $11.44 | $0 | | $40.48 |

*Example 12.* R and F are calendar year taxpayers. R owns all the stock of F, an FSC for the taxable year. During 1985, R purchases 100 units of export property A from B, an unrelated domestic manufacturing company for $850. R's direct selling expenses so attributable are $20. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export product A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925. Thereafter, the 100 units are sold for export by R for $1,050. R factors the trade receivable to unrelated person X for $1,000. Under §1.924(a)–1T(g)(7), total gross receipts for purposes of computing R's and F's combined taxable income is $1,000 (total receipts ($1,050) less the discount ($50)). This $1,000 would have been foreign trading gross receipts had F been the principal on the sale. For purposes of this example, it is assumed that R did not incur any general and administrative expenses. F incurs expenses in the amount of $110, all of which were performed by R under contract to F. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $9.20 computed as follows:

| | |
|---|---|
| Combined taxable income: | |
| R's gross receipts from the sale | $1,000.00 |
| R's cost of goods sold | (850.00) |
| | 150.00 |

| | |
|---|---|
| Less: | |
| R's direct selling expenses | 20.00 |
| F's expenses | 110.00 |
| Total | 130.00 |
| Combined taxable income | $20.00 |
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income ($20) | $4.60 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income, method ($9.20) | $9.20 |
| F may receive a commission from R in the amount of $119.20, computed as follows (the election of § 1.925(a)–1T(b)(2)(ii) has not been made): | |
| F's expenses | $110.00 |
| F's profit | 9.20 |
| F's commission | $119.20 |

*Example 13.* R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, an FSC for the taxable year. During March 1985, R manufactures office equipment, export property within the definition of section 927(a)(1), which it leases on April 1, 1985, to F for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. F subleases the product on April 1, 1985, for a term of 1 year at a monthly rental of $1,200. R's cost for the product leased is $40,000. R's other deductible expenses attributable to the product are $200, all of which are incurred in 1985. Those expenses were not incurred under contract to F. F's expenses attributable to sublease of the export property are $1,150, all of which are incurred in 1985 directly by F. R depreciates the property on a straight line basis, using a half-year convention, assuming a 10 year recovery period (see section 168(f)(2)(C), § 1.48–1(g)). The profit which F may earn with respect to the transaction is $1,483.50 for 1985 and $600 for 1986, computed as follows:

COMPUTATION FOR 1985

| | |
|---|---|
| Combined taxable income: | |
| F's sublease rental receipts for year ($1,200 × 9 months) | $10,800.00 |
| Less: | |
| R's depreciation (($40,000 ×1/10)×9/12) | 3,000.00 |
| R's expenses | 200.00 |
| F's expense | 1,150.00 |
| Total | (4,350.00) |
| Combined taxable income | 6,450.00 |
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income ($6,450) | $1,483.50 |
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts ($197.64) or two times F's profit under the combined taxable income method ($2,967) | $197.64 |
| The section 482 method—F's profit: | |
| F's sublease rental receipts for year | $10,800.00 |
| Less: | |
| F's lease rental payments for year | 9,000.00 |
| F's expenses | 1,150.00 |
| Total | (10,150.00) |
| F's profit | 650.00 |

Since the combined taxable income method results in greater profit to F ($1,483.50) than does either the gross receipts method ($197.64) or the section 482 method ($650), F may earn a profit of $1,483.50 for 1985. Accordingly, the monthly rental payable by F to R for 1985 may be readjusted as long as the monthly rental payable is not readjusted below $907.39, computed as follows:

| | |
|---|---|
| Monthly rental payable by F to R for 1985: | |
| F's sublease rental receipts for year | $10,800.00 |
| Less: | |
| F's expenses | 1,150.00 |
| F's profit | 1,483.50 |
| Total | (2,633.50) |
| Rental payable for 1985 | 8,166.50 |
| Rental payable each month ($8,166.50/9 months) | $907.39 |

COMPUTATION FOR 1986

| | |
|---|---|
| *Combined taxable income:* | |
| F's sublease rental receipts for year ($1,200 × 3 months) | $3,600.00 |
| Less: | |
| R's depreciation (($40,000 × 1/10) × 3/12) | (1,000.00) |
| Combined taxable income | 2,600.00 |
| *The combined taxable income method—F's profit:* | |
| F's profit—23% of combined taxable income ($2,600) | 598.00 |
| *The gross receipts method—F's profit:* | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts ($3,600) or two times F's profit under the combined taxable income method ($1,196) | 65.88 |
| *The section 482 method—F's profit:* | |
| F's sublease rental receipts for year | $3,600.00 |
| Less: | |
| F's lease rental payments for year | (3,000.00) |
| F's profit | 600.00 |

Since the section 482 method results in a greater profit to F ($600) than does either the combined taxable income method ($598) or the gross receipts method ($65.88), F may

earn a profit of $600 for 1986. Accordingly, the monthly rental payable by F to R for 1986 may be readjusted as long as the monthly rental payable is not readjusted below $1,000, computed as follows:

| | |
|---|---|
| *Monthly rental payable by F to R for 1986:* | |
| F's sublease rental receipts for year | $3,600.00 |
| Less: | |
| F's profit | (600.00) |
| Rental payable for 1986 | 3,000.00 |
| Rental payable for each month ($3,000/3 months) | 1,000.00 |

(g) *Effective date.* The provisions of this section and §1.925(b)–1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

[T.D. 8126, 52 FR 6443, Mar. 3, 1987, as amended by T.D. 8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13426, Mar. 6, 2001]

### § 1.925(b)–1T Temporary regulations; marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in §1.927(a)–1T) from which foreign trading gross receipts (as defined in §1.924(a)–1T) are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) The combined taxable income determined under these marginal costing rules may be used to determine whether the ''twice the amount determined under the combined taxable income method'' limitation for the 1.83% of gross receipts test of section 925(d) has been met.

For FSC taxable years beginning after December 31, 1986, if the marginal costing rules are used to determine the section 925(d) limitation, the FSC may not earn more than 100% of full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). The marginal costing rules may be applied even if the related supplier does not manufacture, produce, grow, or extract the export property sold. The marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or that income is under the exceptions in section 954(b)(4). In addition, the marginal costing rules do not apply to leases of property or to the performances of any services even if they are related and subsidiary services (as defined in §1.924(a)–1T(d) and §1.925(a)–1T(b)(2)(iii)(C)).

(b) *Marginal costing rules*—(1) *In general.* Marginal costing is a method under which only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the combined taxable income of the FSC and its related supplier under section 925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in §1.471–11(b)(2)(i)). Costs which are incurred by the FSC and which are not taken into account in computing combined taxable income are deductible by the FSC only to the extent of the FSC's non-foreign trade income. If the related supplier is not the manufacturer or producer of the export property that is sold, the related supplier's purchase price shall be taken into account.

(2) *Overall profit percentage limitation.* Under marginal costing, the combined taxable income of the FSC and its related supplier may not exceed the overall profit percentage (determined under paragraph (c)(2) of this section) multiplied by the FSC's foreign trading gross receipts if the FSC is the principal on the sale (or the related supplier's gross receipts if the FSC is a commission agent) from the sale of export property.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to §1.925(a)–1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under §1.925(a)–1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same item or grouping referred to in subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the group for purposes of the full costing method.

(4) *Application of limitation on FSC income (''no loss'' rules).* The marginal costing rules of this section will not apply if there is a combined loss of the related supplier and the FSC determined in accordance with paragraph (b)(1) of this section. In addition, for FSC taxable years beginning after December 31, 1986, the profit determined under the marginal costing method may be allowed to the FSC only to the extent it does not exceed the FSC's and the related supplier's full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. If either of these ''no loss'' rules apply, the related supplier may nonetheless charge a transfer price or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its full costs, if any, even if to do so would create or increase a loss in the related supplier. The effect of these no-loss rules and of the overall profit percentage limitation of paragraph (c)(2) of this section is that the FSC's profit under these marginal costing rules is limited to the lesser of the following:

(i) 23% of maximum combined taxable income determined under the marginal costing rules,

(ii) 23% of the overall profit percentage limitation, or

(iii) For FSC taxable years beginning after December 31, 1986, 100% of the full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the full costing combined taxable income computed under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the FSC for a product or product line is the percentage which—

(A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of

(B) The total gross receipts (determined under §1.927(b)–1T) of the FSC and related supplier from all sales of the product or product line.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivisions (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and §1.924(a)–1T(h)) of which the FSC is a member, for the FSC's

taxable year and for taxable years of the members ending with or within the FSC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) and (ii) of this paragraph, a sale of property between a FSC and its related supplier or between domestic members of the controlled group shall be taken into account only during the FSC's taxable year (or taxable year of the member ending within the FSC's taxable year) during which the property is ultimately sold to a person which is not related to the FSC or if related, is a foreign person that is not a FSC.

(3) *Full costing method.* For purposes of section 925 and this section, the term ''full costing combined taxable income method'' is the method for determining full costing combined taxable income set forth in §1.925(a)–1T(c)(3) and (6).

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

*Example 1.* R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the administrative pricing rules of section 925(a)(1) and (2). Thereafter, the 100 units are resold for export by F for $950. R's cost of goods sold attributable to the 100 units is $650 consisting in part of $400 of direct materials and $200 of direct labor. R incurs selling expenses directly attributable to the sale in the amount of $100. Those expenses were not required to be incurred by F. For purposes of this example, it is assumed that R does not have general and administrative expenses that are not definitely allocable to any item of gross income. F's expenses attributable to the resale of the 100 units are $120. For purposes of this example, R and F have gross receipts of $4,000 from all domestic and foreign sales. R's total cost of goods sold and total expenses relating to its foreign and domestic sales are $2,730 and $450, respectively. Under full costing, the combined taxable income will be $80, computed as follows:

| | |
|---|---|
| Combined taxable income—full costing: | |
| F's foreign trading gross receipts | $950.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 300.00 |
| Less: | |
| R's direct selling expenses | 100.00 |
| F's expenses | 120.00 |
| Total | (220.00) |
| Combined taxable income (loss) | 80.00 |

F's profit under the full costing combined taxable income method is $18.40, *i.e.*, 23% of full costing combined taxable income ($80). F's profit under the gross receipts method will be $17.39, *i.e.*, 1.83% of F's foreign trading gross receipts ($950). However, under the marginal costing rules, F would have a profit attributable to the export sale in the amount of $38.24, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $166.25). As shown by the computation below, the combined taxable income under marginal costing is limited to the overall profit percentage limitation ($166.25) since that amount is less than the maximum combined taxable income amount ($350):

| | |
|---|---|
| Maximum combined taxable income (determined under paragraph (b)(1) of this section): | |
| F's foreign trading gross receipts | $950.00 |
| Less: | |
| R's direct materials | 400.00 |
| R's direct labor | 200.00 |
| Total | (600.00) |
| Maximum combined total income | 350.00 |
| Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section): | |
| Gross receipts of R and F from all domestic and foreign sales | $4,000.00 |
| R's cost of goods sold | (2,730.00) |
| Combined gross income | 1,270.00 |
| Less: | |
| R's expenses | 450.00 |
| F's expenses | 120.00 |
| Total | (570.00) |
| Total taxable income from all sales computed on a full costing method | 700.00 |
| *Overall profit percentage* (total taxable income ($700) divided by total gross receipts ($4,000) | 17.5% |
| *Overall profit percentage limitation* Overall profit percentage times F's foreign trading gross receipts (17.5% times $950.00) | $166.25 |

The transfer price from R to F may be set at $791.76, computed as follows:

| | |
|---|---|
| Transfer price to F: | |
| F's foreign trading gross receipts | $950.00 |
| Less: | |
| F's expenses | 120.00 |
| F's profit | 38.24 |

| | |
|---|---|
| Total | (158.24) |
| Transfer price | 791.76 |

*Example 2.* Assume the same facts as in *Example 1* except that F's expenses are $170. Under full costing, the combined taxable income will be $30, computed as follows:

| | |
|---|---|
| *Combined taxable income—full costing:* | |
| F's foreign trading gross receipts | $950.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 300.00 |
| Less: | |
| R's expenses | 100.00 |
| F's expenses | 170.00 |
| Total | (270.00) |
| Combined taxable income (loss) | 30.00 |

F's profit under the full costing combined taxable income method is $6.90, *i.e.*, 23% of combined taxable income, $30. Under the marginal costing rules, F may earn a profit attributable to the export sale in the amount of $35.51, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38). Had the transaction occurred in 1987, F would have had a profit attributable to the export sale under these marginal costing rules of only $30, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38) limited, for FSC taxable years beginning after December 31, 1986, to combined taxable income determined under full costing ($30), see paragraph (b)(4) of this section. F's profit under the gross receipts method will be $17.39 *i.e.*, 1.83% of F's foreign trading gross receipts ($950). The computations are as follows:

| | |
|---|---|
| *Maximum combined taxable income* (determined under paragraph (b)(1) of this section): | |
| F's foreign trading gross receipts | $950.00 |
| Less: | |
| R's direct materials | 400.00 |
| R's direct labor | 200.00 |
| Total | (600.00) |
| Maximum combined taxable income | 350.00 |
| *Overall profit percentage limitation calculation* (determined under paragraph (c)(2) of this section): | |
| Gross receipts of R and F from all domestic and foreign sales | 4,000.00 |
| R's cost of goods sold | (2,730.00) |
| Combined gross income | 1,270.00 |
| Less: | |
| R's expenses | 450.00 |
| F's expenses | 170.00 |
| Total | (620.00) |
| Total taxable income from all sales computed on a full costing method | 650.00 |
| *Overall profit percentage* (total taxable income ($650) divided by total gross receipts ($4,000)) | 16.25% |
| *Overall profit percentage limitation* Overall profit percentage times F's foreign trading gross receipts (16.25% times $950.00) | 154.38 |

The transfer price from R to F may be set at $744.49, computed as follows:

| | |
|---|---|
| *Transfer price to F:* | |
| F's foreign trading gross receipts | 950.00 |
| Less: | |
| F's expenses | 170.00 |
| F's profit | 35.51 |
| Total | (205.51) |
| Transfer price | 744.49 |

*Example 3.* Assume the same facts as in *Example 1* except that the transaction occurs in 1987 and that F incurs expenses in the amount of $250. Since a $50 combined loss, as computed below, is incurred, F will not have any profit under either the full costing combined taxable income method, the gross receipts method or the marginal costing rules:

| | |
|---|---|
| *Combined taxable income—full costing:* | |
| F's foreign trading gross receipts | $950.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | 300.00 |
| Less: | |
| R's expenses | 100.00 |
| F's expenses | 250.00 |
| Total | (350.00) |
| Combined taxable income (loss) | (50.00) |

The transfer price to R may be set at $700 so that F may recover its expenses.

*Example 4.* R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures export property A. R enters into a written agreement with F whereby F will receive a commission with respect to sales of export property A by R which result in gross receipts to R which would have been foreign trading gross receipts had F and not R been the principal on the sale. F will receive commissions with respect to such export sales equal to the maximum amount permitted to be received under the transfer pricing rules of section 925. The maximum commission may be earned by F under these marginal costing rules. In this example, R received $950 from the sale of export property A. R's cost of goods sold for that property was $620. R incurred direct selling expenses of $20. Also, it is assumed that R incurred total

general and administrative expenses, in addition to those incurred relating to its contract to perform on behalf of F the functions and activities of section 924 (c), (d) and (e), of $50. R incurred direct and indirect expenses of $130 in performing those functions and activities on behalf of F. During 1985, R had gross receipts from all domestic and foreign sales of $3,500, total cost of goods sold and total expenses relating to the domestic and foreign sales of $1,600 and $259, respectively. The election provided for in §1.925(a)–1T(b)(2)(ii) was not made by R and F.

| | | |
|---|---|---|
| *Combined taxable income—full costing:* | | |
| R's gross receipts from the sale of the export property | ..... | $950.00 |
| R's cost of goods sold | ..... | (620.00) |
| Combined gross income | ..... | 330.00 |
| Less: | | |
| R's direct selling expenses | ..... | 20.00 |
| F's expenses | ..... | 130.00 |
| Apportionment of R's general and administrative expenses: | | |
| R's total G/A expenses | $50 | ..... |
| Combined gross income | 330 | ..... |
| R's total gross income | 1,900 | ..... |
| Apportionment of G/A expenses $50 × $330/$1,900 | ..... | 8.68 |
| Total | ..... | (158.68) |
| Combined taxable income (loss) | ..... | 171.32 |
| *Maximum combined taxable income* (determined under paragraph (b)(1) of this section): | | |
| R's gross receipts from the sale of the export property | | $950.00 |
| Less: | | |
| R's direct materials | | 450.00 |
| R's direct labor | | 100.00 |
| Total | | (550.00) |
| Maximum combined taxable income | | 400.00 |
| *Overall profit percentage limitation calculation* (determined under paragraph (c)(2) of this section): | | |
| Gross receipts of R from all domestic and foreign sales | | 3,500.00 |
| R's cost of goods sold | | (1,600.00) |
| Combined gross income | | 1,900.00 |
| Less: | | |
| R's total expenses | | 259.00 |
| F's total expenses | | 130.00 |
| Total | | (450.00) |
| Total taxable income from all sales computed on a full costing method | | 1,511.00 |
| *Overall profit percentage* (total taxable income ($1,511) divided by total gross receipts ($3,500)) | | 43.17% |
| *Overall profit percentage limitation* Overall profit percentage times R's gross receipts from the sale of export property (*i.e.,* 43.17% times $950.00) | | 410.12 |

Since the overall profit percentage limitation ($410.12) is greater than the maximum combined taxable income ($400), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $400. Under these marginal costing rules, F will have a profit attributable to the sale of $92, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $400). Accordingly, the commission F receives from R is $222, *i.e.*, F's expenses ($130) plus F's profit ($92).

*Example 5.* Assume the same facts as in *Example 4,* except that R's gross receipts from the sale of export property which would have been foreign trading gross receipts had F been the principal on the sale are $1,050 and gross receipts from all sales, domestic and foreign, remain at $3,500. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

| | | |
|---|---|---|
| *Combined taxable income—full costing:* | | |
| R's gross receipts from the sale of the export property | | $1,050.00 |
| R's cost of goods sold | | (620.00) |
| Combined gross income | | 430.00 |
| Less: | | |
| R's direct selling expenses | | 20.00 |
| F's expenses | | 130.00 |
| Apportionment of R's G/A expenses $50 × $430/$1,900 | | 11.32 |
| Total | | (161.32) |
| Combined taxable income (loss) | | 268.68 |
| *Maximum combined taxable income* (determined under paragraph (b)(1) of this section): | | |
| R's gross receipts from the sale of export property | | $1,050.00 |
| Less: | | |
| R's direct materials | | 450.00 |
| R's direct labor | | 100.00 |
| Total | | (550.00) |
| Maximum combined taxable income | | 500.00 |
| *Overall profit percentage* (see example 4) | | 43.17% |

| | |
|---|---|
| *Overall profit percentage limitation* (determined under paragraph (c)(2) of this section) (R's gross receipts from sale ($1,050.00) times the overall profit percentage (43.17%)) | 453.29 |

Since maximum combined taxable income ($500) is greater than the overall profit percentage limitation ($453.29), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $453.29. Under these marginal costing rules, F will have a profit attributable to the sales of $104.26, *i.e.*, 23% of combined taxable income (23% of $453.29). Accordingly, the commission F receives from R is $234.26, *i.e.*, F's expenses ($130) plus F's profit ($104.26).

*Example 6.* Assume the same facts as in *Example 5*, except that F has expenses of $140 and R's cost of goods sold for the export sale was $900. R does not incur any direct selling expenses. Since cost of goods sold has increased by $280, R's total gross income has been reduced from $1,900 to $1,620. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income under the marginal costing rules as follows:

| | |
|---|---|
| *Combined taxable income—full costing:* | |
| R's gross receipts from the sale of export property | $1,050.00 |
| R's cost of goods sold | (900.00) |
| Combined gross income | 150.00 |
| Less: | |
| F's expenses | 140.00 |
| Apportionment of R's G/A expenses $50 × $150/$1,620 | 4.63 |
| Total | (144.63) |
| Combined taxable income (loss) | 5.37 |
| Maximum combined taxable income (determined under paragraph (b)(1) of this section): | |
| R's gross receipts from the sale of export property | $1,050.00 |
| Less: | |
| R's direct materials | 630.00 |
| R's direct labor | 200.00 |
| Total | (830.00) |
| Maximum combined taxable income | 220.00 |
| Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section): | |
| Gross receipts of R and F from all domestic and foreign sales | $3,500.00 |
| R's cost of goods sold | (1,880.00) |
| Combined gross income | 1,620.000 |
| Less: | |
| R's total expenses | 259.00 |
| F's total expenses | 140.00 |
| Total | (399.00) |
| Total taxable income from all sales computed on a full costing method | $1,221.00 |
| Overall profit percentage (total taxable income ($1,221) divided by total gross receipts ($3,500)) | 34.89% |
| Overall profit percentage limitation—overall profit percentage times R's gross receipts from the sale of export property (i.e., 34.89% times $1,050) | $366.35 |

Since the overall profit percentage limitation ($366.35) is greater than the maximum combined taxable income ($220), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $220. Under these marginal costing rules, F will have a profit attributable to the sale of $50.60, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $220). If the transaction occurred in 1987, F's profit would be limited, however, by paragraph (b)(4) of this section to the full costing combined taxable income of $5.37.

[T.D. 8126, 52 FR 6455, Mar. 3, 1987, as amended by T.D.8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13429, Mar. 6, 2001]

### § 1.926(a)–1 Distributions to shareholders.

(a) *Treatment of distributions.* [Reserved]. For guidance, see § 1.926(a)–1T(a).

(b) *Order of distribution*—(1) *In general*—(i) *Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning before January 1, 1990.* Any actual distribution to a shareholder by a FSC (all references to a FSC in this section shall include a small FSC and a former FSC) that is received by the shareholder in a taxable year of the shareholder beginning before January 1, 1990, and made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of operation of section 923(a)(4),

(B) Out of earnings and profits attributable to other exempt foreign trade income,

(C) Out of earnings and profits attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) or (2),

(D) Out of earnings and profits attributable to section 923(a)(2) non-exempt income, and

(E) Out of other earnings and profits.

(ii) *Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning after December 31, 1989.* Any actual distribution to a shareholder by a FSC that is received by the shareholder in a taxable year beginning after December 31, 1989, and that is made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of the operation of section 923(a)(4),

(B) Out of earnings and profits attributable to foreign trade income (other than exempt foreign trade income determined solely because of the operation of section 923(a)(4)) allocable to the marketing of agricultural or horticultural products (or the providing of related services) by a qualified cooperative which is a shareholder of the FSC,

(C) Out of earnings and profits attributable to non-exempt foreign trade income and other exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) and (2). Distributions out of this classification will be made on a pro rata basis so that 15/23 (16/23 with regard to distribution to a non-corporate shareholder) of each distribution will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income. To the extent the distributions are out of earnings and profits attributable to the disposition of, or services related to, military property, 7.5/23 (8/23 with regard to distributions to a non-corporate shareholder) of each distribution will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income,

(D) Out of earnings and profits attributable to other exempt foreign trade income determined under the transfer pricing method of section 925(a)(3),

(E) Out of earnings and profits attributable to section 923(a)(2) non-exempt income,

(F) Out of earnings and profits attributable to effectively connected income, as defined in section 245(c)(4)(B), and

(G) Out of other earnings and profits.

(2) *Determination of earnings and profits.* [Reserved]. For guidance, see §1.926(a)–1T(b)(1).

(c) *Definition of ''former FSC''.* [Reserved]. For guidance, see §1.926(a)–1T(c).

(d) *Personal holding company income.* [Reserved]. For guidance, see §1.926(a)–1T(d).

(e) *Sale of stock if section 1248 applies.* [Reserved]. For guidance, see §1.926(a)–1T(e).

[T.D. 8340, 56 FR 11093, Mar. 15, 1991]

### §1.926(a)–1T Temporary regulations; distributions to shareholders.

(a) *Treatment of distributions.* Any distribution by a FSC (or former FSC) to its shareholder with respect to its stock will be includible in the shareholder's gross income in accordance with the provisions of section 301. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) See section 245(c) for treatment of distributions to domestic corporate shareholders of the FSC. If earnings and profits of a FSC (or former FSC) attributable to foreign trade income are distributed to a shareholder which is a foreign person (or a nonresident alien individual), that distribution shall be treated as United States source income which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States. For this purpose, distributions to a foreign partnership, foreign trust, foreign estate or other foreign entities that would be treated as pass-through entities under U.S. law shall be treated as made directly to the partners of beneficiaries in proportion to their respective interest in the entity.

(b) *Order of distributions*—(1) *In general.* For guidance, see §1.926(a)–1(b)(1).

(2) *Determination of earnings and profits.* For purposes of this section, the earnings and profits of a FSC (or former FSC) shall be the earnings and

profits computed in accordance with the rules, where applicable, prescribed in §1.964–1 (relating to determination of the earnings and profits of a foreign corporation) other than subsections (d) and (e) of that section.

(c) *Definition of ''former FSC''.* Under section 926(c), the term ''former FSC'' refers to a corporation which is not a FSC for a taxable year but which was a FSC for a prior taxable year. However, a corporation is not a former FSC for a taxable year unless such corporation has, at the beginning of such taxable year, earnings and profits attributable to foreign trade income. A corporation which is a former FSC for a taxable year is a former FSC for all purposes of the Code.

(d) *Personal holding company income—* (1) *Treatment of dividends.* Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a FSC (or former FSC) under paragraph (a) of this section shall be treated as a dividend for all purposes of the Code, except that that part of the dividend attributable to foreign trade income, other than an amount attributable to section 923(a)(2) non-exempt income, shall not be considered in applying the personal holding company and foreign personal holding company provisions (sections 541 through 547 and 551 through 558, respectively).

(2) *Look through option.* With regard to distributions from a FSC (or former FSC) which are not treated as personal holding company income under paragraph (d)(1) of this section, the shareholder may, however, treat any amount of that distribution as an item of income described under section 543 (or section 553) (for example, rents) if it establishes to the satisfaction of the Commissioner that such amount is attributable to earnings and profits of the FSC derived from such item of income. For example, distributions from a FSC relating to section 923(a)(2) nonexempt income will be treated as dividends for purposes of the personal holding company provisions of sections 541 through 547 unless the look through option is elected. Under this option, if earnings and profits out of which those distributions are made are attributable to the lease of export property, the FSC shareholder may treat the distribution for purposes of the personal holding company provisions as rents rather than as dividends. This may be beneficial to the shareholder because rents are not considered under section 543(a)(2) as personal holding company income, if in general, rents constitute 50% or more of the shareholder's adjusted ordinary gross income.

(e) *Sale of stock if section 1248 applies.* For purposes of section 1248, the earnings and profits of a FSC (or former FSC) shall not include earnings and profits attributable to foreign trade income.

[T.D. 8126, 52 FR 6458, Mar. 3, 1987, as amended by T.D. 8340, 56 FR 11093, Mar. 15, 1991]

### §1.927(a)–1T Temporary regulations; definition of export property.

(a) *General rule.* Under section 927(a), except as otherwise provided with respect to excluded property in paragraphs (f), (g) and (h) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a FSC) (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise)—

(1) *U.S. manufactured, produced, grown or extracted.* Manufactured, produced, grown, or extracted in the United States by any person or persons other than a FSC (see paragraph (c) of this section),

(2) *Foreign use, consumption or disposition.* Held primarily for sale, lease or rental in the ordinary course of a trade or business by a FSC to a FSC or to any other person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) *Foreign content.* Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) *Non-related FSC purchaser or user.* Which is not sold, leased or rented by a FSC, or with a FSC as commission agent, to another FSC which is a member of the same controlled group (as defined in section 927(d)(4) and §1.924(a)–1T(h)) as the FSC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a FSC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that that person does not qualify as a FSC. Property held by a FSC which was manufactured, produced, grown or extracted by it at a time when it did not qualify as a FSC is not export property of the FSC. Property which sustains further manufacture, production or processing outside the United States prior to sale or lease by a person but after manufacture, production, processing or extraction in the United States will be considered as manufactured, produced, grown or extracted in the United States by that person only if the property is reimported into the United States for further manufacturing, production or processing prior to final export sale. In order to be considered export property, the property manufactured, produced, grown or extracted in the United States must satisfy all of the provisions of section 927(a) and this section.

(2) *Manufactured, produced or processed.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured, produced or processed by that person or by another person pursuant to a contract with that person if the property is manufactured or produced, as defined in §1.954–3(a)(4). For purposes of this section, however, in determining if the 20% conversion test of §1.954–3(a)(4)(iii) has been met, conversion costs include assembly and packaging costs but do not include the value of parts provided pursuant to a services contract as described in §1.924(a)–1T(d)(3). In addition, for purposes of this section, the 20% conversion test is extended and applied to the export property's adjusted basis rather than to its cost of goods sold if it is leased or held for lease.

(d) *Foreign use, consumption or disposition*—(1) *In general.* (i) Under paragraph (a)(2) of this section, export property must be held primarily for the purpose of sale, lease or rental in the ordinary course of a trade or business, by a FSC to a FSC or to any other person, and the sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption, or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if the sale or lease satisfies the destination test described in subdivision (2) of this paragraph, the proof of compliance requirements described in subdivision (3) of this paragraph, and the use outside the United States test described in subdivision (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a FSC is sold or leased for direct use, consumption, or disposition outside the United States, the fact that the acquiring FSC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Fungible export property must be physically segregated from non-export property at all times after purchase by or rental by a FSC or after the start of the commission relationship between the FSC and related supplier with regard to the export property. Non-fungible export property need not be physically segregated from non-export property.

(2) *Destination test.* (i) For purposes of paragraph (d)(1) of this section, the destination test of this paragraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by the seller or lessor (or

an agent of the seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(A) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(B) Within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after the sale or lease,

(C) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a FSC or an interest charge DISC and is not a member of the same controlled group as the seller or lessor,

(D) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of the seller's or lessor's own ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(E) Outside the United States to a purchaser or lessee from a warehouse, storage facility, or assembly site located outside the United States, if the property was previously shipped by the seller or lessor from the United States, or

(F) Outside the United States to a purchaser or lessee if the property was previously shipped by the seller or lessor from the United States and if the property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) the prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the subsequent lease is not a related person with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this paragraph (d)(2) (other than paragraphs (d)(2)(i)(C) and (F)(3)), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this paragraph (d)(2) satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this paragraph (d)(2).

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to the 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of paragraph (d)(2) of this section (other than subdivision (i)(C) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(A) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(B) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(C) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(D) If that country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(E) A facsimile or carbon copy of the Shipper's Export Declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property, or

(F) Any other proof (including evidence as to the nature of the property or the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i)(A), (B), (C), or (E) of this paragraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in subdivision (i)(E) of this paragraph or a document such as an export bill of lading, such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that the document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of paragraph (d)(2)(i) of this section (other than subdivision (i)(C) thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) For purposes of paragraph (d)(2)(i)(C) of this section, a purchaser or lessee of property is deemed to qualify as a FSC or an interest charge DISC for its taxable year if the seller or lessor obtains from the purchaser or lessee a copy of the purchaser's or lessee's election to be treated as a FSC or interest charge DISC together with the purchaser's or lessee's sworn statement that the election has been timely filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of the purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a FSC or interest charge DISC with respect to a sale or lease during a taxable year for which the purchaser or lessee does not qualify as a FSC or interest charge DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time the sale or lease is made that the purchaser or lessee will qualify as a FSC or interest charge DISC for the taxable year.

(v) If a seller or lessor fails to provide proof of compliance with the destination test as required by this paragraph (d)(3), the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of paragraph (d)(1) of this section, the use test in this paragraph (d)(4) is satisfied with respect to property which—

(A) Under subdivision (4)(ii) through (iv) of this paragraph is not sold for ultimate use in the United States, or

(B) Under subdivision (4)(v) of this paragraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (4)(i) of this paragraph, a purchaser of property (including components, as defined in subdivision (4)(vii) of this paragraph) is deemed to use the property ultimately in the United States if any of the following conditions exist:

(A) The purchaser is a related party with respect to the seller and the purchaser ultimately uses the property, or a second product into which the property is incorporated as a component, in the United States.

(B) At the time of the sale, there is an agreement or understanding that the property, or a second product into which the property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(C) At the time of the sale, a reasonable person would have believed that the property or the second product would be ultimately used by the purchaser in the United States unless, in the case of a sale of components, the fair market value of the components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product

into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).

For purposes of subdivision (4)(ii)(B) of this paragraph, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example, there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (4)(ii) of this paragraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by the purchaser if, at any time within 3 years after the purchase of such property or components, either the property is or the components (or the second product into which the components are incorporated) are resold by the purchaser for use by a subsequent purchaser within the United States or the purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use the property or second product predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph).

(iv) *Sales to retailers.* For purposes of subdivision (4)(ii)(C) of this paragraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States will be considered to be used predominantly outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (4)(i) of this paragraph, a lessee of property is deemed to use property ultimately outside the United States during a taxable year of the lessor if the property is used predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this paragraph (d)(4), property is used predominantly outside the United States for any period if, during that period, the property is 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 for any period if, during that period, either the 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 the property are traversed outside the United States. However, property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where the transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations under that section (relating to tax on air transportation of persons). An orbiting satellite is deemed to be located outside the United States. For purposes of applying section 4262(c)(3) to this subdivision, the term ''United States'' includes the Commonwealth of Puerto Rico.

(vii) *Component.* For purposes of this paragraph (d)(4), a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph (e), articles imported into the United States are referred to as ''foreign content.'' The fair market value of the foreign content of export property is computed in accordance with paragraph (e)(4) of this section. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest, finance or carrying charges, or similar charges.)

(2) *Application of 50 percent test.* The 50 percent test is applied on an item-by-item basis. If, however, a person sells or leases a large volume of substantially identical export property in a taxable year and if all of that property contains substantially identical foreign content in substantially the same proportion, the person may determine the portion of foreign content contained in that property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in §1.924(a)–1T(d)(3)) and the price for the parts is not separately stated, the 50 percent test is applied on an aggregate basis to the property and parts. If the price for the parts is separately stated, the 50 percent test is applied separately to the property and to the parts.

(4) *Computation of foreign content*—(i) *Valuation.* For purposes of applying the 50 percent test, it is necessary to determine the fair market value of all articles which constitutes foreign content of the property being tested to determine if it is export property. The fair market value of the imported articles is determined as of the time the articles are imported into the United States.

(A) *General rule.* Except as provided in paragraph (e)(4)(i)(B), the fair market value of the imported articles which constitutes foreign content is their appraised value, as determined under section 403 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation. The appraised value of the articles is the full dutiable value of the articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value.

(B) *Special election.* If all or a portion of the imported article was originally manufactured, produced, grown, or extracted in the United States, the taxpayer may elect to determine the fair market value of the imported articles which constitutes foreign content under the provisions of this paragraph (e)(4)(i)(B) if the property is subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after importation. A taxpayer making the election under this paragraph may determine the fair market value of the imported articles which constitutes foreign content to be the fair market value of the imported articles reduced by the fair market value at the time of the initial export of the portion of the property that was manufactured, produced, grown, or extracted in the United States. The taxpayer must establish the fair market value of the imported articles and of the portion of the property manufactured, produced, grown, or extracted in the United States at the time of the initial export in accordance with subdivision (4)(ii)(B) of this paragraph.

(ii) *Evidence of fair market value*—(A) *General rule.* For purposes of subdivision (4)(i)(A) of this paragraph, the fair market value of the imported articles is their appraised value, which may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of the articles is not the importer (or a related person with respect to the importer), the appraised value of the articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to

the holder by the person from whom the articles (or property incorporating the articles) were purchased. If a customs invoice or certificate described in the preceding sentences is not available to a person purchasing property, the person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(B) *Special election.* For purposes of the special election set forth in subdivision (4)(i)(B) of this paragraph, if the initial export is made to a controlled person within the meaning of section 482, the fair market value of the imported articles and of the portion of the articles that are manufactured, produced, grown, or extracted within the United States shall be established by the taxpayer in accordance with the rules under section 482 and the regulations under that section. If the initial export is not made to a controlled person, the fair market value must be established by the taxpayer under the facts and circumstances.

(iii) *Interchangeable component articles.* (A) If identical or similar component articles can be incorporated interchangeably into property and a person acquires component articles that are imported into the United States and other component articles that are not imported into the United States, the determination whether imported component articles were incorporated in the property that is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(B) The provisions of subdivision (4)(iii)(A) of this paragraph may be illustrated by the following example:

*Example.* Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a FSC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the FSC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the FSC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the FSC, those devices are not export property. The remaining 8,000 devices purchased and exported by the FSC are treated as containing tubes produced in the United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subdivision (2) of this paragraph (relating to property leased to a member of controlled group),

(ii) Property described in subdivision (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to oil and gas products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property leased to a person (whether or not a FSC) which is a member of the same controlled group as the lessor constitutes export property for any period of time only if during the period—

(A) The property is held for sublease, or is subleased, by the person to a third person for the ultimate use of the third person;

(B) The third person is not a member of the same controlled group; and

(C) The property is used predominantly outside the United States by the third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (2)(i)(C) of this paragraph whether the property is used predominantly outside the United States by the third person.

(iii) *Leasing rule.* For purposes of this paragraph (f)(2), leased property is deemed to be ultimately used by a

member of the same controlled group as the lessor if such property is leased to a person which is not a member of the controlled group but which subleases the property to a person which is a member of the controlled group. Thus, for example, if X, a FSC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of the controlled group for showing to the general public, the film is not export property. On the other hand, if X, a FSC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subdivision (3) of this paragraph from being export property, the ultimate use of the property is the sale or exhibition of the property to the general public. Thus, if A, a FSC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this paragraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property.

(g) *Oil and gas*—(1) *In general.* Under section 927(a)(2)(C), export property does not include oil or gas (or any primary product thereof).

(2) *Primary product from oil or gas.* A primary product from oil or gas is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term ''primary product from oil'' means crude oil and all products derived from the destructive distillation of crude oil, including—

(A) Volatile products,

(B) Light oils such as motor fuel and kerosene,

(C) Distillates such as naphtha,

(D) Lubricating oils,

(E) Greases and waxes, and

(F) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term ''primary product from gas'' means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(A) Natural gas,

(B) Condensates,

(C) Liquefied petroleum gases such as ethane, propane, and butane, and

(D) Liquid products such as natural gasoline.

(iii) *Primary products and changing technology.* The primary products from oil or gas described in subdivisions (2)(i) and (ii) of this paragraph and the

processes described in those subdivisions are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. For example, petroleum coke, although not derived from the destructive distillation of crude oil, is a primary product from oil derived from an existing technology.

(iv) *Non-primary products.* For purposes of this paragraph, petrochemicals, medicinal products, insecticides and alcohols are not considered primary products from oil or gas.

(h) *Export controlled products*—(1) *In general.* Section 927(a)(2)(D) provides that an export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an ''export controlled product'' at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979. That policy is to use export controls to the extent necessary to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of foreign demand.

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity, which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (2)(ii) of this paragraph) and ends on and includes the final control date (as defined in subdivision (2)(iii) of this paragraph).

(ii) *Initial control date.* The initial control date of a product or commodity which is subject to short supply export controls is the effective date stated in the regulations to 15 CFR part 377 which subjects the product or commodity to short supply export controls. If there is no effective date stated in these regulations, the initial control date of the product or commodity will be thirty days after the effective date of the regulations which subject the product or commodity to short supply export controls.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes the product or commodity from short supply export controls. If there is no effective date stated in those regulations, the final control date of the product or commodity is the date which is thirty days after the effective date of the regulations which remove the product or commodity from short supply export control.

(iv) *Expiration of Export Administration Act.* An initial control date and final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates*—(i) *Products controlled on January 1, 1985.* If a product or commodity was subject to short supply export controls on January 1, 1985, this paragraph shall apply to all sales, exchanges, other dispositions, or leases of the product or commodity made after January 1, 1985, by the FSC or by the FSC's related supplier if the FSC is the commission agent on the transaction.

(ii) *Products first controlled after January 1, 1985.* If a product or commodity becomes subject to short supply export controls after January 1, 1985, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sales, exchange, lease, or other disposition.* For purposes of this paragraph (h)(3), the date of sale, exchange, or other disposition of a product or commodity is the date as of

which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(i) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive Order designate such property as in short supply. Any property so designated will be treated under section 927(a)(3) as property which is not export property during the period beginning with the date specified in such Executive Order and ending with the date specified in an Executive Order setting forth the President's determination that such property is no longer in short supply.

[T.D. 8126, 52 FR 6459, Mar. 3, 1987]

### § 1.927(b)–1T Temporary regulations; Definition of gross receipts.

(a) *General rule.* Under section 927(b), for purposes of sections 921 through 927, the gross receipts of a person for a taxable year are—

(1) *Business income.* The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) *Other income.* Gross income recognized from whatever source derived, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subdivision (1) of this paragraph),

(ii) Dividends and interest (including tax exempt interest),

(iii) The sale at a gain of any property not described in subdivision (1) of this paragraph, and

(iv) Commission transactions to the extent described in paragraph (e) of this section.

(b) *Non-gross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) *Loan transactions.* The proceeds of a loan or of the repayment of a loan, or

(2) *Non-taxable transactions.* A receipt of property in a transaction to which section 118 (relating to contribution to capital) or section 1032 (relating to exchange of stock for property) applies.

(c) *Non-reduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by costs of goods sold, expenses, losses, a deduction for dividends received, or any other deductible amounts. The total amounts received or accrued by a person are reduced by returns and allowances.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a FSC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the FSC for the taxable year for which such amount is included in the gross income of the FSC.

(e) *Commission transactions*—(1) *In general*—(i) *With a related supplier.* In the case of transactions which give rise to a commission from the FSC's related supplier on the sale or lease of property or the furnishing of services by a principal, the FSC's gross income from all such transactions is the commission paid or payable to the FSC by the related supplier. The FSC's gross receipts for purposes of computing its profit under the administrative pricing methods of section 925(a)(1) and (2) shall be the gross receipts (other than gross receipts which would not be foreign trading gross receipts had they been received by the FSC) derived by the related supplier from the sale or lease of the property or from the furnishing of services, with respect to which the commissions are derived. Also, in determining whether the 50% test in section 924(a) has been met, the relevant gross receipts are the gross receipts of the related supplier.

(ii) *With an unrelated principal.* In the case of transactions which give rise to a commission from an unrelated principal to a FSC on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the FSC as gross income from all such transactions shall be the commission received from the principal.

(2) *Selective commission arrangements*—(i) *In general.* A commission arrangement between the FSC and its related supplier may provide that the FSC will not be the related supplier's commission agent with respect to sales or leases of export property, or the furnishing of services, which do not result in foreign trading gross receipts. In addition, the commission agreement may provide that the FSC will not be the related supplier's commission agent on transactions which would result in a loss to the related supplier under the transfer pricing rules of section 925(a). In a buy-sell FSC situation, selective commission arrangements are not applicable. Determination of which transactions fall within the selective commission arrangement may be made up to the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's income tax return for the taxable year of the FSC during which a transaction occurs.

(ii) *Example.* The treatment of a selective commission arrangement may be illustrated by the following example:

*Example.* A calendar year commission FSC (''F'') entered into a selective commission arrangement with related supplier RS which provided that F will not be RS's commission agent on transactions which would result in a loss to RS under the transfer pricing rules of section 925(a). During 1987, RS sold three different articles of export property A, B and C, all of which fall within the same three digit Standard Industrial Classification. In July of 1988, while preparing the FSC's 1987 income tax return, RS determined that the sale of export property A resulted in a loss to RS under the section 482 method of section 925(a)(3) and that applying that method to the sales of export property B and C resulted in only a small amount of income to both RS and F. In addition, RS determined that grouping export property B and C, while excluding export property A from the grouping, resulted in the highest profit to F under the combined taxable income administrative pricing method of section 925(a)(2). Using the same grouping, the gross receipts method of section 925(a)(1) would result in a lower profit to F. Under the special no-loss rule of §1.925(a)–1T(e)(1)(iii), RS would be prohibited from using the combined taxable income administrative pricing method to determine F's profit for the grouping of export property B and C if it used the section 482 method on the sale of export property A. This results because there was a loss to RS on the sale of export property A. Under the selective commission arrangement, RS could exercise its option and exclude the sale of export property A. Since F is no longer deemed to have been operating as RS's commission agent on that sale, the combined taxable income method may be used to compute F's profit on the grouping of the sales of export property B and C.

(f) *Example.* The definition of gross receipts under this section may be illustrated by the following example:

*Example.* During 1985, M, a related supplier of N, is engaged in the manufacture of machines in the United States. N, a calendar year FSC, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of those machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it, interest on loans, and proceeds from sales of business assets located outside the United States resulting in recognized gains and losses. N's gross receipts for 1985 are $3,550, computed on the basis of the additional facts assumed in the table below:

| | |
|---|---|
| N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses) | $1,500 |
| N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses) | 500 |
| N's gross income from related and subsidiary services for machines manufactured by M (without reduction for service expenses) | 400 |
| N's sales receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales and commission sales expenses) | 550 |
| Dividends received by N | 150 |
| Interest received by N | 200 |
| Proceeds received by N representing recognized gain (but not losses) for sales of business assets located outside the United States | 250 |
| N's gross receipts | 3,550 |

[T.D. 8126, 52 FR 6464, Mar. 3, 1987]

### § 1.927(d)–1 Other definitions.

(a) *Carrying Charges.*

*Q–1.* Under what circumstances is the sales price of property or services sold

by a FSC or a related supplier considered to include carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A–9 of § 1.921–2?

*A–1.* (i) The proceeds received from a sale of export property by a FSC or a related supplier (or the amount paid for services rendered or from rental of export property) may include carrying charges if any part of the sale proceeds (or service or rental payment) is paid after the end of the normal payment period. If the export property is sold or leased by, or if the services are rendered by, the FSC, the entire carrying charges amount as determined in Q&A–2 of this section will be the income of the FSC. If, however, the FSC is the commission agent of a related supplier on these transactions, the carrying charges amount so determined is income of the related supplier. The commission payable to the FSC will be computed by reducing the related supplier's gross receipts from the transaction by the amount of the carrying charges. No carrying charges will be assessed on the commissions paid by the related supplier to the FSC. The carrying charges provisions, likewise, do not apply to any other transaction that does not give rise to foreign trading gross receipts.

(ii) The normal payment period for a sale transaction is 60 days from the earlier of date of sale or date of exchange of property under the contract. For this purpose, the date of sale will be the date the sale is recorded on the seller's books of account under its normal accounting method. The date the transaction was recorded on the seller's books of account shall be disregarded if recording is delayed in order to delay the start of the normal payment period. In these circumstances, the earlier of the date of the contract or date of exchange of property will be deemed the date of sale. For related and subsidiary services that are not separately stated from the sale or lease transaction, the earlier of the date of the sale or date the export property is delivered to the purchaser is the applicable date. For related and subsidiary services which are separately stated from the sale or lease transaction and for other services, such as engineering and architectural services, the normal payment period is 60 days from the earlier of the date payment is due for the services or the date services under the contract are completed. The date of completion of a services contract is the date of final approval of the services by the recipient. With regard to transactions involving the lease or rental of export property, the normal payment period will begin on the date the rental payment is due under the lease. The date the normal payment period begins under this subdivision (ii) will be the same whether or not the transaction is with a related person.

(iii) The carrying charges are computed for the period beginning with the first day after the end of the normal payment period and ending with the date of payment. A FSC may elect at any time prior to the close of the statute of limitations of section 6501(a) for the FSC taxable year to treat the final date of payment stated in the contract as the date of payment if—

(A) The contracts for all transactions completed during the taxable year require that payment be received within the normal payment period,

(B) No more than 20% of transactions for which final payment is received in the taxable year involve payment after the end of the normal payment period. For FSC taxable years beginning after March 3, 1987, the 20% test will apply only to the dollar value of the transactions and not to the number of transactions. For prior taxable years, the 20% test will apply to either the dollar value of the transactions or to the number of transactions. The special grouping rules applicable to determination of the FSC's profit under the administrative pricing rules of section 925 may be applied to this elective provision. Accordingly, transactions may be grouped into product or product-line groupings to determine whether 20% or less of the dollar value (or number of transactions, if applicable) of the grouped transactions involve payment after the end of the normal payment period.

*Q–2.* How are carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A 9 of § 1.921–9 computed?

*A–2.* If carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A 9 of § 1.921–

9 are considered to be included in the sale price of property income or rental payment services, the amount of the carrying charges is equal to the amount in subdivision (i) of this answer if the contract provides for stated interest or the amount in subdivisions (ii) or (iii) of this answer, whichever is applicable, if the contract does not so provide.

(i) If a contract provides for stated interest beginning on the day after the end of the normal payment period, carrying charges will accrue only if the stated interest rate is less than the short-term, monthly Federal rate as of the day after the end of normal payment period and then only to the extent the stated interest is less than the short-term, monthly Federal rate. The short-term, monthly Federal rate is that rate as determined for purposes of section 1274(d) and which is published in the Internal Revenue Bulletin. Carrying charges will not accrue, however, unless payments are made after the end of the normal payment period.

(ii) If a contract for a transaction does not provide for stated interest, and if the taxpayer does not elect the method described in subdivision (iii) of this answer, the amount of carrying charges is equal to the excess of—

(A) The amount of the sales price of property, services income or rental payment that is unpaid on the day after the end of the normal payment period, over

(B) The present value, as of the day after the end of the normal payment period, of all payments that are required to be made under the contract and that are unpaid on the day after the end of the normal payment period. The amount of the sales price of property, service income or rental payment is the amount under the contract whether it be the sales price, amount paid for services or the rental amount determined as of the actual payment date unless a FSC makes the election provided under subdivision (iii) of Q&A 1. If a FSC makes the election provided under subdivision (III) of Q&A 1, the amount of the sales price is the sales price, services income or rental payment under the contract determined as of the final payment date stated in the contract. All payments that are required to be made under the contract include the stated sales price, services income or rental payment as well as stated amounts of interest and carrying charges. The discount rate for the present value computation is simple interest at the short-term monthly Federal rate published in the Internal Revenue Bulletin, determined as of the day after the end of the normal payment period. The present value of a payment is calculated as follows:

$$P = S\frac{1}{(1+(i\times t))}$$

P=present value of a payment that is required and unpaid after the end of the normal payment period

S=amount of a payment that is required and unpaid after the end of the normal payment period

i=the short-term monthly Federal rate

t=the number of days after the end of the normal payment period and before date of payment divided by 365.

If a sale is made, or if services are completed, or if rent is due under a lease in a taxable year and the required date of payment is in a later taxable year, carrying charges for the first taxable year are computed for the number of days after the end of the normal payment period and before the end of the taxable year. For the following taxable year, carrying charges are computed for the number of days after the beginning of the taxable year and before the date of payment.

(iii) At the election of the taxpayer, the amount of carrying charges may be determined under the method described in this subdivision (iii). If the taxpayer elects this method, it must be used for all applicable transactions within the taxable year of the FSC. If this optional method is used, the computation of carrying charges must be made separately for transactions involving related persons and for those transactions involving unrelated persons. In addition, the computation of carrying charges must be made separately for each of the five types of income of the FSC (or of the related supplier if the related supplier is the principal on the transaction) listed in subparagraph (1) through (5) of section 924(a). These groupings are separate and distinct from the groupings that are established

for purposes of determining the FSC's profit on the export transactions. The optional method allowed in this subdivision provides that the amount of carrying charges for a taxable year of a FSC (or related supplier if the related supplier is the principal on the export transaction) is computed using the average of receivables of unrelated persons (or of related persons) and the average time those receivables are outstanding. Receivables are included in this computation only if they are from transactions on which foreign trading gross receipts, as defined in section 924(a), are received by the FSC (or which are received by a related supplier of a FSC and which would have been foreign trading gross receipts had they been received by the FSC). Carrying charges are calculated under this method as follows:

CC=(AR) (I/365) (X) (Y)

CC=Carrying charges
AR=Average monthly receivables balance for the taxable year
I=The average short-term, monthly Federal rate for the year
X=The number of times receivables turn over in the year
Y=The number of days the average receivables are outstanding over 60 days.

This optional method is illustrated in *Example 5* in subdivision (v) of this answer.

(iv) The computation of carrying charges under this answer 2 applies only to the determination of carrying charges under subdivision (ii)(B)(*1*) of Q&A 9 of §1.921–2 and does not apply to the determination of any other unstated interest or for any other purpose.

(v) The following examples illustrate the computation of carrying charges under this section:

*Example 1.* On January 1, 1985, a FSC sells export property for $10,000. The export property is delivered to the purchaser on January 10, 1985. The terms of the contract require payment within 90 days after sale. The normal payment period is 60 days. The FSC does not make an election under subdivision (iii) of Q&A. The contract does not require the payment of any interest or carrying charges. The purchaser pays the entire sales price on March 1, 1985. The sales price is not considered to include any carrying charges because the purchase paid the entire sales price within the normal payment period.

*Example 2.* The facts are the same as in example 1 except that the purchaser pays the entire sales price on April 6, 1985, 96 days after the earlier of the date of sale or date of delivery (*i.e.*, January 1, 1985). Therefore, the sales price is considered to include carrying charges computed as follows:

*Step 1:* Determines the short-term monthly Federal rate as of the earlier of date of sale or date of delivery. For purposes of this example, the rate is 10%.

*Step 2:* Determine the fraction of the year represented by the number of days after 60 days and before date of payment. In this example, the number of days beyond 60 is 96–60=36, which is divided by 365

$$\frac{36\ \text{days}}{365\ \text{days}} = .099\ \text{fraction of the year}$$

*Step. 3:* Using the short-term monthly Federal rate and the fraction of the year, compute the present value of the payment.

$$P = S\frac{1}{\left(1+\left(i\times t\right)\right)}$$

$$P = \$10{,}000\frac{1}{\left(1+\left(.10\sqrt{099}\right)\right)}$$

P=$10,000 (.99)
P=$9,900

*Step 4:* Using the present value of all payments, compute the carrying charges.

Carrying Charges=Sales Price less Present Value.

| | |
|---|---|
| $10,000 | Sales Price |
| –9,900 | Present Value |
| $100 | Carrying charges |

*Example 3.* On October 15, 1985, F, a FSC, leases export property to X for one month with a total rental due of $20,000. Under the terms of the lease, A agreed to pay F $10,000 on October 15, 1985, and the remaining $10,000 on January 15, 1986. The contract does not require the payment of any interest or carrying charges. The second $10,000 payment is made on January 3, 1986. This payment does not include any carrying charges because X paid the $10,000 before the start of the normal payment period.

*Example 4.* On October 15, 1985, F, a FSC, leases export property to X, for one month with a total amount due under the lease of $10,000, payable on October 15, 1985. X delays payment until January 19, 1986, which was 96 days after the start of the normal payment period. The 60 day normal payment period terminated on December 14, 1985. Therefore, the lease payment is considered to include carrying charges of $100 computed in the

same manner as in *Example 2*. Of this $100, 17/36, or $47.22, is carrying charges for 1985 (*i.e.*, 17 days in December), and 19/36, or $52.78, is carrying charges for 1986.

*Example 5*. During 1986, F, a FSC, sold on account export properties A and B to related and unrelated persons.

(A) *Unrelated persons*. During 1986, the sales on account to unrelated persons totaled $6,000. On the last day of each of the months of 1986, F had total receivables from unrelated persons from sales of export properties A and B, as follows:

| | |
|---|---|
| January 31 | $1,400 |
| February 28 | 1,400 |
| March 31 | 1,000 |
| April 30 | 1,000 |
| May 31 | 1,200 |
| June 30 | 1,300 |
| July 31 | 1,000 |
| August 31 | 1,300 |
| September 30 | 1,500 |
| October 31 | 1,100 |
| November 30 | 1,200 |
| December 31 | 1,000 |
| | 14,400 |

Carrying charges for 1986 with unrelated persons under the optional method of subdivision (iii) of this answer will be $19.23, computed as follows:

*Step 1:* Determine the average short-term, monthly Federal rate for the year. For purposes of this example, the rate is assumed to be 9%.

*Step 2:* Determine the average receivables for the year. This average is calculated by totaling the end of the month receivables balance of each month of the year and dividing by twelve. In this example, the average monthly receivables balance is $1,200, calculated as follows:

$1,200=$14,400/12

*Step 3:* Determine the number of times the receivables turn over during the year. This is calculated by dividing the sales on account for the year by the average monthly receivables balance for the year. For purposes of this example, receivables turned over 5 times for 1986, computed as follows:

$$5 = \frac{\$6{,}000}{\$1{,}200}$$

*Step 4:* Determine the number of days the average receivables are outstanding in excess of 60 days. In this example, there are 13 receivable days in excess of 60 days, computed as follows:

$$13\,\text{days} = \left(\frac{365}{5}\right) - 60\,\text{days}$$

*Step 5:* The amount of carrying charges, $19.23, is calculated by using the following equation:

CC=(AR) (I/365) (X)(Y)

CC=Carrying charges
AR=Average monthly receivables balance for the taxable year (step 2)
I=The average short-term monthly Federal rate for the year (step 1)
X=The number of times receivables turn over in the year (step 3)
Y=The number of days the average receivables are outstanding over 60 days (step 4).
CC=$19.23=($1,200) (.09/365) (5) (13)

(B) *Related persons*. Carrying charges, if any, on the sales on account to related persons must be computed separately using this optional method.

*Q–3*. Is a discount from the sales price of property or services for prompt payment considered to be stated carrying charges as defined in subdivision (ii)(A) of Q&A 9 of §1.921–2?

*A–3*. No.

*Q–4*. Is the receipt of an arm's length factoring payment from an unrelated person considered a payment of the sales proceeds for purposes of determining whether payment is made within the normal payment period and the possible imposition of carrying charges?

*A–4*. Yes.

[T.D. 8127, 52 FR 6473, Mar. 3, 1987]

### § 1.927(d)–2T Temporary regulations; definitions and special rules relating to Foreign Sales Corporation.

(a) *Definition of related supplier*. For purposes of sections 921 through 927 and the regulations under those sections, the term ''related supplier'' means a related party which directly supplies to a FSC any property or services which the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party which uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. A FSC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of F, a FSC, and X sells a product to Y which is resold to F, only Y is the related supplier of F. If, however, X sells directly to F and Y also sells directly to F, then, as to the transactions involving direct sales to F, each of X and Y is a related supplier of F.

(b) *Definition of related party*. The term ''related party'' means a person which is owned or controlled directly or indirectly by the same interests as

the FSC within the meaning of section 482 and §1.482–1(a).

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

### § 1.927(e)–1 Special sourcing rule.

(a) *Source rules for related persons*—(1) *In general.* The income of a person described in section 482 from a sale of export property giving rise to foreign trading gross receipts of a FSC that is treated as from sources outside the United States shall not exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under section 994 that corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described in the first sentence of this paragraph (a)(1) that gives rise to foreign trading gross receipts and the transfer pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) *Grouping of transactions.* If, for purposes of determining the FSC's profits under the administrative pricing rules of sections 925(a) (1) and (2), grouping of transactions under §1.925(a)–1T(c)(8) was elected, the same grouping shall be used for making the determinations under the special sourcing rule in this section.

(3) *Corresponding DISC pricing rules*—(i) *In general.* For purposes of this section—

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) *Special rules.* For purposes of this section—

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and

(2) Shall be deemed to be an amount equal to the foreign trading gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

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

*Example 1.* (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is $100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the $100 combined taxable income of R and F ($23) is allocated to F and the remaining $77 is allocated to R. Absent the special sourcing rule, under section 863(b) the $77 income allocated to R would be sourced $38.50 U.S. source and $38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), $50 of the combined taxable income ($100 × .50) would be allocated to the DISC and the remaining $50 would be allocated to the related supplier. Under section 863(b), the $50 income allocated to the DISC's related supplier would be sourced $25 U.S. source and $25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $25.

*Example 2.* (i) Assume the same facts as in *Example 1* except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are $2,000.

(ii) Under section 925(a)(1), 1.83 percent of the $2,000 foreign trading gross receipts

($36.60) is allocated to F and the $63.40 remaining combined taxable income ($100 − $36.60) is allocated to R. Absent the special sourcing rule, under section 863(b) the $63.40 income allocated to R would be sourced $31.70 U.S. source and $31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), $80 ($2,000 × .04) would be allocated to the DISC and the $20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the $20 income allocated to the DISC's related supplier would be sourced $10 U.S. source and $10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $10.

(c) *Effective date.* The rules of this section are applicable to taxable years beginning after December 31, 1997.

[T.D. 8782, 63 FR 50144, Sept. 21, 1998]

### § 1.927(e)–2T Temporary regulations; effect of boycott participation on FSC and small FSC benefits.

(a) *International boycott factor.* If the FSC (or small FSC) or any member of the FSC's (or small FSC's) controlled group participates in or cooperates with an international boycott within the meaning of section 999, the FSC's (or small FSC's) exempt foreign trade income as determined under section 923 (a) shall be reduced by an amount equal to the product of the FSC's (or small FSC's) exempt foreign trade income multiplied by the international boycott factor determined under section 999. The amount of the reduction will be considered as non-exempt foreign trade income.

(b) *Specifically attributable taxes and income method.* If the taxpayer clearly demonstrates that the income earned for the taxable year is attributable to specific operations, then in lieu of applying the international boycott factor for such taxable year, the amount of the exempt foreign trade income as determined under section 923(a) that will be reduced by this section shall be the amount specifically attributable to the operations in which there was participation in or cooperation with an international boycott under section 999(b)(1). The amount of the reduction will be considered as non-exempt foreign trade income.

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

### § 1.927(f)–1 Election and termination of status as a Foreign Sales Corporation.

(a) *Election of status as a FSC or a small FSC.*

*Q–1.* What is the effect of an election by a corporation to be treated as a FSC or small FSC?

*A–1.* A valid election to be treated as a FSC or a small FSC applies to the taxable year of the corporation for which made and remains in effect for all succeeding taxable years in which the corporation qualifies to be a FSC unless revoked by the corporation or unless the corporation fails for five consecutive years to qualify as a FSC (in case of a FSC election) or as a small FSC (in case of a small FSC election).

*Q–2.* Can a corporation established prior to January 1, 1985 be treated as a FSC or a small FSC prior to making a FSC or a small FSC election?

*A–2.* A corporation cannot be treated as a FSC or a small FSC until it has made a FSC or a small FSC election. An election made within the first 90 days of 1985 relates back to January 1, 1985 unless the taxpayer indicates otherwise.

*Q–3.* If a shareholder who has not consented to a FSC or small FSC election transfers some or all of its shares before or during the first taxable year for which the election is made, may the holder of the transferred shares consent to the election?

*A–3.* A holder of the transferred shares may consent to a FSC or small FSC elction under the circumstances described in §1.922–2(c)(1). The rules contained in §1.992–(c) shall apply to the consent by a holder of transferred shares.

*Q–4.* If a shareholder who has consented to a FSC or a small FSC election transfers some or all of its shares before the first taxable year for which the election is made, must the holder of the transferred shares consent to the election?

*A–4.* Yes. Consent must be made by any recipient of such shares on or before the 90th day after the first day of

such first taxable year. If such recipient fails to file his consent on or before such 90th day, and extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of §1.992–2.

*Q–5.* May an election of a corporation to be a FSC or a small FSC be effective as of a time other than the start of the corporation's taxable year?

*A–5.* No.

*Q–6.* If a fiscal year foreign corporation was in existence on December 31, 1984, must it wait until the first day of its taxable year beginning after January 1, 1985, to elect FSC status?

*A–6.* No. If a fiscal year foreign corporation was in existence on December 31, 1984, its taxable year will be deemed to have terminated on that date if the foreign corporation elects FSC status to be effective January 1, 1985. An income tax return will be required for any short years created by the deemed closing of the taxable year unless the corporation is relieved from the necessity of making a return by section 6012 and the regulations under that section. If the corporation's taxable year is deemed closed by operation of this regulation, the filing date of tax returns for the short taxable year ended on December 31, 1984, will be automatically extended until May 18, 1987.

*Q–7.* What is the effect of an election to be treated as a FSC or as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as an interest charge DISC?

*A–7.* The interest charge DISC election shall be treated as revoked for all purposes under the Code as of the date the FSC election is effective. An affirmative revocation of the DISC election is unnecessary. The FSC election shall take effect. As long as the FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as an interest charge DISC for any taxable year including any part of a taxable year during which the corporation's FSC election continues to be effective.

*Q–8.* What is the effect of an election to be treated as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a FSC?

*A–8.* As long as a FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a small FSC for any taxable year including any part of a taxable year during which a FSC election continues to be effective. Any FSC within the controlled group must affirmatively revoke its FSC election for a taxable year including any part of a taxable year for which small FSC status is elected.

*Q–9.* What is the effect of an election to be treated as a FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a small FSC?

*A–9.* As long as a small FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a FSC for any taxable year including any part of the taxable year during which a small FSC election continues to be effective. Any small FSC within the controlled group must affirmatively revoke its small FSC election for a taxable year including any part of a taxable year for which FSC status is elected. An election to be treated as a small FSC is permitted if the corporation or any other member of the controlled group has in effect an election to be treated as a small FSC. For a special rule providing for conversion of a small FSC to a FSC within one taxable year, see §1.921–1T(b)(1) (Q&A–1).

(b) *Termination of election of status as a FSC or a small FSC.*

*Q–10.* How is the status of a corporation as a FSC or as a small FSC terminated?

*A–10.* The status of a corporation as a FSC or as a small FSC is terminated through revocation or by its continued failure to be a FSC.

*Q–11.* For what taxable year may a corporation revoke its election to be treated as a FSC or as a small FSC?

*A–11.* A corporation may revoke its election to be treated as a FSC or as a small FSC for any taxable year of the corporation after the first taxable year for which the election is effective.

*Q–12*. When must a corporation revoke a FSC or a small FSC election if revocation is to be effective for the taxable year in which revocation takes place?

*A–12*. If a corporation files a statement revoking its election to be treated as a FSC or as a small FSC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a FSC or a small FSC after the firs 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

*Q–13*. Can a FSC change its status to a small FSC, or can a small FSC change its status to a FSC as of a date other than the first day of a taxable year?

*A–13*. No. Since a revocation of an election to be a FSC or a small FSC is effective only for entire taxable year, a corporation's change between FSC and small FSC status is effective as of the first day of a taxable year.

*Q–14*. How may a corporation revoke an election by a corporation to be treated as a FSC or a small FSC?

*A–14*. A corporation may revoke its election by filing a statement that the corporation revokes its election under section 922(a) to be treated as a FSC or under section 922(b) to be treated as a small FSC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporate return under section 6062. Such revocation shall be filed with the Service Center with which the corporation filed its return.

*Q–15*. What if the effect is a corporation that has elected to be treated as a FSC or a small FSC fails to qualify as a FSC because it does not meet the requirements of section 922 for a taxable year?

*A–15*. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify as a FSC or a small FSC for a taxable year, the corporation will not be treated as a FSC or a small FSC for the taxable year. However, the failure of a corporation to qualify to be treated as a FSC or a small FSC for a taxable year does not terminate the election of the corporation to be treated as FSC or a small FSC unless the corporation does not qualify under section 922 for each of 5 consecutive taxable years, as provided in Q&A 16 of this section.

*Q–16*. Under what circumstances is the FSC or small FSC election terminated for continued failure to be a FSC?

*A–16*. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify under section 922 to be treated as a FSC or small FSC for each of 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically without notice to such corporation or to the Internal Revenue Service.

[T.D. 8127, 52 FR 6475, Mar. 3, 1987]

POSSESSIONS OF THE UNITED STATES

### § 1.931–1 Exclusion of certain income from sources within Guam, American Samoa, or the Northern Mariana Islands.

[Reserved]. For further guidance, see § 1.931–1T.

[T.D. 9194, 70 FR 18930, Apr. 11, 2005]

### § 1.931–1T Exclusion of certain income from sources within Guam, American Samoa, or the Northern Mariana Islands (temporary).

(a) *General rule*. (1) An individual (whether a United States citizen or an alien), who is a bona fide resident of a section 931 possession during the entire taxable year, shall exclude from gross income the income derived from sources within any section 931 possession and the income effectively connected with the conduct of a trade or business by such individual within any section 931 possession, except amounts received for services performed as an employee of the United States or any agency thereof.

(2) The following example illustrates the application of the general rule in paragraph (a)(1) of this section:

*Example.* [Reserved]

(b) *Deductions and credits.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 931, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions), or any credit, properly allocable to, or chargeable against, the amounts so excluded from gross income. For purposes of the preceding sentence, the rules of §1.861–8 shall apply (with creditable expenditures treated in the same manner as deductible expenditures).

(c) *Definitions.* For purposes of this section:

(1) The term *section 931 possession* means a possession that is a specified possession and that has entered into an implementing agreement, as described in section 1271(b) of the Tax Reform Act of 1986 (Public Law 99–514 (100 Stat. 2085)), with the United States that is in effect for the entire taxable year.

(2) The term *specified possession* means Guam, American Samoa, or the Northern Mariana Islands.

(3) The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of a section 931 possession.

(4) The rules of §1.937–2T shall apply for determining whether income is from sources within a section 931 possession.

(5) The rules of §1.937–3T shall apply for determining whether income is effectively connected with the conduct of a trade or business within a section 931 possession.

(d) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18930, Apr. 11, 2005, as amended by T.D. 9248, 71 FR 5001, Jan. 31, 2006]

### §1.932–1 Coordination of United States and Virgin Islands income taxes.

[Reserved]. For further guidance, see §1.932–1T.

[T.D. 9194, 70 FR 18931, Apr. 11, 2005]

### §1.932–1T Coordination of United States and Virgin Islands income taxes (temporary).

(a) *Scope*—(1) *In general.* Section 932 and this section set forth the special rules relating to the filing of income tax returns and income tax liabilities of individuals described in paragraph (a)(2) of this section. Paragraph (h) of this section also provides special rules requiring consistent treatment of business entities in the United States and in the United States Virgin Islands (Virgin Islands).

(2) *Individuals covered.* This section shall apply to any individual who:

(i) Is a bona fide resident of the Virgin Islands during the entire taxable year;

(ii)(A) Is a citizen or resident of the United States (other than a bona fide resident of the Virgin Islands) during the entire taxable year; and

(B) Has income derived from sources within the Virgin Islands, or effectively connected with the conduct of a trade or business within the Virgin Islands, for the taxable year; or

(iii) Files a joint return for the taxable year with any individual described in paragraph (a)(2)(i) or (ii) of this section.

(3) *Definitions.* For purposes of this section:

(i) The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of the Virgin Islands.

(ii) The rules of §1.937–2T shall apply for determining whether income is from sources within the Virgin Islands.

(iii) The rules of §1.937–3T shall apply for determining whether income is effectively connected with the conduct of a trade or business within the Virgin Islands.

(b) *U.S. individuals with V.I. income*—(1) *Dual filing requirement.* Subject to paragraph (d) of this section, an individual described in paragraph (a)(2)(ii) of this section shall make an income tax return for the taxable year to the United States and file a copy of such return with the Virgin Islands. Such individuals must also attach Form 8689, ''Allocation of Individual Income Tax to the Virgin Islands,'' to the U.S. income tax return and to the income

tax return filed with the Virgin Islands.

(2) *Tax payments.* (i) Each individual to whom this paragraph (b) applies for the taxable year shall pay the applicable percentage of the taxes imposed by this chapter for such taxable year (determined without regard to paragraph (b)(2)(ii) of this section) to the Virgin Islands.

(ii) There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the taxes required to be paid to the Virgin Islands under paragraph (b)(2)(i) of this section which are so paid. Such taxes shall be considered creditable in the same manner as taxes paid to the United States (*e.g.*, under section 31) and not as taxes paid to a foreign government (*e.g.*, under sections 27 and 901).

(iii) For purposes of this paragraph (b)(2):

(A) The term *applicable percentage* means the percentage which Virgin Islands adjusted gross income bears to adjusted gross income.

(B) The term *Virgin Islands adjusted gross income* means adjusted gross income determined by taking into account only income derived from sources within the Virgin Islands and deductions properly apportioned or allocable thereto. For purposes of the preceding sentence, the rules of §1.861–8 shall apply.

(C) Pursuant to §1.937–2T(a), the rules of §1.937–2T(c)(1)(ii) and (c)(2) do not apply.

(c) *Bona fide residents of the Virgin Islands.* Subject to paragraph (d) of this section, an individual described in paragraph (a)(2)(i) of this section shall be subject to the following income tax return filing requirements:

(1) *V.I. filing requirements.* An individual to whom this paragraph (c) applies shall file an income tax return for the taxable year with the Virgin Islands. On this return, the individual shall report income from all sources and identify the source of each item of income shown on the return.

(2) *U.S. filing requirements.* For purposes of calculating the income tax liability to the United States of an individual to whom this paragraph (c) applies, gross income shall not include any amount included in gross income on the return filed with the Virgin Islands pursuant to paragraph (c)(1) of this section, and deductions and credits allocable to such income shall not be taken into account, provided that—

(i) The individual fully satisfied the reporting requirements of paragraph (c)(1) of this section; and

(ii) The individual fully paid the tax liability referred to in section 934(a) to the Virgin Islands with respect to such income.

(d) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction (or jurisdictions) where the spouse who has the greater adjusted gross income for the taxable year would be required under paragraph (b) or (c) of this section to file a return if separate returns were filed and all of their income were the income of such spouse. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall be treated as ending on the date of such death.

(e) *Place for filing returns*—(1) *U.S. returns.* A return required under the rules of paragraphs (b) and (c) of this section to be filed with the United States shall be filed as directed in the applicable forms and instructions.

(2) *V.I. returns.* A return required under the rules of paragraphs (b) and (c) of this section to be filed with the Virgin Islands shall be filed as directed in the applicable forms and instructions.

(f) *Tax accounting standards*—(1) *In general.* A dual filing taxpayer must use the same tax accounting standards on the returns filed with the United States and the Virgin Islands. A taxpayer who has filed a return only with the United States or only with the Virgin Islands as a single filing taxpayer for a prior taxable year and is required to file a return only with the other jurisdiction as a single filing taxpayer for a later taxable year may not, for

such later taxable year, use different tax accounting standards unless the second jurisdiction consents to such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing the taxpayer also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this paragraph (f) must be made to the office where the return is required to be filed under paragraph (e) of this section and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(2) *Definitions.* For purposes of this paragraph (f):

(i) The term *dual filing taxpayer* means a taxpayer who is required to file returns with the United States and the Virgin Islands for the same taxable year under the rules of paragraph (b) or (c) of this section.

(ii) The term *single filing taxpayer* means a taxpayer who is required to file a return only with the United States (because the individual is not described in paragraph (a)(2) of this section) or only with the Virgin Islands (because the individual is described in paragraph (a)(2)(i) of this section and satisfies the conditions of paragraphs (c)(2)(i) and (ii) of this section) for the taxable year.

(iii) The term *tax accounting standards* includes the taxpayer's accounting period, methods of accounting, and any election to which the taxpayer is bound with respect to the reporting of taxable income.

(g) *Extension of territory*—(1) *Section 932(a) taxpayers*—(i) *General rule.* With respect to an individual to whom section 932(a) applies for a taxable year, for purposes of taxes imposed by Chapter 1 of the Internal Revenue Code, the United States generally shall be treated, in a geographical and governmental sense, as including the Virgin Islands. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the Virgin Islands. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Internal Revenue Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (g)(1)(i) of this section apply include:

(A) The characterization of taxes paid to the Virgin Islands. An individual to whom section 932(a) applies may take income tax required to be paid to the Virgin Islands under section 932(b) into account under sections 31, 6315, and 6402(b) as payments to the United States. Taxes paid to the Virgin Islands and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes required to be paid to the Virgin Islands under section 932(b) will be disallowed as a deduction under section 275(a).

(B) The determination of the source of income for purposes of the foreign tax credit (*e.g.*, sections 901 through 904). Thus, for example, after an individual to whom section 932(a) applies determines which items of income constitute income from sources within the Virgin Islands under the rules of section 937(b), such income shall be treated as income from sources within the United States for purposes of section 904.

(C) The eligibility of a corporation to make a subchapter S election (sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the Virgin Islands may make an election under section 1362(a) to be a subchapter S corporation, it shall be treated as a domestic corporation and a shareholder to whom section 932(a) applies shall not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation shall be treated as a domestic corporation for all purposes of the Internal Revenue Code. For the consistency requirement with respect to entity status elections, see paragraph (h) of this section.

(D) The treatment of items carried over from other tax years. Thus, for example, if an individual to whom section 932(a) applies has for a taxable year a net operating loss carryback or carryover under section 172, a foreign tax credit carryback or carryover under section 904, a business credit carryback or carryover under section 39, a capital

loss carryover under section 1212, or a charitable contributions carryover under section 170, the carryback or carryover will be reported on the return filed in accordance with paragraph (b)(1) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with the Virgin Islands under section 932(c).

(E) The treatment of property exchanged for property of a like kind (section 1031). Thus, for example, if an individual to whom section 932(a) applies exchanges real property located in the United States for real property located in the Virgin Islands, notwithstanding the provisions of section 1031(h), such exchange may qualify as a like-kind exchange under section 1031 (provided that all the other requirements of section 1031 are satisfied).

(iii) *Nonapplication of the general rule.* Contexts in which the general rule of paragraph (g)(1)(i) of this section does not apply include:

(A) The application of any rules or regulations that explicitly treat the United States and any (or all) of its possessions as separate jurisdictions (*e.g.*, sections 931 through 937, 7651, and 7654).

(B) The determination of any aspect of an individual's residency (*e.g.*, sections 937(a) and 7701(b)). Thus, for example, an individual whose principal place of abode is in the Virgin Islands is not considered to have a principal place of abode in the United States for purposes of section 32(c).

(C) The characterization of a corporation for purposes other than subchapter S (*e.g.*, sections 367, 951 through 964, 1291 through 1298, 6038, and 6038B). Thus, for example, if an individual to whom section 932(a) applies transfers appreciated tangible property to a corporation created or organized in the Virgin Islands in a transaction described in section 351, he or she must recognize gain unless an exception under section 367(a) applies. Also, if a corporation created or organized in the Virgin Islands qualifies as a passive foreign investment company under sections 1297 and 1298 with respect to an individual to whom section 932(a) applies, a dividend paid to such shareholder does not constitute qualified dividend income under section 1(h)(11)(B).

(2) *Section 932(c) taxpayers*—(i) *General rule.* With respect to an individual to whom section 932(c) applies for a taxable year, for purposes of the territorial income tax of the Virgin Islands (*i.e.*, mirrored sections of the Internal Revenue Code), the Virgin Islands generally shall be treated, in a geographical and governmental sense, as including the United States. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the Virgin Islands. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Internal Revenue Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (g)(2)(i) of this section apply include:

(A) The characterization of taxes paid to the United States. A taxpayer described in section 932(c)(1) may take income tax paid to the United States into account under mirrored sections 31, 6315, and 6402(b) as payments to the Virgin Islands.

(B) The determination of the source of income for purposes of the foreign tax credit (*e.g.*, mirrored sections 901 through 904). Thus, for example, any item of income that constitutes income from sources within the United States under the rules of sections 861 through 865 shall be treated as income from sources within the Virgin Islands for purposes of mirrored section 904.

(C) The eligibility of a corporation to make a subchapter S election (mirrored sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the United States may make an election under mirrored section 1362(a) to be a subchapter S corporation, it shall be treated as a domestic corporation and a shareholder to whom section 932(c) applies shall not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation shall be treated as a domestic corporation for all purposes of the territorial income tax. For the consistency requirement with respect

to entity status elections, see paragraph (h) of this section.

(D) The treatment of items carried over from other tax years. Thus, for example, if an individual to whom section 932(c) applies has for a taxable year a net operating loss carryback or carryover under mirrored section 172, a foreign tax credit carryback or carryover under mirrored section 904, a business credit carryback or carryover under mirrored section 39, a capital loss carryover under mirrored section 1212, or a charitable contributions carryover under mirrored section 170, the carryback or carryover will be reported on the return filed in accordance with paragraph (c)(1) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with the United States.

(E) The treatment of property exchanged for property of a like kind (mirrored section 1031). Thus, for example, if an individual to whom section 932(c) applies exchanges real property located in the United States for real property located in the Virgin Islands, notwithstanding the provisions of mirrored section 1031(h), such exchange may qualify as a like-kind exchange under mirrored section 1031 (provided that all the other requirements of mirrored section 1031 are satisfied).

(iii) *Nonapplication of general rule.* Contexts in which the general rule of paragraph (g)(2)(i) of this section does not apply include:

(A) The determination of any aspect of an individual's residency (*e.g.*, mirrored section 7701(b)). Thus, for example, an individual whose principal place of abode is in the United States is not considered to have a principal place of abode in the Virgin Islands for purposes of mirrored section 32(c).

(B) The determination of the source of income for purposes other than the foreign tax credit (*e.g.*, sections 932(a) and (b), 934(b), and 937). Thus, for example, compensation for services performed in the United States and rentals or royalties from property located in the United States do not constitute income from sources within the Virgin Islands for purposes of section 934(b).

(C) The definition of wages (mirrored section 3401). Thus, for example, services performed by an employee for an employer in the United States do not constitute services performed in the Virgin Islands under mirrored section 3401(a)(8).

(h) *Entity status consistency requirement*—(1) *In general.* Taxpayers should make consistent entity status elections (as defined in paragraph (h)(3) of this section), where applicable, in both the United States and the Virgin Islands. In the case of a business entity to which this paragraph (h) applies:

(i) If an entity status election is filed with the Internal Revenue Service but not with the Virgin Islands Bureau of Internal Revenue (BIR), the Director of the BIR or his delegate, at his discretion, may deem the election also to have been made for Virgin Islands tax purposes.

(ii) If an entity status election is filed with the BIR but not with the Internal Revenue Service, the Commissioner, at his discretion, may deem the election also to have been made for U.S. Federal tax purposes.

(iii) If inconsistent entity status elections are filed with the BIR and the Internal Revenue Service, both the Commissioner and the Director of the BIR or his delegate may, at their individual discretion, treat the elections they each received as invalid and may deem the election filed in the other jurisdiction to have been made also for tax purposes in their own jurisdiction. (See Rev. Proc. 89–8 (1989–1 C.B. 778) for procedures for requesting the assistance of the Internal Revenue Service when a taxpayer is or may be subject to inconsistent tax treatment by the Internal Revenue Service and a U.S. possession tax agency.)

(2) *Scope.* This paragraph (h) applies to the following business entities:

(i) A business entity (as defined in §301.7701–2(a) of this chapter) that is domestic (as defined in §301.7701–5 of this chapter), or otherwise treated as domestic for purposes of the Internal Revenue Code, and that is owned in whole or in part by any person who is either a bona fide resident of the Virgin Islands or a business entity created or organized in the Virgin Islands.

(ii) A business entity that is created or organized in the Virgin Islands and that is owned in whole or in part by

any U.S. person (other than a bona fide resident of the Virgin Islands).

(3) *Definition.* For purposes of this section, the term *entity status election* includes an election under §301.7701–3(c) of this chapter, an election under section 1362(a), and any other similar elections.

(4) *Default status.* Solely for the purpose of determining classification of an eligible entity under §301.7701–3(b), and §301.7701–3(b) as mirrored in the Virgin Islands, an eligible entity subject to this paragraph (h) shall be classified for both U.S. Federal and Virgin Islands tax purposes using the rule that applies to domestic eligible entities.

(5) *Transition rules*—(i) In the case of an election filed prior to April 11, 2005, except as provided in paragraph (h)(5)(ii) of this section, the rules of paragraph (h)(1) of this section shall apply as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(ii) In the unlikely circumstance that inconsistent elections described in paragraph (h)(1)(iii) are filed prior to April 11, 2005, and the entity cannot change its classification to achieve consistency because of the sixty-month limitation described in §301.7701–3(c)(1)(iv) of this chapter, then the entity may nevertheless request permission from the Commissioner or the Director of the BIR or his delegate to change such election to avoid inconsistent treatment by the Commissioner and the Director of the BIR or his delegate.

(iii) Except as provided in paragraphs (h)(5)(i) and (h)(5)(ii) of this section, in the case of an election filed with respect to an entity before it became an entity described in paragraph (h)(2) of this section, the rules of paragraph (h)(1) of this section shall apply as of the first day that such entity is described in paragraph (h)(2) of this section.

(iv) In the case of an entity created or organized prior to April 11, 2005, paragraph (h)(4) of this section shall take effect for U.S. Federal income tax purposes (or Virgin Islands income tax purposes, as the case may be) as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(i) *Examples.* The rules of this section are illustrated by the following examples:

*Example 1.* (i) A is a U.S. citizen who resides in State R. The Federal Individual Income Tax Return, Form 1040, that A prepares for 2004 reports adjusted gross income of $90x, including $30x from sources in the U.S. Virgin Islands (USVI). The income tax liability reported on A's Form 1040 is $18x. A files a copy of his Federal Form 1040 with the USVI Bureau of Internal Revenue as required by section 932(a)(2) and paragraph (b)(1) of this section, and pays the applicable percentage of his Federal income tax liability to the USVI as required by section 932(b) and paragraph (b)(2) of this section, computed as follows:

$30/90 \times 18x = \$6x$ income tax liability to the USVI

(ii) A claims a credit against his Federal income tax liability reported on his Form 1040 in the amount of $6x. A attaches a Form 8689, ''Allocation of Individual Income Tax to the Virgin Islands,'' to the Form 1040 filed with the Internal Revenue Service and to the copy of the Form 1040 filed with the USVI.

*Example 2.* [Reserved]

*Example 3.* H and W are U.S. citizens. H resides in State T and W is a bona fide resident of the U.S. Virgin Islands (USVI). For 2004, H and W prepare a joint Individual Income Tax Return, Form 1040, which reports total adjusted gross income of $75x of which $40x is attributable to compensation that W received for services performed in the USVI and $35x to compensation that H received for services performed in State T. Pursuant to section 932(d) and paragraph (d) of this section, the joint income tax return of H and W is filed with the USVI as required by section 932(c) and paragraph (c) of this section. H and W may claim a tax credit on such return for income tax withheld during 2004 and paid to the Internal Revenue Service.

*Example 4.* (i) The facts are the same as in example 3, except that H also earns $25x for services performed in the USVI, so that H and W's total adjusted gross income is $100x, and their total income tax liability is $20x.

(ii) Pursuant to section 932(d) and paragraph (d) of this section, H and W must file a copy of their joint Federal Form 1040 with the Bureau of Internal Revenue of the USVI as required by section 932(a)(2) and paragraph (b)(1) of this section, and pay the applicable percentage of their Federal income tax liability to the USVI as required by section 932(b) and paragraph (b)(2) of this section, computed as follows:

$65/100 \times 20x = \$13x$ income tax liability to the USVI

(iii) H and W claim a credit against their Federal income tax liability reported on the

Form 1040 in the amount of $13x, the portion of their Federal income tax liability required to be paid to the USVI. H and W attach a Form 8689, ''Allocation of Individual Income Tax to the Virgin Islands,'' to the Form 1040 filed with the Internal Revenue Service and to the copy of the Form 1040 filed with the USVI.

*Example 5.* J is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands (USVI). In 2005, J receives compensation for services performed in the USVI in the amount of $40x. J prepares and files an Individual Income Tax Return, Form 1040, with the USVI and reports gross income of only $30x. J has not satisfied the conditions of section 932(c)(4) and paragraph (c) of this section for an exclusion from gross income for U.S. Federal income tax purposes and, therefore, must file a Federal income tax return in accordance with the Internal Revenue Code and the regulations.

*Example 6.* (i) N is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands. In 2004, N receives compensation for services performed in Country M. N prepares and files an Individual Income Tax Return, Form 1040, with the USVI and reports the compensation as income effectively connected with the conduct of a trade or business in the USVI. N claims a special credit against the tax on this compensation purportedly pursuant to a USVI law enacted within the limits of its authority under section 934.

(ii) Under the principles of section 864(c)(4) as applied pursuant to section 937(b)(1) and §1.937-3T(b), compensation for services performed outside the USVI may not be treated as income effectively connected with the conduct of a trade or business in the USVI for purposes of section 934(b). Consequently, N is not entitled to claim the special credit under USVI law with respect to N's income from services performed in Country M. Given that N has not fully paid his tax liability referred to in section 934(a), he has not satisfied the conditions of section 932(c)(4) and paragraph (c) of this section for an exclusion from gross income for U.S. Federal income tax purposes. Accordingly, N must file a Federal income tax return in accordance with the Internal Revenue Code and the regulations.

(j) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18931, Apr. 11, 2005, as amended by T.D. 9248, 71 FR 5001, Jan. 31, 2006]

### § 1.933–1 Exclusion of certain income from sources within Puerto Rico.

(a) [Reserved]. For further guidance, see §1.933–1T(a).

(b) *Taxable year of change of residence from Puerto Rico.* A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) [Reserved]. For further guidance, see §1.933–1T(c).

(d) [Reserved]. For further guidance, see §1.933–1T(d).

(e) [Reserved]. For further guidance, see §1.933–1T(e).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9194, 70 FR 18934, Apr. 11, 2005]

### § 1.933–1T Exclusion of certain income from sources within Puerto Rico (temporary).

(a) *General rule*—(1) An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, shall exclude from gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof.

(2) The following example illustrates the application of the general rule in paragraph (a)(1) of this section:

*Example.* [Reserved]

(b) [Reserved]. For further guidance, see §1.933–1(b).

(c) *Deductions and credits.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions), or any credit, properly allocable to, or chargeable against, the amounts so excluded from gross income. For

purposes of the preceding sentence, the rules of §1.861–8 shall apply (with creditable expenditures treated in the same manner as deductible expenditures).

(d) *Definitions.* For purposes of this section:

(1) The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of Puerto Rico.

(2) The rules of §1.937–2T shall apply for determining whether income is from sources within Puerto Rico.

(e) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18934, Apr. 11, 2005, as amended by T.D. 9248, 71 FR 5001, Jan. 31, 2006]

### §1.934–1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

[Reserved]. For further guidance, see §1.934–1T.

[T.D. 9194, 70 FR 18935, Apr. 11, 2005]

### §1.934–1T Limitation on reduction in income tax liability incurred to the Virgin Islands (temporary).

(a) *General rule.* Section 934(a) provides that tax liability incurred to the United States Virgin Islands (Virgin Islands) shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in section 934(b). For purposes of the preceding sentence, the term ''tax liability'' means the liability incurred to the Virgin Islands pursuant to subtitle A of the Internal Revenue Code, as made applicable in the Virgin Islands by the Act of July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642), as modified by section 7651(5)(B).

(b) *Exception for V.I. income*—(1) *In general.* Section 934(b)(1) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands to the extent that such tax liability is attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands.

(2) *Limitation.* Section 934(b)(2) limits the scope of the exception provided by section 934(b)(1). Pursuant to this limitation, the exception does not apply with respect to an individual who is a citizen or resident of the United States (other than a bona fide resident of the Virgin Islands). For the rules for determining tax liability incurred to the Virgin Islands by such an individual, see section 932(a) and the regulations thereunder.

(3) *Computation rule*—(i) *Operative rule.* For purposes of section 934(b)(1) and this paragraph (b), tax liability incurred to the Virgin Islands for the taxable year attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands shall be computed as follows:

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a);

(B) Multiply by taxable income from sources within the Virgin Islands and income effectively connected with the conduct of a trade or business within the Virgin Islands (applying the rules of §1.861–8 to determine deductions allocable to such income);

(C) Divide by total taxable income; and

(D) Subtract the portion of any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States) determined by multiplying the amount of taxable income from sources outside the Virgin Islands or the United States that is effectively connected to the conduct of a trade or business in the Virgin Islands divided by the total amount of taxable income from such sources.

(ii) *Limitation.* Tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands, as computed in this paragraph (b)(3), however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Definitions.* For purposes of this section:

(i) *Bona fide resident.* The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of the Virgin Islands.

(ii) *Source.* The rules of §1.937–2T shall apply for determining whether income is from sources within the Virgin Islands.

(iii) *Effectively connected income.* The rules of §1.937–3T shall apply for determining whether income is effectively connected with the conduct of a trade or business in the Virgin Islands.

(c) *Exception for qualified foreign corporations*—(1) *In general.* Section 934(b)(3) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands by a qualified foreign corporation to the extent that such tax liability is attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States.

(2) *Qualified foreign corporation.* For purposes of paragraph (c)(1) of this section, the term *qualified foreign corporation* means any foreign corporation if 1 or more United States persons own or are treated as owning (within the meaning of section 958) less than 10 percent of—

(i) The total voting power of the stock of such corporation; and

(ii) The total value of the stock of such corporation,

(3) *Computation rule*—(i) *Operative rule.* For purposes of section 934(b)(3) and this paragraph (c), tax liability incurred to the Virgin Islands for the taxable year attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States shall be computed as follows—

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a);

(B) Multiply by taxable income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States (applying the rules of §1.861–8 to determine deductions allocable to such income);

(C) Divide by total taxable income; and

(D) Subtract any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States or taxes for which a credit is allowable for U.S. Federal income tax purposes under section 906 of the Internal Revenue Code).

(ii) *Limitation* Tax liability incurred to the Virgin Islands attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States, as computed in this paragraph (c)(3), however, shall not exceed the total amount of income tax liability actually incurred.

(4) *U.S. income*—(i) *In general.* For purposes of this section, except as provided in paragraph (c)(4)(ii) of this section, the rules of sections 861 through 865 and the regulations thereunder shall apply for determining whether income is from sources outside the United States or effectively connected with the conduct of a trade or business within the United States.

(ii) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(A) The income is received in exchange for consideration provided to another person; and

(B) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Examples.* The rules of this section are illustrated by the following examples:

*Example 1.* (i) S is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands (USVI). For 2005, S files a Form 1040INFO, ''Non-Virgin Islands Source Income of Virgin Islands Residents,'' with the USVI on which S reports total gross income as follows:

| | |
|---|---|
| Compensation for services performed in the USVI | $50,000 |
| Compensation for services performed in the United States | 40,000 |
| Compensation for services performed in Mexico | 30,000 |

| | |
|---|---|
| Income from inventory sales in Latin America attributable to USVI Office | 20,000 |
| Interest on a U.S. bank account | 6,000 |
| Interest on a V.I. bank account | 5,000 |
| Dividends from a U.S. corporation | 4,000 |

(ii) Accordingly, S has total gross income of $155,000, comprising income from sources within the USVI or effectively connected to the conduct of a trade or business in the USVI (USVI ECI) of $75,000, income from sources within the United States of $50,000, and income from other sources (not USVI ECI) of $30,000. After taking into account allowable deductions, S's total taxable income is $120,000, of which $45,000 is taxable income from sources within the USVI, $15,000 is taxable income from other sources that is USVI ECI under the rules of section 937(b) and §§1.937–2T and 1.937–3T, and $22,500 is taxable income from sources outside the USVI (and outside the United States) that is not USVI ECI. S's tax liability incurred to the USVI pursuant to the Internal Revenue Code as applicable in the USVI (mirror code) is $30,000. S is entitled to claim a credit under section 901 of the mirror code in the amount of $10,000 for income tax paid to Mexico and other Latin American countries, for a net income tax liability of $20,000.

(iii) Pursuant to a USVI law that was duly enacted within the limits of its authority under section 934, S may claim a special deduction relating to his business activities in the USVI. However, under section 934(b), S's ability to claim this special deduction is limited. Specifically, the maximum amount of the reduction in S's mirror code tax liability that may result from claiming this deduction, computed in accordance with paragraph (b)(3) of this section, is as follows:

(20,000 + 10,000) × ((45,000 + 15,000) / (120,000)) − 10,000 × ((15,000) / (15,000 + 22,500)) = 30,000 × (.5) − 10,000 × (.4) = 15,000 minus; 4,000 = $11,000

(iv) Accordingly, S's net tax liability incurred to the USVI must be at least $19,000 (30,000 − 11,000), prior to taking into account any foreign tax credit.

*Example 2.* The facts are the same as *Example 1*, except that S is a U.S. citizen who resides in the United States. As required by section 932(a) and (b), S files with the U.S. Virgin Islands (USVI) a copy of his Federal income tax return and pays to the USVI the portion of his Federal income tax liability that his Virgin Islands adjusted gross income bears to his adjusted gross income. Under section 934(b)(2), S may not claim the special deduction offered under USVI law relating to business activities like his in the USVI to reduce any of his tax liability payable to the USVI under section 932(b).

*Example 3.* (i) Z is a nonresident alien who resides in Country FC. In 2005, Z receives dividends from a corporation organized under the law of the U.S. Virgin Islands (USVI) in the amount of $90x. Z's tax liability incurred to the USVI pursuant to section 871(a) of the Internal Revenue Code as applicable in the USVI (mirror code) is $27x.

(ii) Pursuant to a USVI law that was duly enacted within the limits of its authority under section 934, Z may claim a special exemption for income relating to his investment in the USVI. The maximum amount of the reduction in Z's mirror code tax liability that may result from claiming this exemption, computed in accordance with paragraph (b)(3) of this section, is as follows:

27x (90x/90x) = $27x

(iii) Accordingly, depending on the terms of the exemption as provided under USVI law, Z's net tax liability incurred to the USVI may be reduced or eliminated entirely.

*Example 4.* (i) A Corp is organized under the laws of the U.S. Virgin Islands (USVI) and is engaged in a trade or business in the United States through an office in State N. All of A Corp's outstanding stock is owned by U.S. citizens who are bona fide residents of the USVI. During 2005, A Corp had $50x in gross income from sources within the USVI (as determined under section 937(b) and §1.937–2T) that is not effectively connected with the conduct of a trade or business in the United States; $20x in gross income from sources in Country H that is effectively connected with the conduct of A Corp's trade or business in the United States; and $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp's trade or business in the United States.

(ii) Section 934(b)(3) permits the USVI to reduce or remit the income tax liability of a *qualified foreign corporation* arising under the Internal Revenue Code as applicable in the USVI (mirror code) with respect to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business in the United States. A foreign corporation constitutes a ''qualified foreign corporation'' under section 934(b)(3)(B) if less than 10 percent of the total voting power and value of the stock of the corporation is owned or treated as owned (within the meaning of section 958) by one or more United States persons. A U.S. citizen is a *United States person* as defined in section 7701(a)(30)(A). Given that 10 percent or more of the voting power and value of its stock is owned by U.S. citizens, A Corp does not constitute a ''qualified foreign corporation'' under section 934(b)(3)(B). Accordingly, the USVI may only reduce or remit A Corp's mirror code income tax liability with respect to its $50x in gross income from sources within the USVI.

*Example 5.* (i) The facts are the same as in *Example 4*, except that the outstanding stock of A Corp is owned by the following individuals:

| | |
|---|---|
| U.S. citizens who are bona fide residents of the USVI | 5% |
| U.S. citizens who are not bona fide residents of the USVI | 3% |
| Nonresident aliens who are bona fide residents of the USVI | 42% |
| Nonresident aliens who are not bona fide residents of the USVI | 50% |

(ii) Given that less than 10 percent of the voting power and value of its stock is owned by United States persons, A Corp constitutes a *qualified foreign corporation* under section 934(b)(3)(B). Accordingly, the USVI may reduce or remit A Corp's mirror code income tax liability with respect to its $50x in gross income from sources within the USVI and its $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp's trade or business in the United States. In no event, however, may the USVI reduce or remit A Corp's mirror code income tax liability with respect to its $20x in gross income from sources in Country H that is effectively connected with the conduct of A Corp's trade or business in the United States.

(e) *Effective date*. Except as otherwise provided in this paragraph (e), this section applies for taxable years ending after October 22, 2004. Paragraph (c)(4)(ii) of this section applies to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18935, Apr. 11, 2005; 70 FR 32490, June 3, 2005]

### § 1.935–1 Coordination of individual income taxes with Guam and the Northern Mariana Islands.

(a)(1) through (a)(3) [Reserved]. For further guidance, see § 1.935–1T(a)(1) through (a)(3).

(b)(1) [Reserved]. For further guidance, see § 1.935–1T(b)(1).

(2) *Joint returns*. In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction where the spouse who has the greater adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his return if separate returns were filed. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall be treated as ending on the date of such death.

(b)(3) [Reserved]. For further guidance, see § 1.935–1T(b)(3).

(4) *Tax accounting standards*. A taxpayer who has filed his return with one of the jurisdictions named in subparagraph (1) of this paragraph for a prior taxable year and is required to file his return for a later taxable year with the other such jurisdiction may not, for such later taxable year, change his accounting period, method of accounting, or any election to which he is bound with respect to his reporting of taxable income to the first jurisdiction unless he obtains the consent of the second jurisdiction to make such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing he also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this subparagraph must be made to the office where the return is required to be filed under subparagraph (3) of this paragraph and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(b)(5) through (b)(7) [Reserved]. For further guidance, see § 1.935–1T(b)(5) through (b)(7).

(c) through (f) [Reserved]. For further guidance, see § 1.935–1T(c) through (f).

(g) [Reserved]. For further guidance, see § 1.935–1T(g).

(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. 7385, 40 FR 50261, Oct. 29, 1975, as amended by T.D. 9194, 70 FR 18937, Apr. 11, 2005]

### § 1.935–1T Coordination of individual income taxes with Guam and the Northern Mariana Islands (temporary).

(a) *Application of section*—(1) *Scope*. Section 935 and this section set forth the special rules relating to the filing of income tax returns, income tax liabilities, and estimated income tax of individuals described in paragraph (a)(2) of this section. Paragraph (e) of this section also provides special rules

requiring consistent treatment of business entities in the United States and in section 935 possessions.

(2) *Individuals covered.* This section shall apply to any individual who—

(i) Is a bona fide resident of a section 935 possession during the entire taxable year, whether or not such individual is a citizen of the United States or a resident alien (as defined in section 7701(b)(1)(A));

(ii) Is a citizen of a section 935 possession but not otherwise a citizen of the United States;

(iii) Has income from sources within a section 935 possession for the taxable year, is a citizen of the United States or a resident alien (as defined in section 7701(b)(1)(A)) and is not a bona fide resident of a section 935 possession during the entire taxable year; or

(iv) Files a joint return for the taxable year with any individual described in paragraph (a)(2)(i), (ii), or (iii) of this section.

(3) *Definitions.* For purposes of this section:

(i) The term *section 935 possession* means Guam or the Northern Mariana Islands, unless such possession has entered into an implementing agreement, as described in section 1271(b) of the Tax Reform Act of 1986 (Pub. L. 99–514 (100 Stat. 2085)), with the United States that is in effect for the entire taxable year.

(ii) The term *relevant possession* means:

(A) With respect to an individual described in paragraph (a)(2)(i) of this section, the section 935 possession of which such individual is a bona fide resident.

(B) With respect to an individual described in paragraph (a)(2)(ii) of this section, the section 935 possession of which such individual is a citizen.

(C) With respect to an individual described in paragraph (a)(2)(iii) of this section, the section 935 possession from which such individual derives income.

(iii) The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of a section 935 possession.

(iv) The rules of §1.937–2T generally shall apply for determining whether income is from sources within a section 935 possession. Pursuant to §1.937–2T(a), however, the rules of §1.937–2T(c)(1)(ii) and (c)(2) do not apply for purposes of section 935(a)(3) (as in effect before the effective date of its repeal) and paragraph (a)(2)(iii) of this section.

(v) The term *citizen of the United States* means any individual who is a citizen within the meaning of §1.1–1(c), except that the term does not include an individual who is a citizen of a section 935 possession but not otherwise a citizen of the United States. The term *citizen of a section 935 possession but not otherwise a citizen of the United States* means any individual who has become a citizen of the United States by birth or naturalization in the section 935 possession.

(vi) With respect to the United States, the term *resident* means an individual who is a citizen (as defined in §1.1–1(c)) or resident alien (as defined in section 7701(b)) and who does not have a tax home (as defined in section 911(d)(3)) in a foreign country during the entire taxable year. The term does not include an individual who is a bona fide resident of a section 935 possession.

(vii) The term *U.S. taxpayer* means an individual described in paragraph (b)(1)(i) or (iii)(B) of this section.

(b) *Filing requirement*—(1) *Tax jurisdiction.* An individual described in paragraph (a)(2) of this section shall file an income tax return for the taxable year—

(i) With the United States if such individual is a resident of the United States;

(ii) With the relevant possession if such individual is described in paragraph (a)(2)(i) of this section; or

(iii) If neither paragraph (b)(1)(i) nor paragraph (b)(1)(ii) of this section applies—

(A) With the relevant possession if such individual is described in paragraph (a)(2)(ii) of this section; or

(B) With the United States if such individual is a citizen of the United States, as defined in paragraph (a)(3) of this section.

(2) [Reserved]. For further guidance, see §1.935–1(b)(2).

(3) *Place for filing returns*—(i) *U.S. returns.* A return required under this paragraph (b) to be filed with the United States shall be filed as directed

in the applicable forms and instructions.

(ii) *Guam returns.* A return required under this paragraph (b) to be filed with Guam shall be filed as directed in the applicable forms and instructions.

(iii) *NMI returns.* A return required under this paragraph (b) to be filed with the Northern Mariana Islands shall be filed as directed in the applicable forms and instructions.

(4) [Reserved]. For further guidance, see §1.935–1(b)(4).

(5) *Tax payments.* The tax shown on the return shall be paid to the jurisdiction with which such return is required to be filed and shall be determined by taking into account any credit under section 31 for tax withheld by the relevant possession or the United States on wages, any credit under section 6402(b) for an overpayment of income tax to the relevant possession or the United States, and any payments under section 6315 of estimated income tax paid to the relevant possession or the United States.

(6) *Liability to other jurisdiction*—(i) *Filing with the relevant possession.* In the case of an individual who is required under paragraph (b)(1) of this section to file a return with the relevant possession for a taxable year, if such individual properly files such return and fully pays his or her income tax liability to the relevant possession, such individual is relieved of liability to file an income tax return with, and to pay an income tax to, the United States for the taxable year.

(ii) *Filing with the United States.* In the case of an individual who is required under paragraph (b)(1) of this section to file a return with the United States for a taxable year, such individual is relieved of liability to file an income tax return with, and to pay an income tax to, the relevant possession for the taxable year.

(7) *Information reporting.* [Reserved]

(c) *Extension of territory*—(1) *U.S. taxpayers*—(i)*General rule.* With respect to a U.S. taxpayer, for purposes of taxes imposed by Chapter 1 of the Internal Revenue Code, the United States generally shall be treated, in a geographical and governmental sense, as including the relevant possession. The purpose of this rule is to facilitate the coordination of the tax systems of the United States and the relevant possession. Accordingly, the rule will have no effect where it is manifestly inapplicable or its application would be incompatible with the intent of any provision of the Internal Revenue Code.

(ii) *Application of general rule.* Contexts in which the general rule of paragraph (c)(1)(i) of this section apply include:

(A) The characterization of taxes paid to the relevant possession. Income tax paid to the relevant possession may be taken into account under sections 31, 6315, and 6402(b) as payments to the United States. Taxes paid to the relevant possession and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes paid to the relevant possession will be disallowed as a deduction under section 275(a).

(B) The determination of the source of income for purposes of the foreign tax credit (*e.g.*,, sections 901 through 904). Thus, for example, after a U.S. taxpayer determines which items of income constitute income from sources within the relevant possession under the rules of section 937(b), such income shall be treated as income from sources within the United States for purposes of section 904.

(C) The eligibility of a corporation to make a subchapter S election (sections 1361 through 1379). Thus, for example, for purposes of determining whether a corporation created or organized in the relevant possession may make an election under section 1362(a) to be a subchapter S corporation, it shall be treated as a domestic corporation and a U.S. taxpayer shareholder shall not be treated as a nonresident alien individual with respect to such corporation. While such an election is in effect, the corporation shall be treated as a domestic corporation for all purposes of the Internal Revenue Code. For the consistency requirement with respect to entity status elections, see paragraph (e) of this section.

(D) The treatment of items carried over from other tax years. Thus, for example, if a U.S. taxpayer has for a taxable year a net operating loss carryback or carryover under section

172, a foreign tax credit carryback or carryover under section 904, a business credit carryback or carryover under section 39, a capital loss carryover under section 1212, or a charitable contributions carryover under section 170, the carryback or carryover will be reported on the return filed with the United States in accordance with paragraph (b)(1)(i) or (b)(1)(iii)(B) of this section, even though the return of the taxpayer for the taxable year giving rise to the carryback or carryover was required to be filed with a section 935 possession.

(E) The treatment of property exchanged for property of a like kind (section 1031). Thus for example, if a U.S. taxpayer exchanges real property located in the United States for real property located in the relevant possession, notwithstanding the provisions of section 1031(h), such exchange may qualify as a like-kind exchange under section 1031 (provided that all the other requirements of section 1031 are satisfied).

(iii) *Nonapplication of general rule.* Contexts in which the general rule of paragraph (c)(1)(i) of this section does not apply include:

(A) The application of any rules or regulations that explicitly treat the United States and any (or all) of its possessions as separate jurisdictions (*e.g.*,, sections 931 through 937, 7651, and 7654).

(B) The determination of any aspect of an individual's residency (*e.g.*, sections 937(a) and 7701(b)). Thus, for example, an individual whose principal place of abode is in the relevant possession is not considered to have a principal place of abode in the United States for purposes of section 32(c).

(C) The determination of the source of income for purposes other than the foreign tax credit (*e.g.*, sections 935, 937, and 7654). Thus, for example, income determined to be derived from sources within the relevant possession under section 937(b) shall not be considered income from sources within the United States for purposes of Form 5074, ''Allocation of Individual Income Tax to Guam or the Commonwealth of the Northern Mariana Islands''.

(D) The definition of wages (section 3401). Thus, for example, services performed by an employee for an employer in the relevant possession do not constitute services performed in the United States under section 3401(a)(8).

(E) The characterization of a corporation for purposes other than subchapter S (*e.g.*, sections 367, 951 through 964, 1291 through 1298, 6038, and 6038B). Thus, for example, if a U.S. taxpayer transfers appreciated tangible property to a corporation created or organized in the relevant possession in a transaction described in section 351, he or she must recognize gain unless an exception under section 367(a) applies. Also, if a corporation created or organized in the relevant possession qualifies as a passive foreign investment company under sections 1297 and 1298 with respect to a U.S. taxpayer, a dividend paid to such shareholder does not constitute qualified dividend income under section 1(h)(11)(B).

(2) *Application in relevant possession.* In applying the territorial income tax of the relevant possession, such possession generally shall be treated, in a geographical and governmental sense, as including the United States. Thus, for example, income tax paid to the United States may be taken into account under sections 31, 6315, and 6402(b) as payments to the relevant possession. Moreover, a citizen of the United States (as defined in paragraph (a)(3) of this section) not a resident of the relevant possession will not be treated as a nonresident alien individual for purposes of the territorial income tax of the relevant possession. Thus, for example, a citizen of the United States (as so defined), or a resident of the United States, will not be treated as a nonresident alien individual for purposes of section 1361(b)(1)(C) of the Guamanian Territorial income tax.

(d) *Special rules for estimated income tax*—(1) *In general.* An individual must make each payment of estimated income tax (and any amendment to the estimated tax payment) to the jurisdiction with which the individual reasonably believes, as of the date of that payment (or amendment), that he or she will be required to file a return for the taxable year under paragraph (b)(1) of this section. In determining the amount of such estimated income tax,

income tax paid to the relevant possession may be taken into account under sections 31 and 6402(b) as payments to the United States, and vice versa. For other rules relating to estimated income tax, see section 6654.

(2) *Joint estimated income tax.* In the case of married persons making a joint payment of estimated income tax, the taxpayers must make each payment of estimated income tax (and any amendment to the estimated tax payment) to the jurisdiction where the spouse who has the greater estimated adjusted gross income for the taxable year would be required under paragraph (d)(1) of this section to pay estimated income tax if separate payments were made. For this purpose, estimated adjusted gross income of each spouse for the taxable year is determined without regard to community property laws.

(3) *Erroneous payment.* If the individual or spouses erroneously pay estimated income tax to the United States instead of the relevant possession or vice versa, only subsequent payments or amendments of the payments are required to be made pursuant to paragraph (d)(1) or (d)(2) of this section with the other jurisdiction.

(4) *Place for payment.* Estimated income tax required under this paragraph (d) to be paid to Guam or the Northern Mariana Islands shall be paid as directed in the applicable forms and instructions issued by the relevant possession. Estimated income tax required under paragraph (d)(1) of this section to be paid to the United States shall be paid as directed in the applicable forms and instructions.

(5) *Liability to other jurisdiction*—(i) *Filing with Guam or the Northern Mariana Islands.* Subject to paragraph (d)(6) of this section, an individual required under this paragraph (d) to pay estimated income tax (and amendments thereof) to Guam or the Northern Mariana Islands is relieved of liability to pay estimated income tax (and amendments thereof) to the United States.

(ii) *Filing with the United States.* Subject to paragraph (d)(6) of this section, an individual required under this paragraph (d) to pay estimated income tax (and amendments thereof) to the United States is relieved of liability to pay estimated income tax (and amendments thereof) to the relevant possession.

(6) *Underpayments.* The liability of an individual described in paragraph (a)(2) of this section for underpayments of estimated income tax for a taxable year, as determined under section 6654, shall be to the jurisdiction with which the individual is required under paragraph (b) of this section to file his or her return for the taxable year.

(e) *Entity status consistency requirement*—(1) *In general.* Taxpayers should make consistent entity status elections (as defined in paragraph (e)(3)(ii) of this section), when applicable, in both the United States and section 935 possessions. In the case of a business entity to which this paragraph (e) applies:

(i) If an entity status election is filed with the Internal Revenue Service but not with the relevant possession, the appropriate tax authority of the relevant possession, at his discretion, may deem the election also to have been made for the relevant possession tax purposes.

(ii) If an entity status election is filed with the relevant possession but not with the Internal Revenue Service, the Commissioner, at his discretion, may deem the election also to have been made for U.S. Federal tax purposes.

(iii) If inconsistent entity status elections are filed with the relevant possession and the Internal Revenue Service, both the Commissioner and the appropriate tax authority of the relevant possession may, at their individual discretion, treat the elections they each received as invalid and may deem the election filed in the other jurisdiction to have been made also for tax purposes in their own jurisdiction. (See Rev. Proc. 89–8 (1989–1 C.B. 778) for procedures for requesting the assistance of the Internal Revenue Service when a taxpayer is or may be subject to inconsistent tax treatment by the Internal Revenue Service and a U.S. possession tax agency.)

(2) *Scope.* This paragraph (e) applies to the following business entities:

(i) A business entity (as defined in §301.7701–2(a) of this chapter) that is domestic (as defined in §301.7701–5 of this chapter), or otherwise treated as

domestic for purposes of the Internal Revenue Code, and that is owned in whole or in part by any person who is either a bona fide resident of a section 935 possession or a business entity created or organized in a section 935 possession.

(ii) A business entity that is created or organized in a section 935 possession and that is owned in whole or in part by any U.S. person (other than a bona fide resident of such possession).

(3) *Definitions.* For purposes of this section—

(i) The term *appropriate tax authority of the relevant possession* means the individual responsible for tax administration in such possession or his delegate.

(ii) The term *entity status election* includes an election under §301.7701–3(c) of this chapter, an election under section 1362(a), and any other similar elections.

(4) *Default status.* Solely for the purpose of determining classification of an eligible entity under §301.7701–3(b), and §301.7701–3(b) as mirrored in the relevant possession, an eligible entity subject to this paragraph (e) shall be classified for both U.S. Federal and the relevant possession tax purposes using the rule that applies to domestic eligible entities.

(5) *Transition rules*—(i) In the case of an election filed prior to April 11, 2005, except as provided in paragraph (e)(5)(ii) of this section, the rules of paragraph (e)(1) of this section shall apply as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(ii) In the unlikely circumstance that inconsistent elections described in paragraph (e)(1)(iii) are filed prior to April 11, 2005, and the entity cannot change its classification to achieve consistency because of the sixty-month limitation described in §301.7701–3(c)(1)(iv) of this chapter, then the entity may nevertheless request permission from the Commissioner or appropriate tax authority of the relevant possession to change such election to avoid inconsistent treatment by the Commissioner and the appropriate tax authority of the relevant possession.

(iii) Except as provided in paragraphs (e)(5)(i) and (e)(5)(ii) of this section, in the case of an election filed with respect to an entity before it became an entity described in paragraph (e)(2) of this section, the rules of paragraph (e)(1) of this section shall apply as of the first day that such entity is described in paragraph (e)(2) of this section.

(iv) In the case of an entity created or organized prior to April 11, 2005, paragraph (e)(4) of this section shall take effect for U.S. Federal income tax purposes (or the relevant possession income tax purposes, as the case may be) as of the first day of the first taxable year of the entity beginning after April 11, 2005.

(f) *Examples.* The application of this section is illustrated by the following examples:

*Examples 1–2.* [Reserved]

(g) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18937, Apr. 11, 2005; 70 FR 32490, June 3, 2005; T.D. 9248, 71 FR 5001, Jan. 31, 2006]

### §1.936–1 Elections.

(a) *Making an election.* A domestic corporation shall make an election under section 936(e), for any taxable year beginning after December 31, 1975, by filing Form 5712 on or before the later of—

(1) The date on which such corporation is required, pursuant to sections 6072(b) and 6081, to file its Federal income tax return for the first taxable year for which the election is made; or

(2) April 8, 1980.

Form 5712 shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 (Philadelphia Center).

(b) *Revoking an election.* Any corporation to which an election under section 936 (e) applies on February 8, 1980 is hereby granted the consent of the Secretary to revoke that election for the first taxable year to which the election applied. (The corporation may make a new election under §1.936–1 (a) for any subsequent taxable year.) The corporation shall make this revocation by sending to the Philadelphia Center a

written statement of revocation on or before April 8, 1980.

(Secs. 7805 and 936(e) of the Internal Revenue Code of 1954 (68A Stat. 917 and 90 Stat. 1644; 26 U.S.C. 7805 and 936(e)))

[T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 7673, 45 FR 16174, Mar. 13, 1980]

### § 1.936–4 Intangible property income in the absence of an election out.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

*Q. 1:* If a possessions corporation and its affiliates do not make an election under either the cost sharing or 50/50 profit split option, what rules will govern the treatment of income attributable to intangible property owned or leased by the possessions corporation?

*A. 1:* Intangible property income will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign person or a tax-exempt person, the possessions corporation will be taxable on that shareholder's pro rata amount of the intangible property income. If any class of the stock of a possessions corporation is regularly traded on an established securities market, then the intangible property income will be taxable to the possessions corporation rather than the corporation's U.S. shareholders. For these purposes, a United States shareholder includes any shareholder who is a United States person as described under section 7701(a)(30). The term ''intangible property income'' means the gross income of a possessions corporation attributable to any intangible property other than intangible property which has been licensed to such corporation since prior to 1948 and which was in use by such corporation on September 3, 1982.

*Q. 2:* What is the source of the intangible property income described in question 1?

*A. 2:* The intangible property income is U.S. source, whether taxed to U.S. shareholders or taxed to the possessions corporation. Such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possessions source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B).

*Q. 3:* How will the amount of income attributable to intangible property be measured?

*A. 3:* Income attributable to intangible property includes the amount received by a possessions corporation from the sale, exchange, or other disposition of any product or from the rendering of a service which is in excess of the reasonable costs it incurs in manufacturing the product or rendering the service (other than costs incurred in connection with intangibles) plus a reasonable profit margin. A reasonable profit margin shall be computed with respect to direct and indirect costs other than (i) costs incurred in connection with intangibles, (ii) interest expense, and (iii) the cost of materials which are subject to processing or which are components in a product manufactured by the possessions corporation. Notwithstanding the above, certain taxpayers who have been permitted by the Internal Revenue Service in taxable years beginning before January 1, 1983, to use the cost-plus method of pricing without reflecting a return from intangibles, but including the cost of materials in the cost base, will not be precluded from doing so. (Sec. 3.02(3), Rev. Proc. 63–10, 1963–1 C.B. 490.) Thus, the Internal Revenue Service may continue in appropriate cases to permit such taxpayers to continue to report their income as they have been under existing procedures described in the previous sentence if it is appropriate under all the facts and circumstances and does not distort the income of the taxpayer.

*Q. 4:* If there is no intangible property related to a product produced in whole or in part by a possessions corporation, what method may the possessions corporation use to compute its income?

*A. 4:* The taxpayer may compute its income using the appropriate method as provided under section 482 and the regulations thereunder. The taxpayer may also elect the cost sharing or profit split method.

[T.D. 8090, 51 FR 21524, June 13, 1986]

**§ 1.936–5 Intangible property income when an election out is made: Product, business presence, and contract manufacturing.**

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(a) *Definition of product.*

*Q. 1:* What does the term ''product'' mean?

*A. 1:* The term ''product'' means an item of property which is the result of a production process. The term ''product'' includes component products, integrated products, and end-product forms. A component product is a product which is subject to further processing before sale to an unrelated party. A component product may be produced from other items of property, and if it is so produced, may be treated as including or not including (at the choice of the possessions corporation) one or more of such other items of property for all purposes of section 936(h)(5). An integrated product is a product which is not subject to any further processing before sale to an unrelated party and which includes all component products from which it is produced. An end-product form is a product which—

(1) Is not subject to any further processing before sale to an unrelated party;

(2) Is produced from a component product or products; and

(3) Is treated as not including certain component products for all purposes of section 936(h)(5).

A possessions corporation may treat a component product, integrated product, or end-product form as its possession product even though the final stage or stages of production occur outside the possession. Further processing includes transformation, incorporation, assembly, or packaging.

*Q. 2:* If a possessions corporation produces both a component product and an integrated product (which by definition includes the end-product form), may the possessions corporation use the options under section 936(h)(5) to compute its income with respect to either the component product, the integrated product or the end-product form?

*A. 2:* Yes. The possessions corporation may choose to treat the component product, the integrated product, or the end-product form as the product for purposes of determining whether the possessions corporation satisfies the significant business presence test. The possessions corporation must treat the same item of property as its product (the possession product) for all purposes of section 936(h)(5) for that taxable year, including the significant business presence test under section 936(h)(5)(B)(ii), the possessions sales calculation under section 936(h)(5)(C)(i)(I), the determination of income under section 936(h)(5)(C)(i)(II), and the combined taxable income computations under section 936(h)(5)(C)(ii). Although the possessions corporation must treat the same item of property as its product for all purposes of section 936(h)(5) in a particular taxable year, its choice of the component product, integrated product or end-product form may be different from year to year. The possessions corporation must specify the possession product on a statement attached to its return (Schedule P of Form 5735). The possessions corporation may specify its choice by either listing the components that are included in the possession product or the components that are excluded from the possession product. The possessions corporation must file a separate Schedule P with respect to each possession product. The possessions corporation must attach to each Schedule P detailed computations indicating how the significant business presence test is satisfied with respect to the possession product identified in that Schedule P.

*Q. 3:* A possessions corporation produces a product that is sometimes sold to unrelated parties without further processing and is sometimes sold to unrelated parties after further processing. May the possessions corporation choose to treat the same item of property as the possession product even though in some cases it is an integrated product and in some cases it is a component product?

*A. 3:* Yes. Except as provided in questions and answers 4 and 5, the possessions corporation must designate a single possession product even though it

is sometimes a component product and sometimes an integrated product.

*Q. 4:* A possessions corporation produces a product that is sometimes sold without further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption and is sometimes sold after further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption. May the possessions corporation designate two products as possession products?

*A. 4:* The possessions corporation may designate two or more possession products. The possessions corporation must use a consistent definition of the possession product for all items of property that are sold to unrelated parties or consumed by related parties at the same stage in the production process. The significant business presence test shall apply separately to each product designated by the possessions corporation. The possessions corporation shall compute its income separately with respect to each product.

*Q. 5:* A possessions corporation produces a product in one taxable year and does not sell all of the units that it produced. In the next taxable year the possessions corporation produces a product which includes the product produced in the prior year. The possessions corporation could not have satisfied the significant business presence test with respect to the units produced the first taxable year if the larger possession product had been designated. May the possessions corporation designate two possession products in the second year?

*A. 5:* Yes. The possessions corporation may designate two possession products. However, once a product has been designated for a particular year all sales of units produced in that year must be defined in the same manner. In addition, the taxpayer must maintain a significant business presence in a possession with respect to that product. Sales shall be deemed made first out of the current year's production. If all of the current year's production is sold and some inventory is liquidated, then the taxpayer's method of inventory accounting shall be applied to determine what year's layer of inventory is liquidated.

*Example 1.* A possessions corporation S, manufactures a bulk pharmaceutical in a possession. S transfers the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers. S satisifes the significant business presence test with respect to the bulk pharmaceutical (the component product) and the combination of the bulk pharmaceutical and the capsule (the integrated product). S may use the cost sharing or profit split method to compute its income with respect to either the component product or the integrated product.

*Example 2.* The facts are the same as in example 1 except that S does not satisfy the significant business presence test with respect to the integrated product. S may use the cost sharing or profit split method to compute its income only with respect to the component product. However, if in a later taxable year S satisfies the significant business presence test with respect to the integrated product, then S may use the cost sharing or profit split method to compute its income with respect to that integrated product for that later taxable year.

*Example 3.* P, a domestic corporation, produces in bulk form in the United States the active ingredient for a pharmaceutical product, P transfers the bulk form to S, a wholly owned possessions corporation. S uses the bulk form to produce in Puerto Rico the finished dosage form drug. S transfers the drug in finished dosage form to P, which sells the drug to unrelated customers in the U.S. The direct labor costs incurred in Puerto Rico by S during its taxable year in formulating, filling and finishing the dosage form are at least 65 percent of the total direct labor costs incurred by the affiliated group in producing the bulk and finished forms during that period. S manufactures (within the meaning of section 954(d)(1)(A)) the finished dosage form. S has elected out under section 936(h)(5) under the profit split option for the drug product area (SIC 283). P and S may treat the bulk and finished dosage forms as parts of an integrated product. Since S satisfies the significant business presence requirement with respect to the integrated product, it is entitled to 50 percent of the combined taxable income on the integrated product.

*Example 4.* A possessions corporation, S. produces the keyboard of an electric typewriter and incorporates the keyboard with components acquired from a related corporation into finished typewriters. S does not satisfy the significant business presence test with respect to the typewriters (the integrated product). Therefore, S may use the

cost sharing or profit split method to compute its income only with respect to a component product or end-product form. For taxable year 1983, S specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product is the end-product form. The statement indentifies the components—for example, the keyboard structure and frame—which are included in the possession product. S's definition of the possession product will apply to all units of the electric typewriters which S produces in whole or in part in the possession and which are sold in 1983. Thus, all units of a given component incorporated into such typewriters will be treated in the same way. For example, all keyboards and all frames will be included in the possession product, and all electric drive mechanisms and rollers will be excluded from the possession product.

*Example 5.* Possessions corporation A produces printed circuit boards in a possession. The printed circuit boards are sold to unrelated parties. A also uses the boards to produce personal computers in the possession. A may designate two possession products: printed circuit boards and personal computers. The significant business presence test applies separately with respect to each of these products. Thus, for those printed circuit boards that are sold to unrelated parties, only the costs of the possessions corporation and the other members of the affiliated group that are incurred with respect to units of the printed circuit boards which are produced in whole or in part in the possessions and sold to third parties shall be taken into account. Conversely, with respect to personal computers, only the costs incurred with respect to the personal computers shall be taken into account. This would include the costs with respect to printed circuit boards that are incorporated into personal computers but not the costs incurred with respect to printed circuit boards that are sold without further processing to unrelated parties.

*Example 6.* Possessions corporation S produces integrated circuits in a possession. P, an affilate of S, produces circuit boards in the United States. P transfers the circuit boards to S. S assembles the integrated circuits and the circuit boards. S sells some of the loaded circuit boards to third parties. S retains some of the loaded circuit boards and incorporates them into central processing units. The central processing units are then sold to third parties. S may designate two possession products. S must use a consistent definition of the possession product for all units that are sold at the same stage in the production process. Thus, with respect to those units sold after assembly of the integrated circuits and the printed circuits boards, if S cannot satisfy the significant business presence test with respect to all the loaded circuit boards (the integrated product), then S must designate a lesser product, either the integrated circuit (the component product) or the loaded circuit board less the printed circuit board (the end-product form) as its possession product. With respect to the central processing units sold the same rule would apply. Thus, if S cannot satisfy the significant business presence test with respect to the entire central processing unit for all of the central processing units sold, S must designate some lesser product as its possession product.

*Example 7.* S is a possession corporation. In 1985, S produced 100 units of product X. Those units were finished into product Y in 1985 by affiliates of S. Product X is a component of product Y. In 1985, S satisfies the direct labor test with respect to product X but not with respect to product Y. S designates the component product X as its possession product. In 1986 S produces 100 units of product X and finishes those units into product Y. S would have satisfied the significant business presence test with respect to product X if S had designated product X as its possession product in 1986. In addition, in 1986 S satisfies the significant business presence test with respect to the integrated product Y. In 1986, S sells 150 units of Y. One hundred of those units would be deemed to be produced in 1986. With respect to those units S may designate the integrated product Y as its possession product. Under S's method of inventory accounting the remaining 50 units were determined to have been produced in 1985. With respect to those units S must define its possession product as it did for the taxable year in which those units were produced. Thus, S's possession product would be the component product X.

*Q. 6:* May an affiliated group establish groupings of possession products and treat the groupings as single products?

*A. 6:* An affiliated group may establish reasonable groupings of possession products based on similarities in the production processes of the possession products. Possession products that are grouped shall be treated as a single product. The determination of whether the production processes involved in producing the products that are to be grouped are similar is based on the production processes of the components that are included in the possession product. The affiliated group may establish new groupings each year. Any grouping which materially distorts a taxpayer's income or the application of the significant business presence test may be disallowed by the Commissioner. The mere fact that a grouping

results in an increased allocation of income to the possessions corporation does not, of itself, create a material distortion of income. If the Commissioner determines that the taxpayer's grouping is improper with respect to one or more products in a group, then those products shall be excluded from the group. The effect of excluding a product or products from the group is that the taxpayer must demonstrate that the group without the excluded products (and each excluded product itself) satisfies the significant business presence test. If the group without the excluded products, or any of the excluded products themselves, fails to satisfy the significant business presence test, then the possessions corporation's income from those products shall be determined under section 936(h)(1) through (4) and the regulations thereunder.

*Example 1.* The following are examples of possession products the processes of production of which are sufficiently similar that they may be grouped and treated as a single product:

(A) Beverage bases or concentrates for different soft drinks or soft drink syrups, regardless of whether some include sweeteners and some do not:

(B) Different styles of clothing;

(C) Different styles of shoes;

(D) Equipment which relies on gravity to deliver solutions to patients intravenously;

(E) Equipment which relies on machines to deliver solutions to patients intravenously;

(F) Video game cartridges, even though the concept and design of each game title is, in part, protected against infringement by separate copyrights;

(G) All integrated circuits;

(H) All printed circuit boards; and

(I) Hardware and software if the software is one of several alternative types of software offered by the manufacturer and sold only with the hardware, and a purchaser of the hardware would ordinarily purchase one or more of the manufacturer-provided alternative types of software. In all other cases, hardware and software may not be grouped and treated as a single product.

Groupings (D) and (E) do not include any solutions which are delivered through the equipment described therein.

*Example 2.* A possessions corporation produces in Puerto Rico non-programmable, interactive cathode ray tube computer terminals that vary in price. These terminals all interact with a computer or controller to perform their functions of data entry, graphics word processing, and program development. The terminals can be purchased with options that include a built-in printer, different language keyboards, specialized cathode ray tubes, and different power supply features. All terminals are produced in one integrated process requiring the same skills and operations. The differences in the production of the terminals include differences in the number of printed circuit boards incorporated in each terminal, the use of unique keyboards, and the installation and testing of the built-in printer. Some difference in direct labor time to manufacture the terminals occurs, primarily due to the differing number and complexity of printed circuit boards incorporated into each terminal. Different model numbers are assigned to various computer terminals. A grouping by the taxpayer of all of the terminals as one product will be respected by the Service, unless the Service establishes that substantial distortion results. This grouping is proper because the processes of producing each of the terminals are similar.

*Example 3.* A possessions corporation, S produces several models of serial matrix impact printers and teleprinters. These products have differing performance standards based on such factors as speed (in characters per second), numbers of columns, and cost. The production process for all types of printers involves production of three basic elements: electronic circuitry, the printing head, and the mechanical parts. The process of producing all the printers is similar. Thus, all printers could be grouped and treated as a single product. S purchases electronic circuitry and mechanical parts from a U.S. affiliate. S performs manufacturing functions relative to the printing head and assembles and tests the finished printers. S does not satisfy the significant business presence test with respect to the integrated products. S therefore specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product for both the serial matrix printers and the teleprinters is the end-product form. The statement identifies the components which are included in each possession product. S may group and treat as a single product the serial matrix printers and the teleprinters if both end-product forms include and exclude similar components. Thus, if the end-product form for both the serial matrix printers and the teleprinters includes the mechanical parts and excludes the electronic circuitry, then S may group and treat as a single product the two end-product forms. If, however, the end-product forms for the two items of property contain components that are not similar and as a result of this definition of the end-product forms the production processes involved in producing the two end-product forms are not similar, then S may not group the end-product forms.

*Q. 7:* Is the affiliated group permitted to include in a group an item of property that is not produced in whole or in part in a possession?

*A. 7:* No.

*Example 1.* Possessions corporation S produces 70 units of product A in a possession. P, an affiliate of S, produces 30 units of product A entirely in the United States. All of the units are sold to unrelated parties. The affiliated group is not permitted to group the 30 units of product A produced in the United States with the 70 units produced in the possession because those units are not produced in whole or in part in a possession.

*Example 2.* The facts are the same as in example 1 except that the 30 units of product A are transferred to possessions corporation S. S incorporates the 100 units of product A into product B. This incorporation takes place in the possession. S may group and treat as a single product all of the units of product B even though some of those units contain units of product A that were produced in the possession and some that were produced in the United States.

*Q. 8:* What factors should be disregarded in determining whether a particular grouping of similar items of property is reasonable?

*A. 8:* In general, differences in the following factors will be disregarded in determining whether a particular grouping of items of property is reasonable:

(1) Differences in testing requirements (*e.g.*, some products sold for military use may require more extensive or different testing than products sold for commercial use);

(2) Differences in the product specifications that are designed to accommodate the product to its area of use or for conditions under which used (*e.g.*, electrical products designed for ultimate use in the United States differ from electrical products designed for ultimate use in Europe);

(3) Differences in packaging or labeling (*e.g.*, differences in the number of units of the items shipped in one package); and

(4) Minor differences in the operations of the items of property.

*Q. 9:* What rules apply for purposes of determining whether pharmaceutical products are properly grouped and treated as a single product?

*A. 9:* The rules contained in questions and answers 6 through 8 of this section shall apply. Thus, an affiliated group may establish reasonable groupings based on similarities in the production processes of two or more possession products. In establishing a group the affiliated group may only compare the production processes involved in producing the possession products. The fact that two pharmaceutical products contain different active or inert ingredients is not relevant to the determination of whether the pharmaceutical products may be grouped. For example, if the possession products are bulk chemicals and the production processes involved in producing the bulk chemicals are similar, those bulk chemicals may be grouped and treated as a single product even though they contain different active or inert ingredients. The affiliated group may also group and treat as a single product the finished dosage form drug as long as the production processes involved in producing the finished dosage forms are similar. For these purposes, the production processes involved in producing the following classes of items shall be considered to be sufficiently similar that possession products delivered in a form described in one of the categories may be grouped with other possession products delivered in a form described in the same category.

The categories are:

(1) Capsules, tablets, and pills;

(2) Liquids, ointments, and creams; or

(3) Injectable and intravenous preparations.

No distinctions should be based on packaging, list numbers, or size of dosage. The affiliated group may group and treat as a single product the integrated product (combination of the bulk and the delivery form) only if all the production processes involved in producing the integrated products are similar. The rules of this question and answer are illustrated by the following examples.

*Example 1.* Possessions corporation S produces two chemical active ingredients X and Y. Both chemical ingredients are produced through the process of fermentation. The affiliated group is permitted to group and treat as a single product the two chemical ingredients.

*Example 2.* The facts are the same as in example 1 and possessions corporation S finishes chemical ingredient X into tablets and

chemical ingredient Y into capsules. The affiliated group is permitted to group and treat as a single product the combination of the bulk pharmaceutical and the finishing because the production processes involved in producing the integrated products are similar.

*Example 3.* Possessions corporation S produces in a possession a bulk chemical X by fermentation. A United States affiliate, P, produces in the United States a bulk chemical, Y, by fermentation. Both bulk chemicals are finished by S in the possession. The finished dosage form of X is in pill form. The finished dosage form of Y is in injectable form. If S's possession product is the integrated product or the end-product form then S may not group X and Y because the production processes involved in producing the finished dosage form of X and Y are not similar. If S's possession product is the component then S may not group X and Y because the bulk chemical Y is not produced in whole or in part in a possession.

*Q. 10:* Will the fact that a manufacturer of a drug must submit a New Drug Application (''NDA'') or a supplemental NDA to the Food and Drug Administration have any effect on the definition or grouping of a product?

*A. 10:* No.

*Q. 11:* A possessions corporation which produced a product or rendered a type of service in a possession on or before September 3, 1982, is not required to meet the significant business presence test in a possession with respect to such product or type of service for its taxable years beginning before January 1, 1986 (the interim period). During such interim period, how will the term ''product'' be defined for purposes of allocating income under the cost sharing or profit split methods?

*A. 11:* During the interim period the product will be determined based on the activities performed by the possessions corporation within a possession on September 3, 1982. During the interim period the possessions corporation may compute its income under the cost sharing or profit split method only with respect to the product that is produced or manufactured within the meaning of section 954(d)(1)(A) within the possession. If the product is manufactured from a component or components produced by an affiliated corporation or a contract manufacturer, then the product will not be treated as including such component or components for purposes of the computation of income under the cost sharing or profit split methods. Thus, the possessions corporation is not entitled to any return on the intangibles associated with the component or components. Notwithstanding the preceding sentences, for taxable years beginning before January 1, 1986, a possessions corporation may compute its income under the cost sharing or profit split method with respect to a product which includes a component or components produced by an affiliated corporation or contract manufacturer if the possessions corporation satisfies with respect to such product the significant business presence test described in section 936(h)(5)(B)(ii) and the regulations thereunder.

*Example 1.* A possessions corporation, S, was manufacturing (within the meaning of section 954(d)(1)(A)) integrated circuits in a possession on September 3, 1982. S transferred those integrated circuits to related corporation P. P incorporated the integrated circuits into central processing units (CPUs in the United States) and sold the CPUs to unrelated parties. S continued to manufacture integrated circuits in the possession through Juanuary 1, 1986. For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split method with respect to the integrated circuits regardless of whether S satisfies the significant business presence test. However, unless S satisfies the significant business presence test with respect to the central processing units, S may not compute its income under the cost sharing or profit split methods with respect to the CPUs, and thus, S is not entitled to any return on manufacturing intangibles associated with CPUs to the extent that they are not related to the integrated circuits produced by S, nor (except as provided in the profit split methods) to any return on marketing intangibles.

*Example 2.* A possessions corporation, S, was engaged on September 3, 1982, in the manufacture (within the meaning of section 954(d)(1)(A)) of a bulk pharmaceutical in Puerto Rico from raw materials. S sold the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers as the product X. Because S was not engaged in the encapsulation of X, S is not considered to have manufactured the integrated product, X, in Puerto Rico. During the interim period, S may compute its income under the cost sharing or profit split methods with respect to the integrated product, X, only if S satisfies the significant business presence test with respect to X. S may compute its income under the cost sharing or profit split

methods with respect to the component product (the bulk pharmaceutical).

*Example 3.* P is a domestic corporation that is not a possessions corporation. P manufactures a bulk pharmaceutical in the United States. P transfers the bulk pharmaceutical to its wholly owned subsidiary, S, a possessions corporation. On September 3, 1982, S was engaged in the encapsulation of the bulk pharmaceutical in Puerto Rico in a manner which satisfies the test of section 954(d)(1)(A). For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split methods with respect to the end-product form the (the encapsulated drug) regardless of whether S meets the significant business presence test. However, unless S satisfies the significant business presence test with respect to the integrated product, S may not compute its income under the cost sharing or profit split methods with respect to the integrated product, and thus, S is not entitled to any return on the intangibles associated with the bulk pharmaceutical.

*Q. 12:* On September 3, 1982, a possessions corporation, S was engaged in the manufacture (within the meaning of section 954(d)(1)(A)) of X in a possession. During the interim period, after September 3, 1982, but before January 1, 1986, S produced Y, which differs from X in terms of minor design features. S did not produce Y in a possession on September 3, 1982. Will S be considered to have commenced production of a new product after September 3, 1982, for purposes of the application of the significant business presence test for the interim period?

*A. 12:* No. X and Y will be considered to be a single product, and therefore S will not be required to satisfy the business presence test separately with respect to Y during the interim period. In all cases in which the items of property produced on or before September 3, 1982 and the items of property produced after that date could have been grouped together under the guidelines provided in §1.936–5(a) questions and answers 6 through 10, the possessions corporation will not be considered to manufacture a new product after September 3, 1982.

*Q. 13:* May the term ''product'' be defined differently for export sales than for domestic sales?

*A. 13:* Yes. For rules concerning the application of the separate election for export sales see §1.936–7(b).

(b) *Requirement of significant business presence—(1) General rules.*

*Q. 1:* In general, a possessions corporation may compute its income under the cost sharing or profit split methods with respect to a product only if the possessions corporation has a significant business presence in a possession with respect to that product. When will a possession corporation be considered to have a significant business presence in a possession?

*A. 1:* For purposes of the cost sharing method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test. For purposes of the profit split method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test and also manufactures the product in the possession within the meaning of section 954(d)(1)(A).

*Q. 2:* How may a possessions corporation satisfy the direct labor test with respect to a product?

*A. 2:* The possessions corporation will satisfy the direct labor test with respect to a product if the direct labor costs incurred by the possessions corporation as compensation for services performed in a possession are greater than or equal to 65 percent of the direct labor costs of the affiliated group for units of the possession product produced during the taxable year in whole or in part by the possessions corporation.

*Q. 3:* How may a possessions corporation satisfy the value added test?

*A. 3:* In order to satisfy the value added test, the production costs of the possessions corporation incurred in the possession with respect to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold or otherwise disposed of during the taxable year by the affiliated group to unrelated parties must be greater than or equal to twenty-five percent of the difference between gross receipts from such sales or other dispositions and the direct material costs of the affilated group for materials purchased for such units from unrelated parties.

*Q. 4:* Must the significant business presence test be met with respect to all

units of the product produced during the taxable year by the affiliated group?

*A. 4:* No. The significant business presence test must be met with respect to only those units of the product produced during the taxable year in whole or in part by the possessions corporation in a possession.

*Q. 5:* For purposes of determining whether a possessions corporation satisfies the significant business presence test, how shall the possessions corporation treat the cost of components transferred to the possessions corporation by a member of the affiliated group?

*A. 5:* The treatment of the cost of components transferred from an affiliate depends on whether the possession product is treated as including the components for purposes of section 936(h). If it is, then for purposes of the value added test, the production costs associated with the component shall be treated as production costs of the affiliated group that are not incurred by the possessions corporation. Those production costs, other than the cost of materials, shall not be treated as a cost of materials. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such components shall be treated as direct labor costs of the affiliated group that are not incurred by the possessions corporation. If the possession product is treated as not including such component for purposes of section 936(h), then, solely for purposes of determining whether the possessions corporation satisfies the value added test, the cost of the component shall not be treated as either a cost of materials or as a production cost. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such component shall not be treated as direct labor costs of the affiliated group. If the possession product is treated as not including such component, then the possessions corporation shall not be entitled to any return on the intangibles associated with the manufacturing or marketing of the component.

*Q. 6:* May two or more related possessions corporations aggregate their production or direct labor costs for purposes of determining whether they satisfy the significant business presence test with respect to a single product?

*A. 6:* No.

*Q. 7:* A possessions corporation, S, purchases raw materials and components from an unrelated corporation which conducts business outside of a possession. The unrelated corporation is not a contract manufacturer. What is the treatment of such raw materials and components for purposes of the significant business presence test?

*A. 7:* Where Company S purchases raw materials or components from an unrelated corporation which is not a contract manufacturer, the raw materials and components are treated as materials, and the costs related thereto are treated as a cost of materials.

(2) *Direct labor costs.*

*Q. 1:* How is the term ''direct labor costs'' to be defined?

*A. 1:* The term ''direct labor costs'' has the same meaning which it has for purposes of §1.471–11(b)(2)(i). Thus, direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

*Q. 2:* May a taxpayer treat a cost as a direct labor cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

*A. 2:* No. A cost may be treated as a direct labor cost only if it is included in inventoriable costs. However, a cost may be considered a direct labor cost even though the activity to which it relates would not constitute manufacturing under section 954(d)(1)(A) as long as the cost is included in inventoriable costs.

*Q. 3:* May the members of the affiliated group include as direct labor costs

the labor element in indirect production costs?

*A. 3:* No. The labor element of indirect production costs may not be considered as part of direct labor costs.

*Q. 4:* Do direct labor costs include the costs which can be identified or associated with particular units or groups of units of a specific product if those costs could also be described as quality control and inspection?

*A. 4:* Yes. Direct labor costs include costs which can be identified or associated with particular units or groups of units of a specific product. Thus, if quality control and inspection is an integral part of the production process, then the labor associated with that quality control and inspection shall be considered direct labor. For example, integrated circuits are soldered to printed circuit boards by passing the boards over liquid solder. Employees inspect each of the boards and repair any imperfectly soldered joints discovered on that inspection. The labor associated with this process is direct labor. However, if a person performs random inspections on limited numbers of products, then that labor associated with those inspections shall be considered quality control and therefore indirect labor.

*Q. 5:* Do direct labor costs of the possessions corporation include only the costs which were actually incurred or do they take into account, in addition, any labor savings which result because the activities were performed in a possession rather than in the United States?

*A. 5:* Direct labor costs include only the costs which were actually incurred.

*Q. 6:* For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its direct labor costs of units of the product?

*A. 6:* The direct labor test shall be applied separately to products produced in whole or in part by the possessions corporation in the possession during each taxable year. Sales shall be deemed to be made first out of the current year's production. If sales are made only out of the current year's production, then the direct labor costs of producing those units that are sold shall be the pro rata portion of the total direct labor costs of producing all the units that are produced in whole or in part in the possession by the possessions corporation during the current year. If all of the current year's production is sold and some inventory is liquidated, then the direct labor test shall be applied separately to the current year's production and the liquidated inventory. The direct labor costs of producing the liquidated inventory shall be the pro rata portion of the total direct labor costs that were incurred in producing all the units that were produced in whole or in part by the possessions corporation in the possessions in the layer of liquidated inventory determined under the member's method of inventory accounting.

*Example.* S is a cash basis calendar year taxpayer that has made an election under section 936(a). In 1985 S produced 100 units of product X. Fifty percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. Thus, S did not satisfy the significant business presence test with respect to product X in taxable year 1985. During 1986 S produced 100 units of product X. One hundred percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. In 1986 S sells 150 units of product X. One hundred of those units are deemed to be from the units produced in 1986. With respect to those units S satisfies the significant business presence test. Under S's method of inventory accounting the remaining 50 units were determined to be produced in 1985. With respect to those units S does not satisfy the significant business presence test because only 50% of the direct labor costs incurred in producing those units were incurred by S and were compensation for services performed in the possession.

*Q. 7:* What is the result if in a particular taxable year the possessions corporation satisfies the significant business presence test with respect to units of the product produced in one year and fails the significant business with respect to units produced in another year?

*A. 7:* For those units of the product with respect to which the possession corporation satisfies the significant business presence test, the possessions corporation may compute its income

under the provisions of section 936(h)(5). For those units of the product with respect to which the possessions corporations fails the significant business presence test, the possessions corporation must compute its income under section 936(h)(1) through (4).

*Q. 8:* Do direct labor costs include costs incurred in a prior taxable year with respect to units of the possession product that are finished in a later taxable year?

*A. 8:* Yes.

(3) *Direct material costs.*

*Q. 1:* How is the term ''direct material costs'' to be defined?

*A. 1:* Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See §1.471–3 for the elements of direct material costs.

*Q. 2:* May a taxpayer treat a cost as a direct material cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

*A. 2:* A taxpayer may not treat such costs as direct material costs.

(4) *Production costs.*

*Q. 1:* How is the term ''production costs'' defined?

*A. 1:* The term ''production costs'' has the same meaning which it has for purposes of §1.471–11(b) except that the term does not include direct material costs and interest. Thus, production costs include direct labor costs and fixed and variable indirect production costs (other than interest).

*Q. 2:* With respect to indirect production costs described in §1.471–11(c)(2)(ii) and (iii), may a possessions corporation include these costs in production costs for purposes of section 936, if they are not included in inventoriable costs under section 471 and the regulations thereunder?

*A. 2:* No. A possessions corporation may include these costs only if they are included for purposes of section 471 and the regulations thereunder. If a possessions corporation and the other members of the affiliated group include and exclude different indirect production costs in their inventoriable costs, then, for purposes of the significant business presence test, the possessions corporation shall compute its production costs and the production costs of the other members of the affiliated group by subtracting from the production costs of each member all indirect costs included by that member that are not included in production costs by all other members of the affiliated group.

*Q. 3:* Does a change in a taxpayer's method of accounting for purposes of section 471 affect the taxpayer's computation of production costs for purposes of section 936?

*A. 3:* Yes. If a taxpayer changes its method of accounting for purposes of section 471, then the same change shall apply for purposes of section 936.

*Q. 4:* For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its costs of producing units of the product sold or otherwise disposed to unrelated parties during the taxable year?

*A. 4:* All members of the affiliated group may elect to use their current year production costs regardless of whether the members use the FIFO or LIFO method of inventory accounting. If some or all of the current year's production of a product is sold, then the production costs of producing those units sold shall be the pro rata portion of the total production costs of producing all the units produced in the current year. If all of the current year's production of a product is sold and some inventory is liquidated, then the production costs of producing the liquidated inventory shall be the pro rata portion of the production costs incurred in producing the layer of liquidated inventory as determined under the member's method of inventory accounting.

*Q. 5:* How should the members of the affiliated group determine the portion of their production costs that is allocable to units of the product sold or otherwise disposed of during the taxable year?

*A. 5:* The members of the affiliated group may use either standard production costs (so long as variances are not

material), average production costs, or FIFO production costs to determine the production costs that will be considered to be attributable to units of the product sold or otherwise disposed of during the taxable year. However, all members of the affiliated group must use the same method.

*Q. 6:* When is the quality control and inspection of a product considered to be part of the production activity for that product?

*A. 6:* Quality control and inspection of a manufactured product before its sale or other disposition by the manufacturer, or before its incorporation into other products, is considered to be part of the indirect production activity for that initial product. Subsequent testing of a product to ensure that the product is compatible with other products is not a part of the production activity for the initial product.

When a component is incorporated into an end-product form and the end-product form is then tested, the latter testing will be considered to be a part of the indirect production activity for the end-product form and will not be considered to be a part of the production activity for the component.

*Q. 7:* For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of installation of a product?

*A. 7:* For purposes of the significant business presence test and the allocation of income to a possessions corporation, product installation costs need not be taken into account as costs incurred in the manufacture of that product, if the taxpayer keeps such permanent books of account or records as are sufficient to establish the fair market price of the uninstalled product. In such a case, the cost of installation materials, the cost of the labor for installation, and a reasonable profit for installation will not be included in the costs and income associated with the possession product. If the taxpayer does not keep such permanent books of account or records, then the cost of installation materials and the cost of labor for installation shall be treated as costs associated with the possession product and income will be allocated to the possessions corporation and its affiliates under the rules provided in these regulations.

*Q. 8:* For purposes of the significant business presence test and the allocation of income to a product or service, what is the treatment of the cost of servicing and maintaining a possession product that is sold to an unrelated party?

*A. 8:* The cost of servicing and maintaining a possession product after it is sold is not associated with the production of that product.

*Q. 9:* For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of samples?

*A. 9:* The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for these purposes. However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

(5) *Gross receipts.*

*Q. 1:* How shall the affiliated group determine gross receipts from sales or other dispositions by the affiliated group to unrelated parties of the possession product?

*A. 1:* Gross receipts shall be determined in the same manner as possession sales under the rules contained in §1.936–6(a)(2).

(6) *Manufacturing within the meaning of section 954(d)(1)(A).*

*Q. 1:* What is the test for determining, within the meaning of section 954(d)(1)(A), whether a product is manufactured or produced by a possessions corporation in a possession?

*A. 1:* A product is considered to have been manufactured or produced by a possessions corporation in a possession within the meaning of section 954(d)(1)(A) and §1.954–3(a)(4) if—

(i) The property has been substantially transformed by the possessions corporation in the possession;

(ii) The operations conducted by the possessions corporation in the possession in connection with the property are substantial in nature and are generally considered to constitute the manufacture or production of property; or

(iii) The conversion costs sustained by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product and testing of the manufactured product before sales account for 20 percent or more of the total cost of goods sold of the possessions corporation.

In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute manufacture or production of property. See particularly examples 2 and 3 of §1.954–3(a)(4)(iii).

*Q. 2:* Does the requirement that a possession product be produced or manufactured in a possession within the meaning of section 954(d)(1)(A) apply to taxable years beginning before January 1, 1986?

*A. 2:* A possessions corporation must satisfy this requirement for taxable years beginning before January 1, 1986, in the following cases:

(i) If the possessions corporation makes a separate election under section 936(h)(5)(F)(iv)(II) with respect to export sales;

(ii) If the possessions corporation is electing as its possession product a product that is subject to the interim period rules of §1.936–5(a) question and answer (10); or

(iii) If the possessions corporation is electing as its possession product a product that is not subject to the interim period rules of §1.936–5 (a) question and answer (10) and the possessions corporation computes its income under the profit split method with respect to that product.

For rules concerning products first produced in a possession after September 3, 1982, see §1.936–5(b)(7) question and answer (2).

(7) *Start-up operations.*

*Q. 1:* With respect to products not produced (and types of services not rendered) in the possession on or before September 3, 1982, when must a possessions corporation first satisfy the 25 percent value added test or the 65 percent direct labor test?

*A. 1:* A transitional period is established such that a possessions corporation engaged in start-up operations with respect to a product or service need not satisfy the 25 percent value added test or the 65 percent labor test until the third taxable year following the taxable year in which such product is first sold by the possessions corporation or such service is first rendered by the possessions corporation. During the transitional period, the applicable percentages for these tests will be as follows:

| | Any year after 1982 | | |
|---|---|---|---|
| | 1 | 2 | 3 |
| Value added test | 10 | 15 | 20 |
| Labor test | 35 | 45 | 55 |

*Q. 2:* Does the requirement that a possession product be produced or manufactured in a possessions within the meaning of section 954(d)(1)(A) apply to a product if the possessions corporation is engaged in start-up operations with respect to that product?

*A. 2:* The possessions corporation must produce or manufacture the possessions product within the meaning of section 954(d)(1)(A) if the possessions corporation computes its income with respect to that product under the profit split method.

*Q. 3:* When will a possessions corporation be considered to be engaged in start-up operations?

*A. 3:* A possessions corporation is engaged in start-up operations if it begins operations in a possession with respect to a product or type of service after September 3, 1982. Subject to the further provisions of this answer, a possessions corporation will be considered to begin operations with respect to a product if, under the rules of §1.936–5(a) questions and answers (6) through (10), such product could not be grouped with any other item of property manufactured in whole or in part in the possessions by any member of the affiliated group in any preceding taxable year. Any improvement or other change in a possession product which does not substantially change the production process would not be deemed to create a new product. A change in the division of manufacturing activity between the possessions corporation and its affiliates with respect to an item of property will not give rise to a new product. If a possessions corporation was producing a possession product that was either a component product or an

end-product form and the possessions corporation expands its operations in the same possession so that it is now producing a product that includes the earlier possession product, the possessions corporation will not be entitled to use the start-up significant business presence test unless the production costs incurred by the possessions corporation in the possession in producing a unit of its new possession product are at least double the production costs incurred by the possessions corporation in the possession in producing a unit of the earlier possession product. If any member of an affiliated group actually groups two or more items of property then, solely for the purposes of determining whether any item of property in that group is a new product, that grouping shall be respected. However, the fact that an affiliated group does not actually group two or more items of property shall be disregarded in determining whether any item of property is a new product. Notwithstanding the above, if a possessions corporation is producing a possession product in one possession and such corporation or a member of its affiliated group begins operations in a different possession, regardless of whether the items of property could be grouped, the affiliated group may treat the units of the item of property produced at the new site of operations in the different possession as a new product.

(8) *Alternative significant business presence test.*

*Q. 1:* Will the Secretary adopt a significant business presence test other than those set forth in section 936(h)(5)(B)(ii)?

*A. 1:* Yes. The following significant business presence test is adopted both for the transitional period and thereafter. A possessions corporation will have a significant business presence in a possession for a taxable year with respect to a product or type of service if—

(i) No less than 50 percent of the direct labor costs of the affiliated group for units of the product produced, in whole or in part, during the taxable year by the possessions corporation or for the type of service rendered by the possessions corporation during the taxable year are incurred by the possessions corporation as compensation for services performed in the possession; and

(ii) The direct labor costs of the possessions corporation for units of the product produced or the type of service rendered plus the base period construction costs are no less than 70 percent of the sum of such base period construction costs and the direct labor costs of the affiliated group for such units of the product produced or the type of service rendered.

Notwithstanding satisfaction of the above test, for purposes of determining whether a possessions corporation may compute its income under the profit split method, a possessions corporation will not be treated as having a significant business presence in a possession with respect to a product unless the possessions corporation manufactures the product in the possession within the meaning of section 954(d)(1)(A).

*Q. 2:* How is the term ''base period construction costs'' defined?

*A. 2:* The term ''base period construction costs'' means the average construction costs incurred by or on behalf of the possessions corporation for services in the possession during the taxable year and the preceding four taxable years for section 1250 property (as defined in section 1250(c) and the regulations thereunder) that is used for the production of the product or the rendering of the service in the possession, and which represents the original use of the section 1250 property. For purposes of the preceding sentence, if the possessions corporation was not in existence during one or more of the four preceding taxable years, its construction costs for that year or years shall be deemed to be zero. Construction costs include architects' and engineers' fees, labor costs, and overhead and profit (if the construction is performed by a person that is not a member of the affiliated group).

(c) *Definition and treatment of contract manufacturing.*

*Q. 1:* For purposes of determining whether a possessions corporation satisfies the significant business presence test with respect to a product, the costs incurred by the possessions corporation or by any of its affiliates in

connection with contract manufacturing which is related to that product and is performed outside the possession shall be treated as direct labor costs of the affiliated group and shall not be treated as production costs of the possessions corporation or as material costs. How is the term ''contract manufacturing'' to be defined?

*A. 1:* The term ''contract manufacturing'' includes any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person if the unrelated person:

(1) Performs work on inventory owned by a member of the affiliated group for a fee without the passage of title;

(2) Performs production activities (including manufacturing, assembling, finishing, or packaging) under the direct supervision and control of a member of the affiliated group; or

(3) Does not undertake any significant risk in manufacturing its product (*e.g.*, it is paid by the hour).

*Q. 2:* Does an arrangement between a member of the affiliated group and an unrelated party constitute contract manufacturing if the unrelated party uses an intangible owned or licensed by a member of the affiliated group?

*A. 2:* Such an arrangement will be treated as contract manufacturing if the unrelated party makes use of a patent owned or licensed by a member of the affiliated group in producing the product which becomes part of the possession product of the possessions corporation. In addition, such use of manufacturing intangibles other than patents may be treated as contract manufacturing if it is established that the arrangement has the effect of materially distorting the application of the significant business presence test. However, the preceding sentence shall not apply if the possessions corporation establishes that the arrangement was entered into for a substantial business purpose (e.g., to obtain the benefit of special expertise of the manufacturer or economies of scale). These rules shall not apply to such contract manufacturing performed in taxable years beginning before January 1, 1986, nor shall the rules apply to binding contracts for the performance of such contract manufacturing entered into before June 13, 1986.

*Q. 3:* For purposes of the significant business presence test, how shall a possessions corporation treat the cost of contract manufacturing performed within a possession?

*A. 3:* If the possessions corporation uses the value added test, it will be permitted to treat the cost of the contract manufacturing performed in a possession, not including material costs, as a production cost of the possessions corporation. If it uses the direct labor test or the alternative significant business presence test set forth in § 1.936–5(b)(8), it is permitted to treat the direct labor costs of the contract manufacturer associated with such contract manufacturing as a cost of direct labor of the possessions corporation. The allowable amount of the direct labor cost shall be determined in accordance with question and answer 4 below.

*Q. 4:* How are the amounts paid by a possessions corporation to a contract manufacturer for services rendered in a possession to be treated by the possessions corporation in computing the direct labor cost of the product to which such contract manufacturing relates?

*A. 4:* If the possessions corporation can establish the contract manufacturer's direct labor cost which was incurred in the possession, such cost will be treated as incurred by the possessions corporation as compensation for services performed in the possession. If the possessions corporation cannot establish such cost, then 50 percent of the amount paid to such contract manufacturer may be treated as incurred by the possessions corporation as compensation for services performed in the possession: provided, that not more than 50 percent of the fair market value of the product manufactured by the contract manufacturer is attributable to articles shipped into the possession, and the possessions corporation receives a statement from the contract manufacturer that this test has been satisfied. If this fair market value test is not satisfied, then the cost of contract manufacturing performed within a possession shall not be treated as a production cost or a direct labor

cost of either the possessions corporation or the affiliated group.

*Q. 5:* For purposes of the significant business presence test, what is the treatment of costs which are incurred by a member of the affiliated group (including the possessions corporation) for contract manufacturing performed outside of the possession with respect to an item of property which is a component of the possession product?

*A. 5:* If the possession product is treated as including such component, the cost of the contract manufacturing shall be treated as a direct labor cost of members of the affiliated group other than the possessions corporation for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials for purposes of the value added test. If the possession product is treated as not including such component, the cost of the contract manufacturing shall not be treated as a direct labor cost of any member of the affiliated group for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials for purposes of the value added test.

[T.D. 8090, 51 FR 21524, June 13, 1986; 51 FR 27174, July 30, 1986]

### § 1.936–6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e) where applicable.

(a) *Cost sharing option*—(1) *Product area research.*

*Q. 1:* Cost sharing payments are based on research undertaken by the affiliated group in the ''product area'' which includes the possession product. The term ''product area'' is defined by reference to the three-digit classification under the Standard Industrial Classification (SIC) code. Which governmental agency has jurisdiction to decide the proper SIC category for any specfic product?

*A. 1:* Solely for the purpose of determining the tax consequences of operating in a possession, the Secretary or his delegate has exclusive jurisdiction to decide the proper SIC category under which a product is classified. For this purpose, the product area under which a product is classified will be determined according to the 1972 edition of the SIC code. From time to time and in appropriate cases, the Secretary may prescribe regulations or issue rulings determining the proper SIC category under which a particular product is to be classified, and may prescribe regulations for aggregating two or more three-digit classifications of the SIC code and for classifying product areas according to a system other than under the SIC code.

*Q. 2:* How is the term ''affiliated group'' defined for purposes of the cost sharing option?

*A. 2:* For purposes of the cost sharing option, the term ''affiliated group'' means the possessions corporation and all other organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, within the meaning of section 482.

*Q. 3:* Are research and development expenditures that are included in product area research limited to research and development expenditures that are deductible under section 174 or that are incurred by U.S. affiliates?

*A. 3:* No, product area research is not limited to product area research expenditures deductible under section 174 or to expenses incurred by U.S. affiliates. Product area research also includes deductions permitted under section 168 with respect to research property which are not deductible under section 174; qualified research expenses within the meaning of section 30(b); payments (such as royalities) for the use of, or right to use, a patent, invention, formula, process, design, pattern or know-how; and a proper allowance for amounts incurred in the acquisition of manufacturing intangible property. In the case of an acquisition of depreciable or amortizable manufacturing intangible property, the annual amount of product area research shall

be be equal to the allowable depreciation or amortization on the intangible property for the taxable year. In the case of an acquisition of nondepreciable or nonamortizable manufacturing intangible property, the amount expended for the acquisition shall be deemed to be amortized over a five year period and included in product area research in the year of the deemed amortization. Any contingent payment made with respect to the acquisition of nonamortizable manufacturing intangible property shall be treated as amounts incurred in the acquisition of nonamortizable manufacturing intangible property when paid or accrued.

*Q. 4:* Does royalty income from a person outside the affiliated group with respect to the manufacturing intangibles within a product area reduce the product area research pool within the same product area?

*A. 4:* Yes.

*Q. 5:* Does income received from a person outside the affiliated group from the sale of a manufacturing intangible reduce the product area research pool within the same product area?

*A. 5:* In determining product area research, the income from the sale attributable to noncontingent payments will reduce product area research ratably over the remaining useful life of the property in the case of an amortizable intangible and ratably over a 5-year period in the case of a nonamortizable intangible. Any income attributable to contingent amounts received with respect to the sale of manufacturing intangible property shall be treated as amounts received from the sale of the manufacturing intangible property in the year in which such contingent amounts are received or accrued.

*Q. 6:* If a member of an affiliated group incurs research and development expenses pursuant to a contract with an unrelated person who is entitled to exclusive ownership of all the technology resulting from the expenditures, is the amount of product area research reduced by the amount of such expenditures?

*A. 6:* To the extent that the product area research expenditures can be allocated solely to the technology produced for the unrelated person, such expenditures will not be included in product area research expenditures provided, however, that the unrelated person has exclusive ownership of all the technology resulting from these expenditures, and further that no member of the affiliated group has a right to use any of the technology.

*Q. 7:* What is the treatment of product area research expenditures attributable to a component where the component and the integrated product fall within different product areas?

*A. 7:* For purposes of the computation of product area research expenditures in the product area by the affiliated group, the product area in which the component falls is aggregated with the product area in which the integrated product falls. However, if the component product and integrated product are in separate SIC codes and if the component product is not included in the definition of the possession product, then the product area research expenditures are not aggregated. The same rule applies where the taxpayer elects a component product which encompasses another component product and the two component products fall into separate SIC codes. In such case, the product area in which the first component falls is aggregated with the product area in which the second component falls.

(2) *Possession sales and total sales.*

*Q. 1:* The cost sharing payment is the same proportion of the total cost of product area research which the amount of ''possession sales'' of the affiliated group bears to the ''total sales'' of the affiliated group within the product area. How are ''possession sales'' defined for purposes of the cost sharing fraction?

*A. 1:* The term ''possession sales'' means the aggregate sales or other dispositions of the possession product, to persons who are not members of the affiliated group, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year. Except as otherwise indicated in §1.936–6(a)(2), the sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

*Q. 2:* For purposes of the numerator of the cost sharing fraction, how are possession sales computed where the possession product is a component product or an end-product form?

*A. 2:* (i) The sales price of the component product or end-product form is determined as follows. With respect to a component product, an independent sales price from comparable uncontrolled transactions must be used if such price can be determined in accordance with §1.482–2(e)(2). If an independent sales price of the component product from comparable uncontrolled transactions cannot be determined, then the sales price of the component product shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the active conduct of a trade or business in the possession with respect to the component product. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may treat the sales price for the component product as equal to the same proportion of the third party sales price of the integrated product which the production costs attributable to the component product bear to the total production cost for the integrated product. Production cost will be the sum of direct and indirect production costs as defined in §1.936–5(b)(4). If the possessions corporation determines the sales price of the component product using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the component product under the cost sharing method may not be greater than such sales price.

(ii) With respect to an end-product form, the sales price of the end-product form is equal to the difference between the third party sales price of the integrated product and the independent sales price of the excluded component(s) from comparable uncontrolled transactions, if such price can be determined under §1.482–2(e)(2). If an independent sales price of the excluded component(s) from uncontrolled transactions cannot be determined, then the sales price of the end-product form shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the active conduct of a trade or business in the possession with respect to such end-product form. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may use the production cost ratio method described above to determine the sales price of the end-product form (*i.e.*, the same proportion of the third party sales price of the integrated product which the production costs attributable to the end-product form bear to the total production costs for the integrated product). If the possessions corporation determines the sales price of the end-product form using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the end-product form under the cost sharing method may not be greater than such sales price. For similar rules applicable to the profit split option see §1.936–6(b)(1), question and answer 12.

*Q. 3:* For purposes of determining possessions sales in the numerator of the cost sharing fraction, will the replacement part price of the product be treated as a price from comparable uncontrolled transactions?

*A. 3:* Prices for replacement parts are generally higher than prices for equipment sold as part of an original system. Thus, prices for replacement parts cannot generally be used directly as prices for comparable uncontrolled transactions. However, replacement part prices may be used for estimating comparable uncontrolled prices where the price differential can be reasonably determined and taken into account under §1.482–2(e)(2).

*Q. 4:* For purposes of determining possession sales in the cost sharing fraction, what is the treatment of components that are purchased by one possessions corporation from an affiliated possessions corporation and which are incorporated into a possession product

where the transferor possessions corporation treats the transferred component as a possession product?

*A. 4:* When one possessions corporation purchases components from a second possessions corporation which is an affiliated corporation, the purchase price of the components paid to the second possessions corporation shall be subtracted from the sales proceeds of the product produced in the possession by the first possessions corporation, and only the remainder is included in the numerator of the cost sharing formula for the first corporation. For example, assume that N corporation manufactures a component for sale to O corporation for $100 (a price which reflects prices in comparable uncontrolled transactions). Both N and O are affiliated possessions corporations. N has designated that component product as its possession product. O then incorporates that product into a second product which is sold to customers for $300 N and O must make separate cost sharing payments. The cost sharing payment of N corporation is determined by including $100 as possession sales, and the payment of O is determined by subtracting that $100 purchase price from the $300 received from customers. Thus, the possessions sales amount of O is $200. This rule is intended to prevent the double counting of the sales of a component produced by one possessions corporation and incorporated into another product by an affiliated possessions corporation.

*Q. 5:* Are pre-TEFRA sales included in the cost sharing fraction?

*A. 5:* No. Pre-TEFRA sales are sales of products produced by the possessions corporation and transferred to an affiliate prior to a possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA sales are not included in either the numerator or denominator of the cost sharing fraction. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies. If the U.S. affiliate uses the LIFO method of costing inventory (either dollar-value or specific goods LIFO), pre-TEFRA inventor will be treated as inventory sold by the U.S. affiliate in the year in which the U.S. afiliate's LIFO layer containing pre-TEFRA LIFO inventory is liquidated.

*Q. 6:* How are ''possession sales'' determined under the cost sharing formula if members of the affiliated group (other than the possessions corporation) include purchases of the possession product, X, in a dollar-value LIFO inventory pool (as provided under §1.472–8)?

*A. 6:* Possession sales may be determined by applying the revenue identification method provided under paragraph (b)(1) Question and Answer 18 of this section.

*Q. 7:* Do possession sales include excise taxes paid by the possessions corporation when the product is sold for ultimate use or consumption in the possession?

*A. 7:* No. The amount of excise taxes is excluded from both the numerator and denominator of the cost sharing fraction.

*Q. 8:* How are ''total sales'' defined for purposes of the cost sharing fraction?

*A. 8:* The term ''total sales'' means aggregate sales or other dispositions of products in the same product area as the possession product, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year to persons who are not members of the affiliated group. The sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

*Q. 9:* In computing that cost sharing payment, how are ''total sales'' computed if the dollar-value LIFO inventory pool includes some products which are not included in the product area (determined under the 3-digit SIC code) on which the denominator of the cost sharing fraction is based?

*A. 9:* In such case, the amount of the total sales within the product area to persons who are not members of the affiliated group by persons who are members of the affiliated group is determined by multiplying the total sales of the products within the dollar-value LIFO inventory pool by a fraction. The numerator of the fraction includes the dollar-value of purchases by members

of the affiliated group (including the possessions corporation) of products within the product area made during the year, plus any added production costs (as defined in §1.471–11(b), (c), and (d) but not including the costs of materials) incurred by the affiliates during the same period. The denominator of the fraction includes the dollar-value of purchases by members of the affiliated group (including the possessions corporation) of products within the dollar-value LIFO inventory pool made during the same period (including any production costs, as described above, incurred by the affiliate during the same period). For these purposes, purchases of a possession product are determined on the basis of the possessions corporation's cost for its inventory purposes.

*Q. 10:* May a possessions corporation compute its income under the cost sharing method with respect to a possession product which the possessions corporation sells to a member of its affiliated group and which that member then leases to an unrelated person or uses in its own trade or business?

*A. 10:* Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with §1.482–2(e)(2), and, provided further, that such member complies with the requirements of §1.936–6(a)(2), question and answer 14. If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may, if such member complies with the requirements of §1.936–6(a)(2), question and answer 14, compute its income under the cost sharing method with respect to such possession product. In that case, the cost sharing payment shall be computed under the following question and answer.

*Q. 11:* How are possession sales and total sales to be determined for purposes of computing the cost sharing payment with respect to a possession product which the possessions corporation sells to a member of its affiliated group where that member then leases the possession product to unrelated persons or uses it in its own trade or business?

*A. 11:* If the possessions corporation is entitled to compute its income from such sales of the possession product under the cost sharing method, both possession sales and total sales shall be determined as if the possession product had been sold by the affiliate to an unrelated person at the time the possession product was first leased or otherwise placed in service by the affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any. If the possession product is a component product or an end-product form for which there is no such independent sales price but there is a comparable uncontrolled price for the integrated product which includes the possession product, the deemed sales price of the possession product shall be computed under the rules of §1.936–6(a)(2) question and answer 2. The full amount of income received under the lease shall be treated as income of (and taxed to) the affiliate and not the possessions corporation.

*Q. 12:* When may a possessions corporation take into account in computing total sales under the cost sharing method products in the same product area as the possession product (other than the possession product itself) where such products are leased by members of the affiliated group to unrelated persons or used by any such member in its own trade or business?

*A. 12:* For purposes of computing total sales under the cost sharing method, the possessions corporation may take into account products in the same product area as the possession product itself where such products are leased by members of the affiliated group to unrelated persons or used in the trade or business of any such member, but only if an independent sales price of such products from comparable uncontrolled transactions may be determined under §1.482–2(e)(2). In such cases, the units of such products which are leased or otherwise used internally by members of the affiliated group may be treated as sold to unrelated persons for such independent sales price for purposes of computing total sales.

*Q. 13:* Assuming that a possessions corporation is entitled to compute its income under the cost sharing method with respect to sales of a possession product to affiliates in cases where those affiliates lease units of the possession product to unrelated persons or use them internally, is the possessions corporation's income from the possession product any different than if the affiliates had sold the product to unrelated parties?

*A. 13:* No.

*Q. 14:* If a possessions corporation sells units of a possession product to a member of its affiliated group and that affiliate then leases those units to an unrelated person or uses the units in its own trade or business, what requirements must the affilate meet in order for the possessions corporation to be entitled to the benefits of the cost sharing method with respect to such units?

*A. 14:* (i) For taxable years of the possessions corporation beginning on or before June 13, 1986, the affiliate need not meet any special requirements in order for the possessions corporation to be entitled to the beneifts of the cost sharing method with respect to such units. Thus, the affiliate's basis in such units shall be equal to the transfer price used for computing the possessions corporation's gross income with respect to such units under section 936(h)(5)(C)(i)(II), and the income derived by the affiliate from such lease or internal use shall be reported by the affiliate when and to the extent actually derived. The affiliate shall not be deemed to have sold such units to an unrelated party at the time they were first leased or otherwise placed in service for any purpose other than the computation of possession sales and total sales. A similar rule applies to other products in the same product area as the possession product which are sold by any member in its own trade or business and which the possessions corporation takes into account in computing total sales under the cost sharing method.

(ii) For taxable years of the possessions corporations beginning after June 13, 1986, a possessions corporations will not be entitled to the benefits of the cost sharing method with respect to units of the possession product which the possessions corporation sells to an affiliate where the affiliate then leases such units to an unrelated person or uses them in its own trade or business, unless the affiliate agrees to be treated for all tax purposes as having sold such units to an unrelated party at the time they were first leased or otherwise placed in service by such affiliate. The affiliate must demonstrate such agreement by reporting its income from such units as if:

(A) It had sold such units to an unrelated person at such time at a price equal to the price used to compute possessions sales under §1.936–6(a)(2), question and answer 11;

(B) It had immediately repurchased such units for the same price; and

(C) Its basis in such units for all subsequent purposes was equal to its cost basis from such deemed repurchase.

For treatment of other products in the same product area as the possession product see §1.936–6(a)(2), question and answer 12.

(iii) The principles contained in questions and answers 11, 12, 13, and 14 are illustrated by the following example:

*Example.* Possessions corporation S and its affiliate A are calendar year taxpayers. In 1985, S manufactures 100 units of possession product X. S sells 50 units of X to unrelated persons in arm's length transactions for $10 per unit. In applying the cost sharing method to determine the portion of its gross income from such sales which qualifies for the possessions tax credit, S determines that $8 of the $10 sales price may be taken into account. S sells the remaining 50 units of X to A, and A then leases such units to unrelated persons. In 1985, A also manufacturers 100 units of product Y, the only other product in the same product area as X manufactured or sold by any member of the affiliated group. A manufactured the 100 units of Y at a cost of $15 per unit, sold 50 units of Y to unrelated persons in arm's length transactions for $20 per unit, and leased the remaining 50 units of Y to unrelated persons.

S may compute its income under the cost sharing method with respect to the 50 units of X it sold to A because S can determine an independent sales price of X from comparable uncontrolled transactions under §1.482–2(e)(2). For purposes of computing both possessions sales and total sales, the 50 units of X sold to A will be deemed to have been sold by A to an unrelated person for $10 per unit. The income of S qualifying for the possessions tax credit from the sale of those

50 units of X to A, and A's basis in those units, will both be determined using the $8 transfer price determined under section 936(h)(5)(C)(i)(II). For purposes of computing total sales in the denominator of the cost sharing fraction, S may also take into account the 50 units of Y leased by A to unrelated persons, as if A had sold those units for $20 per unit. A's basis in those units of Y will continue to be its actual cost basis of $15 per unit.

If all of the above transactions had occurred in 1987, S would be entitled to compute its income under the cost sharing method with respect to the 50 units of X it sold to A only if A agreed to be treated for all tax purposes as if it had sold such units for $10 per unit, realized income on such deemed sale of $2 per unit, repurchased such units immediately for $10 per unit, and then leased such units, which would then have a $10 per unit basis in A's hands. For purposes of computing total sales, S would be entitled to take into account the 50 units of X leased by A to unrelated persons as if A had sold such units for $20 per unit.

(3) *Credits against cost sharing payments.*

*Q. 1:* Is the cost of product area research paid or accrued by the possessions corporation in a taxable year creditable against the cost sharing payment?

*A. 1:* Yes, if the cost of the product area research is paid or accrued solely by the possessions corporation. Thus, payments by the possessions corporation under cost sharing arrangements with, or royalties paid to, unrelated persons are so creditable. Amounts (such as royalties) paid directly or indirectly to, or on behalf of, related persons and amounts paid under any cost sharing agreements with related persons are not creditable against the cost sharing payment.

*Q. 2:* Do royalties or other payments made by an affiliate of the possessions corporation to another member of the affiliated group reduce the cost sharing payment if such royalties or other payments are based, in part, on activity of the possessions corporation?

*A. 2:* No. Payments made between affiliated corporations do not reduce the cost sharing payment. Thus, for example, if a possessions corporation sells a component to a foreign affiliate for incorporation by the foreign affiliate into an integrated product sold to unrelated persons, and the foreign affiliate pays a royalty to the U.S. parent of the possessions corporation based on the total value of the integrated product, the cost sharing payment of the possessions corporation is not reduced.

(4) *Computation of cost sharing payment.*

*Q. 1:* S is a possessions corporation engaged in the manufacture and sale of four products (A, B, C, and D) all of which are classified under the same three-digit SIC code. S sells its production to a U.S. affiliate, P, which resells it to unrelated parties in the United States. P's third party sales of each of these products produced in whole or in part by S (computed as provided under paragraph (a)(2) of §1.936–6) are $1 million or a total of $4 million for A, B, C, and D. P's other sales of products in the same SIC code are $3,000,000; and the defined worldwide product area research of the affiliated group is $350,000. How should S compute the cost sharing amount for products A, B, C, and D?

*A. 1:* The cost sharing amount is computed separately for each product on Schedule P of Form 5735. S should use the following formula for each of the products A, B, C, and D:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research}$$

$$\frac{\$1{,}000{,}000}{\$7{,}000{,}000} \times \$350{,}000 = \$50{,}000$$

*Q. 2:* The facts are the same as in question 1 except that S manufactures product D under a license from an unrelated person. S pays the unrelated party an annual license fee of $20,000. Thus, the worldwide product area research expense of the affiliated group

is $370,000. How should the cost sharing payment be adjusted?

*A. 2:* The cost sharing fee should be reduced by the $20,000 license fee made as a direct annual payment to a third party on account of product D. The cost sharing payment with respect to product D in this example will be adjusted as follows:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research} - \text{Amount paid by the possessions corporation to an unrelated party}$$

$$\left(\frac{1{,}000{,}000}{\$7{,}000{,}000} \times \$370{,}000\right) - \$20{,}000 = \$32{,}857$$

*Q. 3:* The facts are the same as in question 1 except that S also manufactures and exports product E to a foreign affiliate, which resells it to unrelated persons for $1 million. S makes a separate election for its export sales. How should S compute the cost sharing amount for product E?

*A. 3:* The numerator of the cost sharing fraction is the aggregate sales or other dispositions by members of the affiliated group of the units of product E produced in whole or in part in the possession to persons who are not members of the affiliated group. The cost sharing amount for product E would be computed as follows:

$$\frac{\text{Export sales of E}}{\text{Total sales of products in SIC code (In this example, U. S. Sales of A, B, C, and D + export sales of E)}} \times \text{Worldwide product area research}$$

or

$$\frac{\$1{,}000{,}000}{(\$7{,}000{,}000 + \$1{,}000{,}000)} \times \$350{,}000 = \$43{,}750$$

*Q. 4:* The facts are the same as in question 1, except that S also receives $10,000 in royalty income from unrelated persons for the licensing of certain manufacturing intangible property rights. What is the amount of the product area research that must be allocated in determining the cost sharing amount?

*A. 4:* If the affiliated group receives royalty income from unrelated persons with respect to manufacturing intangibles in the same product area, then the product area research to be considered shall be first reduced by such royalty income. In this case, the amount of product area research to be used in determining S's cost sharing payment should be reduced by the $10,000 royalty payment received to $340,000.

*Q. 5:* May a possessions corporation redetermine the amount of its required cost sharing payment after filing its tax return?

*A. 5:* If after filing its tax return, a possessions corporation files an amended return, or if an adjustment is made on audit, either of which affects the amount of the cost sharing payment required, then a redetermination of the cost sharing payment must be made. See, however, section 936(h)(5)(C)(i)(III)(*a*) with respect to the increase in the cost sharing payment due to interest imposed under section 6601(a).

(5) *Effect of election under the cost sharing method.*

*Q. 1:* What is the effect of the cost sharing method?

*A. 1:* The cost sharing payment reduces the amount of deductions (and the amount of reductions in earnings and profits) otherwise allowable to the U.S. affiliates (other than tax-exempt affiliates) within the affiliated group as determined under section 936(h)(5)(C)(i)(I)(*b*) which have incurred research expenditures (as defined in §1.936–6(a)(1), question and answer (3) in the same product area for which the cost sharing option is elected, during the taxable year in which the cost sharing payment accrues. If there are no such U.S. affiliates, the reductions with respect to deductions and earnings and profits, as the case may be, are made with respect to foreign affiliates within the same affiliated group which have incurred product area research expenditures in such product area attributable to a U.S. trade or business. If there are no affiliates which have incurred research expenditures in such product area, the reductions are then made with respect to any other U.S. affiliate and, if there is no such U.S. affiliate, then to any other foreign affiliate. The allocations of these reductions in each case shall be made in proportion to the gross income of the affiliates. In the case of foreign affiliates, the allocation shall be made in proportion to gross income attributable to the U.S. trade or business or worldwide gross income, as the case may be. With respect to each group above, the reduction of deductions shall be applied first to deductions under section 174, then to deductions under section 162, and finally to any other deductions on a pro rata basis.

*Q. 2:* For purposes of estimated tax payments, when is the cost sharing amount deemed to accrue?

*A. 2:* The cost sharing amount is deemed to accrue to the appropriate affiliate on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends.

*Q. 3:* If the cost sharing method is elected and the year of accrual of the cost sharing payment to the appropriate affiliate (described in question and answer 1 of this paragraph (a)(5)) differs from the year of actual payment by the possessions corporation, in what year are the deductions of the recipients reduced?

*A. 3:* In the year the cost sharing payment has accrued.

*Q. 4:* What is the treatment of income from intangibles under the cost sharing method?

*A. 4:* Under the cost sharing method, a possessions corporation is treated as the owner, for purposes of obtaining a return thereon, of manufacturing intangibles related to a possession product. The term ''manufacturing intangible'' means any patent, invention, formula, process, design, pattern, or know-how. The possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any manufacturing intangibles related to a component product produced by an affiliated corporation and transferred to the possessions corporation for incorporation into the possession product, except in the case that the possession product is treated as including such component product for all purposes of section 936(h)(5). Further, the possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any marketing intangibles except ''covered intangibles.'' (See §1.936–6(c).)

*Q. 5:* If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner of the manufacturing intangibles related to the possession product in order for the possessions corporation to receive a full return with respect to such intangibles?

*A. 5:* No. There is no requirement that manufacturing intangibles be owned by the possessions corporation.

*Q. 6:* How is income attributable to marketing intangibles treated under the cost sharing method?

*A. 6:* Except in the case of ''covered intangibles'' (see §1.936–6(c)), the possessions corporation is not treated as the owner of any marketing intangibles, and income attributable to marketing intangible of the possessions corporation will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign, person or is otherwise tax exempt, the possessions corporation is taxable on that shareholder's pro rata amount of the intangible property income. If the possessions corporation is a corporation any class of the stock of which is regularly traded on an established securities market, then the income attributable to marketing intangibles will be taxable to the possessions corporation rather than the corporation's U.S. shareholders.

*Q. 7:* What is the source of the intangible property income described in question and answer 6?

*A. 7:* The intangible property income is U.S. source whether taxed to the U.S. shareholder or taxed to the possessions corporation and section 863 (b) does not apply for this purpose. However, such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test.

*Q.7a:* What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

*A.7a:* Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after November 13, 1998.

*Q. 8:* May marketing intangible income, if any, be allocated to the possessions corporation with respect to custom-made products?

*A. 8:* No. If the cost sharing option is elected, then income attributable to marketing intangibles (other than ''covered intangibles'' described in §1.936–6(c)) will be taxed as discussed in questions and answers 6 and 7 of paragraph (a)(5) of this section. It is immaterial whether the product is custom-made.

*Q. 9:* In order to sell a pharmaceutical product in the United States, a New Drug Application (''NDA'') for the product must be approved by the U.S. Food and Drug Administration. Is an NDA considered a manufacturing or marketing intangible for purposes of the allocation of income under the cost sharing method?

*A. 9:* A manufacturing intangible.

*Q. 10:* Can a copyright be, in whole or in part, a manufacturing intangible for purposes of the allocation of income under the cost sharing method?

*A. 10:* In general, a copyright is a marketing intangible. See section 936(h)(3)(B)(ii). However, copyrights may be treated either as manufacturing intangibles or nonmanufacturing intangibles (or as partly each) depending upon the function or the use of the copyright. If the copyright is used in manufacturing, it will be treated as a manufacturing intangible; but if it is used in marketing, even if it is also classified as know-how, it will be treated as a marketing intangible.

*Q. 11:* If the cost sharing option is elected and a patent is related to the product produced by the possessions corporation, does the return to the possessions corporation with respect to the manufacturing intangible include the make, use, and sell elements of the patent?

*A. 11:* Yes. A patent confers an exclusive right for 17 years to sell a product

covered by the patent. During this period, the return to the possessions corporation includes the make, use and sell elements of the patent.

*Q. 12:* For purposes of the cost sharing option, may a safe haven rule be applied to determine the amount of marketing intangible income?

*A. 12:* No. The amount of marketing intangible income is determined on the basis of all relevant facts and circumstances. The section 482 regulations will continue to apply except to the extent modified by the election. Rev. Proc. 63–10 and Rev. Proc. 68–22 do not apply for this purpose.

*Q. 13:* If a product covered by the cost sharing election is sold by a possessions corporation to an affiliated corporation for resale to an unrelated party, may the resale price method under section 482 be used to determine the intercompany price of the possessions corporation?

*A. 13:* In general, the resale price method may be used if (a) no comparable uncontrolled price for the product exists, and (b) the affiliated corporation does not add a substantial amount of value to the product by manufacturing or by the provision of services which are reflected in the sales price of the product to the customer. The possessions corporation will not be denied use of the resale price method for purposes of such inter-company pricing merely because the reseller adds more than an insubstantial amount to the value of the product by the use of intangible property.

*Q. 14:* If a possessions corporation makes the cost sharing election and uses the cost-plus method under section 482 to determine the arm's-length price of a possession product, will the cost base include the cost of materials which are subject to processing or which are components in the possession product?

*A. 14:* A taxpayer may include the cost of materials in the cost base if it is appropriate under the regulations under § 1.482–2(e)(4).

*Q. 15:* If the possessions corporation computes its income with respect to a product under the cost sharing method, and the price of the product is determined under the cost-plus method under section 482, does the cost base used in computing cost-plus under section 482 include the amount of the cost sharing payment?

*A. 15:* The amount of the cost sharing payment is included in the cost base. However, no profit with respect to the cost sharing payment will be allowed.

*Q. 16:* If a member of the affiliated group transfers to a possessions corporation a component which is incorporated into a possession product, how will the transfer price for the component be determined?

*A. 16:* The transfer price for the component will be determined under section 482, and as follows. If the possession product is treated as not including such component for purposes of section 936(h)(5), the transfer price paid for the component will include a return on all intangibles related to the component product. If the posssession product is treated as including such component for purposes of section 936(h)(5), then the transfer price paid for the component by the possessions corporation will not include a return on any manufacturing intangible related to the component product, and the possessions corporation will obtain the return on the manufacturing intangibles associated with the component.

*Q. 17:* If the possessions corporation computes its income with respect to a product under the cost sharing method, with respect to which units of the product shall the possessions corporation be treated as owning intangible property as a result of having made the cost sharing election?

*A. 17:* The possessions corporation shall not be treated as owning intangible property, as a result of having made the cost sharing election, with respect to any units of a possession product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(b) *Profit split option*—(1) *Computation of combined taxable income.*

*Q. 1:* In determining combined taxable income from sales of a possession

product, how are the allocations and apportionments of expenses, losses, and other deductions to be determined?

*A. 1:* (i) Expenses, losses, and other deductions are to be allocated and apportioned on a ''fully-loaded'' basis under §1.861–8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates). For purposes of the profit split option, the term ''affiliated group'' is defined the same as under §1.936–6 (a)(1) question and answer 2. The amount of research, development, and experimental expenses allocated and apportioned to combined gross income is to be determined under §1.861–8(e)(3). The amount of research, development and experimental expenses and related deductions (such as royalties paid or accrued with respect to manufacturing intangibles by the possessions corporation or other domestic members of the affiliated group to unrelated persons or to foreign affiliates) allocated and apportioned to combined gross income shall in no event be less than the amount of the cost sharing payment that would have been required under the rules set forth in section 936(h)(5)(C)(i)(II) and paragraph (a) of this section if the cost sharing option had been elected. Other expenses which are subject to §1.861–8(e) are to be allocated and apportioned in accordance with that section. For example, interest expense (including payments made with respect to bonds issued by the Puerto Rican Industrial, Medical and Environmental Control Facilities Authority (AFICA)) is to be allocated and apportioned under §1.861–8(e)(2). With the exception of marketing and distribution expenses discussed below, the other remaining expenses which are definitely related to a class of gross income shall be allocated to that class of gross income and shall be apportioned on the basis of any reasonable method, as described in §1.861–8 (b)(3) and (c)(1). Examples of such methods may include, but are not limited to, those specified in §1.861–8(c)(1)(i) through (vi).

(ii) The class of gross income to which marketing and distribution expenses relate and shall be allocated is generally to be defined by the same ''product area'' as is determined for the relevant research, development, and experimental expenses (*i.e.*, the appropriate 3-digit SIC code), but shall include only gross income generated or reasonably expected to be generated from the geographic area or areas to which the expenses relate. It shall be presumed that marketing and distribution expenses relate to all product sales within the same product area. If, however, it can be established that any of these expenses are separately identifiable expenses, such as advertising, and relate, directly or indirectly, solely to a specific product or a specific group of products, such expenses shall be allocated to the class of gross income defined by the specific product or group of products. Thus, advertising and other separately identifiable marketing expenses which relate specifically and exclusively to a particular product must be allocated entirely to the gross income from that product, even though the taxpayer or other members of an affiliated group which includes the taxpayer produce and market other products in the same 3-digit SIC code classification. The mere display of a company logo or mention of a company name solely in the context of identifying the manufacturer shall not prevent an advertisement from relating specifically and exclusively to a particular product or group of products.

(iii) If marketing and distribution expenses are allocated to a class of gross income which consists both of income from sales of possession products (the statutory grouping) and other income such as from sale by U.S. affiliates of products not produced in the possession (the residual grouping), then these marketing and distribution expenses shall be apportioned on a ''fully loaded'' basis which reflects, to a reasonably close extent, the factual relationship between these deductions and the statutory and residual groupings of gross income. Apportionment methods based upon comparisons of amounts incurred before ultimate sale of a product (including apportionment on a comparison of costs of goods sold, other expenses incurred, or other comparisons set forth in §1.861–8 (c)(1)(v), such as time spent) are not on a ''fully-

loaded'' basis and do not reflect this required factual relationship. These deductions shall be apportioned on a basis of comparison of the amount of gross sales or receipts or another method if it is established that such method similarly reflects the required factual relationship. Thus, for example, a comparison of units sold may be used only where the units are of the same or similar value and are, thus, in fact comparable.

(iv) The rules for allocation and apportionment of marketing and distribution expenses may be illustrated by the following examples:

*Example 1.* Assume that possessions corporation A manufacturers prescription pharmaceutical product #1 for resale by P, its U.S. parent corporation, in the United States. Additionally, assume that P manufactures prescription pharmaceutical products #2 and #3 in the United States for sale there. Further, assume that all three products are within the same product area, and that marketing and distribution expenses are internally divided by P among the three products on the basis of time spent by sales persons of P on marketing of the three products, as follows:

| | |
|---|---|
| Product #1 | 50X |
| Product #2 | 80X |
| Product #3 | 110X |
| Total | 240X |

These expenses of 240X are allocated to gross income generated by all three products and shall be apportioned on the basis of gross sales or receipts of product #1 as compared to products #2 and #3 or another method which similarly reflects the factual relationship between these expenses and gross income derived from product #1 and products #2 and #3. Thus, if a sales method were used and sales of product #1 accounted for one-third of sales receipts from the three products, 80X (240 ÷ 3) of marketing and distribution expenses would be apportioned to the combined gross income from product #1.

*Example 2.* Corporation B produces and sells Brand W whiskey, in the United States. B's subsidiary, S, which is a possessions corporation, produces soft drink extract in Puerto Rico which it sells to independent bottlers to produce Brand S soft drinks for sale in the United States. Corporation B's advertisements and other promotional materials for Brand W whiskey make no reference to Brand S soft drinks (or any other Corporation B products), and Brand S soft drink advertisements and other promotional materials make no reference to Brand W whiskey (or any other corporation B products). For purposes of section 936(h), the advertising and other promotional expenses for Brand W whiskey must be allocated entirely to the gross income from sales of Brand W whiskey and the advertising and other promotional expenses for Brand S soft drink must be allocated entirely to the gross income from the sales of soft drink extract, notwithstanding the fact that whiskey and soft drink extract are both included in SIC code 208. A similar result would apply, for example, to separately identifiable advertising and other marketing expenses which relate specifically and exclusively to one or the other of the following pairs of products: chewing gum and granulated sugar (SIC code 206); canned tuna fish and freeze-dried coffee (SIC code 209); children's underwear and ladies' brassieres (SIC code 234); aspirin tablets and prescription antibiotic tablets (SIC code 283); floor wax and perfume (SIC code 284); adhesives and inks (SIC code 289); semi-conductors and cathode-ray tubes (SIC code 367); batteries and extension cords (SIC code 369); bandages and dental supplies (SIC code 384); stainless steel flatware and jewelry parts (SIC code 391); children's toys and sporting goods (SIC code 394); hair curlers and zippers (SIC code 396); and paint brushes and linoleum tiles (SIC code 399).

*Example 3.* Assume the same facts as in Example 1 and that possessions corporation A also manufactures aspirin, a non-prescription product, for resale by its U.S. parent corporation, P. Further, assume that the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales total $100 and that these expenses are allocable solely to gross income derived from aspirin sales. The sales method continues to be used to apportion the marketing and distribution expenses related, directly or indirectly, to products #1, #2, and #3, and the apportionment of such expenses to product #1 for purposes of determining combined taxable income from product #1 will remain as stated in Example 1. None of the advertising and other separately identifiable marketing expenses which relate specifically and exclusively to aspirin will be taken into account in allocating and apportioning the marketing and distribution expenses relating to the gross income attributable to products #1, #2, and #3. Gross income attributable to aspirin will be considered as a separate class of gross income, and all the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales of $100 will be allocated to the class of gross income derived from aspirin sales. Similarly, none of the marketing and distribution expenses, directly or indirectly, related solely to the group of products #1, #2, and #3 will be taken into account in determining the combined taxable income from aspirin sales. the remaining marketing and distribution expenses which do not, directly or indirectly,

relate solely to any specific product or group of products (*e.g.*, the salaries of a Vice-President of Marketing who has responsibility for marketing all products and his staff) shall be allocated and apportioned on the basis of the gross receipts from the sales of all of the products (or a similar method) in determining combined taxable income of any product.

*Q. 2:* How may the allocation and apportionment of expenses to combined gross income be verified?

*A. 2:* Substantiation of the allocation and apportionment of expenses will be required upon audit of the possessions corporation and affiliates. Detailed substantiation may be necessary, particularly where the entities are engaged in multiple lines of business involving distinct product areas. Sources of substantiation may include certified financial reports. Form 10–K's, annual reports, internal production reports, product line assembly work papers, and other relevant materials. In this regard, *see* §1.861–8(f)(5).

*Q. 3:* Does section 936(h) override the moratorium provided by section 223 of the Economic Recovery Tax Act of 1981 and any subsequent similar moratorium?

*A. 3:* Yes. Thus, the allocation and apportionment of product area research described in question and answer 1 must be made without regard to the moratorium.

*Q. 4:* Is the cost of samples treated as a marketing expense?

*A. 4:* Yes. The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for purposes of determining combined taxable income (and compliance with the significant business presence test). However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

*Q. 5:* If a possessions corporation uses the profit split method to determine its taxable income from sales of a product, how does it determine its gross income for purposes of the 80-percent possession source test and the 65-percent active trade or business test of section 936(a)(2)?

*A. 5:* One-half of the deductions of the affiliated group (other than foreign affiliates) which are used in determining the combined taxable income from sales of the product are added to the portion of the combined taxable income allocated to the possessions corporation in order to determine the possessions corporation's gross income from sales of such product.

*Q. 6:* How will income from intangibles related to a possession product be treated under the profit split method?

*A. 6:* Combined taxable income of the possessions corporation and affiliates from the sale of the possession product will include income attributable to all intangibles, including both manufacturing and marketing intangibles, associated with the product.

*Q. 7:* Can a possessions corporation apply the profit split option to a possession product if no U.S. affiliates derive income from the sale of the possession product?

*A. 7:* Yes.

*Q. 8:* With respect to the factual situation discussed in question and answer 7 how is combined taxable income computed?

*A. 8:* The profit split option is applied to the taxable income of the possessions corporation from sales of the possession product to foreign affiliates and unrelated persons. Fifty percent of that income is allocated to the possessions corporation, and the remainder is allocated to the appropriate affiliates as described in question and answer 13 of this paragraph (b)(1).

*Q. 9:* May a possessions corporation compute its income under the profit split method with respect to units of a possession product which it sells to a U.S. affiliate if the U.S. affiliate leases such units to unrelated persons or to foreign affiliates or uses such units in its own trade or business?

*A. 9:* Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with §1.482–2 (e)(2). If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may compute its income under the profit split method with respect to

such units. In either case, the possessions corporation shall compute combined taxable income with respect to such units under the following question and answer.

*Q. 10:* If the possessions corporation is entitled to use the profit split method in the situation described in *Q. 9* (leasing units of the possession product or use of such units in the taxpayer's own trade or business), how should it compute combined taxable income with respect to such units?

*A. 10:* (i) Combined taxable income shall be computed as if the U.S. affiliate had sold the units to an unrelated person (or to a foreign affiliate) at the time the units were first leased or otherwise placed in service by the U.S. affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any.

(ii) If the possession product is a component product or an end-product form, the combined taxable income with respect to the possession product shall be determined under *Q&A. 12* of this paragraph (b)(1).

(iii) For purposes of determining the basis of a component product or an end-product form, the deemed sales price of such product must be determined. The deemed sales price of the component product shall be determined by multiplying the deemed sales price of the integrated product that includes the component product by a ratio, the numerator of which is the production costs of the component product and the denominator of which is the production costs of the integrated product that includes the component product. The deemed sales price of an end-product form shall be determined by multiplying the deemed sales price of the integrated product that includes the end-product form by a ratio, the numerator of which is the production costs of the end-product form and the denominator of which is the production costs of the integrated product that includes the end-product form. For the definition of production costs, see *Q&A. 12* of this paragraph (b)(1).

(iv)(A) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of a component product, the deemed sales price shall be determined by using the actual sales price of that product when sold as an integrated product (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(B) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of an end-product form, the deemed sales price shall be determined by subtracting from the deemed sales price of the integrated product that includes the end-product form (e.g., the leased property) the actual sales price of the excluded component when sold as an integrated product to an unrelated person (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(v) The full amount of income received under the lease shall be treated as income of (and be taxed to) the U.S. affiliate and not the possessions corporation.

*Q. 11:* In the situation described in question 9, how does the U.S. affiliate determine its basis in such units for purposes of computing depreciation and similar items?

*A. 11:* The U.S. affiliate shall be treated, for purposes of computing its basis in such units, as if it had repurchased such units immediately following the deemed sale and at the deemed sales price as provided in *Q&A. 10* of this paragraph (b)(1).

The principles of questions and answers 10 and 11 are illustrated by the following example:

*Example:* Possessions corporation S manufactures 100 units of possession product X. S sells 50 units of X to an unrelated person in an arm's length transaction for $10 per unit. S sells the remaining 50 units to its U.S. affiliate, A, which leases such units to unrelated persons. The combined taxable income for the 100 units of X is computed below on the basis of the given production, sales, and cost data:

| | |
|---|---|
| Sales: | |
| 1. Total sales by S to unrelated persons (50 × $10) | $500 |
| 2. Total deemed sales by A to unrelated persons (50 × $10) | 500 |
| 3. Total gross receipts (line 1 plus line 2) | 1,000 |
| Total costs: | |
| 4. Material costs | 200 |
| 5. Production costs | 300 |
| 6. Research expenses | 0 |
| 7. Other expenses | 100 |
| 8. Total (add lines 4 through 7) | 600 |

| | |
|---|---|
| Combined taxable income attributable to the 100 units of X: | |
| 9. Combined taxable income (line 3 minus line 8) | 400 |
| 10. Share of combined taxable income apportioned to S (50% of line 9) | 200 |
| 11. Share of combined taxable income apportioned to A (line 9 minus line 10) | 200 |
| A's basis in 50 units of X leased by it to unrelated persons: | |
| 12. 50 units times $10 deemed repurchase price | 500 |

Subsequent leasing income is entirely taxed to A.

*Q. 12:* If the possession product is a component product or an end-product form, how is the combined taxable income for such product to be determined?

*A. 12:* (i) Except as provided in paragraph (v) of this *A. 12*, combined taxable income for a component product or an end-product form is computed under the production cost ratio (PCR) method.

(ii) Under the PCR method, the combined taxable income for a component product will be the same proportion of the combined taxable income for the integrated product that includes the component product that the production costs attributable to the component product bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the component product. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is a component product that is transformed into an integrated product in whole or in part by a contract manufacturer outside of the possession, within the meaning of §1.936–5(c), the denominator of the PCR shall be computed by including the same amount paid to the contract manufacturer, less the costs of materials of the contract manufacturer, as is taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5*.

(iii) Under the PCR method the combined taxable income for an end-product form will be the same proportion of the combined taxable income for the integrated product that includes the end-product form that the production costs attributable to the end-product form bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the end-product form. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is an end-product form and an excluded component is contract manufactured outside of the possession, within the meaning of §1.936–5(c), the denominator shall be computed by including the same amount paid to the contract manufacturer, less cost of materials of the contract manufacturer, as is also taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5*.

(iv) This paragraph (iv) of *A. 12* illustrates the computation of combined taxable income for a component product or end-product form under the PCR method. S, a possessions corporation, is engaged in the manufacture of microprocessors. S obtains a component from a U.S. affiliate, O. S sells its production to another U.S. affiliate, P, which incorporates the microprocessors into central processing units (CPUs). P transfers the CPUs to a U.S. affiliate, Q, which incorporates the CPUs into computers for sale to unrelated persons. S chooses to define the possession product as the CPUs. The combined taxable income for the sale of the possession product on the basis of the given production, sales, and cost data is computed as follows:

| | |
|---|---|
| Production costs (excluding costs of materials): | |
| 1. O's costs for the component | 100 |
| 2. S's costs for the microprocessors | 500 |
| 3. P's costs for the CPUs (the possession product) | 200 |
| 4. Q's costs for the computers | 400 |
| 5. Total production costs for the computer (Add lines 1 through 4) | 1,200 |
| 6. Combined production costs for the CPU (the possession product) (Add lines 1 through 3) | 800 |
| 7. Ratio of production costs for the CPUs (the possession product) to the production costs for the computer | 0.667 |
| Determination of combined taxable income for computers: | |

| | |
|---|---|
| Sales: | |
| 8. Total possession sales of computers to unrelated customers and foreign affiliates | 7,500 |
| Total costs of O, S, P, and Q incurred in production of a computer: | |
| 9. Production costs (enter from line 5) | 1,200 |
| 10. Material costs | 100 |
| 11. Total costs (line 9 plus line 10) | 1,300 |
| 12. Combined gross income from sale of computers (line 8 minus line 11) | 6,200 |
| Expenses of the affiliated group (other than foreign affiliates) allocable and apportionable to the computers or any component thereof under the rules of §§ 1.861–8 through 1.861–14T and 1.936–6 (b)(1), Q&A. 1: | |
| 13. Expenses (other than research expenses) | 980 |
| Research expenses of the affiliated group allocable and apportionable to the computers: | |
| 14. Total sales in the 3-digit SIC Code | 12,500 |
| 15. Possession sales of the computers (enter from line 8) | 7,500 |
| 16. Cost sharing fraction (divide line 15 by line 14) | 0.6 |
| 17. Research expenses incurred by the affiliated group in 3-digit SIC Code multiplied by 120 percent | 700 |
| 18. Cost sharing amount (multiply line 16 by line 17) | 420 |
| 19. Research of the affiliated group (other than foreign affiliates) allocable and apportionable under §§ 1.861–17 and 1.861–14T(e)(2) to the computers | 300 |
| 20. Enter the greater of line 18 or line 19 | 420 |
| Computation of combined taxable income of the computer and the CPU: | |
| 21. Combined taxable income attributable to the computer (line 12 minus line 13 and line 20) | 4,800 |
| 22. Combined taxable income attributable to CPUs (multiply line 21 by line 7) (production cost ratio) | 3,200 |
| 23. Share of combined taxable income apportioned to S (50 percent of line 22) | 1,600 |
| Share of combined taxable income apportioned to U.S. affiliate(s) of S: | |
| 24. Adjustments for research expenses (line 18 minus line 19 multiplied by line 7) | 80 |
| 25. Adjusted combined taxable income (line 22 plus line 24) | 3,280 |
| 26. Share of combined taxable income apportioned to affiliates of S (line 25 minus line 23) | 1,680 |

(v)(A) If a possession product is sold by a taxpayer or its affiliate to unrelated persons in covered sales both as an integrated product and as a component product and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income derived from covered sales of the component product under this paragraph (v). In that case, the combined taxable income derived from covered sales of the component product shall be determined by using the same per unit combined taxable income as is derived from covered sales of the product as an integrated product, but subject to the limitation of paragraph (v)(D) of this *A. 12*.

(B) In the case of a possession product that is an end-product form, if all of the excluded components are also separately sold by the taxpayer or its affiliate to unrelated persons in uncontrolled transactions and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income of such end-product form under this paragraph (v). In that case, the combined taxable income derived from covered sales of the end-product form shall be determined by reducing the per unit combined taxable income from the integrated product that includes the end-product form by the per unit combined taxable income for excluded components determined under the rules of this paragraph (v), but subject to the limitation of paragraph (v)(D) of this *A. 12*. For this purpose, combined taxable income of the excluded components must be determined under section 936 as if the excluded components were possession products.

(C) In the case of component products, this paragraph (v) applies only if the sales price of the possession product sold in covered sales as an integrated product (i.e., in uncontrolled transactions) would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for the component product. For purposes of applying the fourth sentence of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes the component product is treated as being immediately preceded by a sale of the component (i.e. without further processing) in a controlled transaction. In the case of end-product forms, this paragraph (v) applies only if the sales price of excluded components separately sold in uncontrolled transactions would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for all excluded components of an integrated product that includes an end-product form. For purposes of applying the fourth sentence

of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes excluded components is treated as being immediately preceded by a sale of the excluded components (i.e. without further processing) in a controlled transaction. Under the fourth sentence of §1.482–3(b)(2)(ii)(A), the uncontrolled transactions referred to in this paragraph (v)(C) must have no differences with the controlled transactions that would affect price, or have only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made (resulting in appropriate adjustments to the computation of combined taxable income). If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the method provided by this paragraph (v)(C) cannot be used. Thus, for example, these uncontrolled transactions must involve substantially identical property in the same or a substantially identical geographic market, and must be substantially identical to the controlled transaction in terms of their volumes, contractual terms, and market level. See §1.482–3(b)(2)(ii)(B).

(D) In no case can the per unit combined taxable income as determined under paragraph (v)(A) or (B) of this *A. 12* be greater than the per unit combined taxable income of the integrated product that includes the component product or end-product form.

(E) The provisions of this paragraph (v) are illustrated by the following example. Taxpayer manufactures product A in a U.S. possession. Some portion of product A is sold to unrelated persons as an integrated product and the remainder is sold to related persons for transformation into product AB. The combined taxable income of integrated product A is $400 per unit and the combined taxable income of product AB is $300 per unit. The production cost ratio with respect to product A when sold as a component of product AB, is 2/3. Unless the taxpayer elects and satisfies the conditions of this paragraph (v), the combined taxable income with respect to A will be $200 per unit (combined taxable income for AB of $300 × the production cost ratio of 2/3). If, however, the comparability standards of paragraph (v)(C) of this *A. 12* are met, the taxpayer may elect to determine combined taxable income of product A when sold as a component of product AB using the same per unit combined taxable income as product A when sold as an integrated product. However, the per unit combined taxable income from sales of product A as a component product may not exceed the per unit combined taxable income on the sale of product AB. Therefore, the combined taxable income of component product A may not exceed $300 per unit.

(vi) Taxpayers that have not elected the percentage limitation under section 936(a)(1) for the first taxable year beginning after December 31, 1993, may do so if the taxpayer has elected the profit split method and computation of combined taxable income is affected by *Q&A.12* of this paragraph (b)(1).

(vii) The rules of *Q&A. 12* of this paragraph (b)(1) apply for taxable years ending after June 9, 1996. If, however, the election under paragraph (v) of *A. 12* of §1.936–6(b)(1) is made, this election must be made for the taxpayer's first taxable year beginning after December 31, 1993, and if not made effective for that year, the election cannot be made for any later taxable year. A successor corporation that makes the same or substantially similar products as its predecessor corporation cannot make an election under paragraph (v) of A.12 of §1.936–6(b)(1) unless the election was made by its predecessor corporation for its first taxable year beginning after December 31, 1993.

*Q. 13:* If the profit split option is elected, how is the portion of combined taxable income not allocated to the possessions corporation to be treated?

*A. 13:* (i) The income shall be allocated to affiliates in the following order, but no allocations will be made to affiliates described in a later category if there are any affiliates in a prior category—

(A) First, to U.S. affiliates (other than tax exempt affiliates) within the group (as determined under section 482) that derive income with respect to the product produced in whole or in part in the possession;

(B) Second, to U.S. affiliates (other than tax exempt affiliates) that derive income from the active conduct of a trade or business in the same product area as the possession product;

(C) Third, to other U.S. affiliates (other than tax-exempt affiliates);

(D) Fourth, to foreign affiliates that derive income from the active conduct of a U.S. trade or business in the same product area as the possession product (or, if the foreign members are resident in a country with which the U.S. has an income tax convention, then to those foreign members that have a permanent establishment in the United States that derives income in the same product area as the possession product); and

(E) Fifth, to all other affiliates.

(ii) The allocations made under paragraph (i)(A) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate with respect to the product produced in whole or in part in the possession. For this purpose, gross income must be determined consistently for each affiliate and consistently from year to year.

(iii) The allocations made under paragraphs (i)(B) and (i)(D) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate from the active conduct of the trade or business in the same product area.

(iv) The allocations made under paragraphs (i)(C) and (i)(E) of this *A. 13* shall be made on the basis of the relative total gross income of each such affiliate before allocating income under this section.

(v) Income allocated to affiliates shall be treated as U.S. source and section 863(b) does not apply for this purpose.

(vi) For purposes of determining an affiliate's estimated tax liability for income thus allocated for taxable years beginning prior to January 1, 1995, the income shall be deemed to be received on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends. For taxable years beginning after December 31, 1994, quarterly estimated tax payments will be required as provided under section 711 of the Uruguay Round Agreements, Public Law 103–465 (1994), page 230, and any administrative guidance issued by the Internal Revenue Service thereunder.

*Q. 14:* What is the source of the portion of combined taxable income allocated to the possessions corporation?

*A. 14:* Income allocated to the possessions corporation shall be treated as possession source income and as derived from the active conduct of a trade or business within the possession.

*Q. 15:* How is the profit split option to be applied to properly account for costs incurred in a year with respect to products which are sold by the possessions corporation to a U.S. affiliate during such year, but are not resold by the U.S. affiliate to persons who are not members of the affiliated group or to foreign affiliates until a later year?

*A. 15:* The rules under §1.994–1(c)(5) are to be applied. Incomplete transactions will not be taken into consideration in computing combined taxable income. Thus, for example, if in 1983, A, a possessions corporation, sells units of a product with a cost to A of $5000 to B corporation, its U.S. affiliate, which use the dollar-value LIFO method of costing inventory, and B sells units with a cost of $4000 (representing A's cost) to C corporation, a foreign affiliate, only $4000 of such costs shall be taken into consideration in computing the combined taxable income of the possessions corporation and U.S. affiliates for 1983. If a specific goods LIFO inventory method is used by B, the determination of whether A's goods remain in B's inventory shall be based on whether B's specific goods LIFO grouping has experienced an increment or decrement for the year on the specific LIFO cost of such units, rather than on an average unit cost of such units. If the FIFO method of costing inventory is used by B, transfers may be based on the cost of the specific units transferred or on the average unit production cost of the units transferred, but in each case a FIFO flow assumption shall be used to identify the units transferred. For a determination of which goods are sold by taxpayers using the LIFO method, see question and answer 19.

*Q. 16:* If a possessions corporation purchases materials from an affiliate

and computes combined taxable income for a possession product which includes such materials, how are those materials to be treated in the possessions corporation's inventory?

*A. 16:* The cost of those materials is considered to be equal to the affiliate's cost using the affiliate's method of costing inventory.

*Q. 17:* If the possessions corporation uses the FIFO method of costing inventory and the U.S. affiliate uses the LIFO method of costing inventory, or *vice versa*, what method of costing inventory should be used in computing combined taxable income?

*A. 17:* The transferor corporation's method of costing inventory determines the cost of inventory for purposes of combined taxable income while the transferee corporation's method of costing inventory determines the flow. Assume, for example, that X corporation, a possessions corporation, using the FIFO method of costing inventory purchases materials from Y corporation, U.S. affiliate, also using the FIFO method. X corporation produces a product which it transfers to Z corporation, another U.S. affiliate using the LIFO method. Assume also that the final product satisfies the significant business presence test. Under the facts, the cost of the materials purchased by X from Y is Y's FIFO cost. The costs of the inventory transferred by X to Z are determined under X's FIFO method of accounting as is the flow of the inventory from X to Z. The costs added by Z are determined under Z's LIFO method of inventory, as is the flow of the inventory from Z to unrelated persons or foreign affiliates.

*Q. 18:* How are the costs of a possession product and the revenues derived from the sale of a possession product determined if the U.S. affiliate includes purchases of the possessions product in a dollar-value LIFO inventory pool (as provided under §1.472–8)?

*A. 18:* The following method will be accepted in determining the revenues derived from the sale of a possession product and the costs of a possession product if the U.S. affiliate includes purchases of the possession product in a dollar-value LIFO inventory pool. The rules apply solely for the cost sharing and profit split options under section 936(h).

(i) *Revenue identification.* The identification of revenues derived from sales of a possession product must generally be made on a specific identification basis. The particular method employed by a taxpayer for valuing its inventory will have no impact on the determination of what units are sold or how much revenue is derived from such sales. Thus, if a U.S. affiliate sells both item A (a possession product) and item B (a non-possession product), the actual sales revenues received by the U.S. affiliate from item A sales would constitute possession product revenue for purposes of the profit split option and possession sales for purposes of the cost sharing option regardless of whether the U.S. affiliate values its inventories on the FIFO or the LIFO method. In instances where sales of item A (*i.e.*, the possession product) cannot be determined by use of specific identification (for example, in cases where items A and B are identical except that one is produced in the possession (item A) and the other (item B) is produced outside of the possession and it is not possible to segregate these items in the hands of the U.S. affiliate), it will be necessary to identify the portion of the combined sales of items A and B (which together can be identified on a specific identification basis) which is attributed to item A sales and the portion which is attributed to item B sales. The determination of the portion of aggregated sales attributable to item A and item B is independent of the LIFO method used to determine the cost of such sales and may be made under the following approach. A taxpayer may, for purposes of this section of the regulations, use the relative purchases (in units) of items A and B by the U.S. affiliate during the taxable year (or other appropriate measuring period such as the period during the taxable year used to determine current-year costs, *i.e.*, earliest acquisitions period, latest acquisitions period, etc.) in determining the ratio to apply against the combined items A and B sales revenue. If the sales exceed current purchases, the taxpayer can use a FIFO unit approach which identifies actual unit sales on a

first-in, first-out basis. Revenue determination where specific identification is not possible is illustrated by the following example:

*Example.* At the end of year 1, there are 600 units of combined items A and B which are to be allocated between A and B on the basis of annual purchases of A and B units during year 1. During year 1, 1,000 units of item A, a possession product, and 2,000 units of item B, a non-possession product, were purchased. Thus, the 600 units in year 1 ending inventory are allocated 200 (i.e. ⅓) to item A units and 400 (i.e. ⅔) to item B units based on the relative purchases of A (1,000) and B (2,000) in year 1. These units appear as beginning inventory in year 2.

In year 2, 1,500 units of item A are purchased and 1,500 units of item B are purchased. However, 3,300 units of items A and B in the aggregate are sold for $600,000. The relative proportion of the $600,000 attributable to item A and to item B sales would be determined as follows:

| Year 2 sales | Item A | Item B |
|---|---|---|
| Unit sales from opening inventory | 200 | 400 |
| Unit sale from current-year purchases | 1,350 | 1,350 |
| Total unit sales (3,300) | 1,550 | 1,750 |
| Percentage | 47 | 53 |

$$\text{Revenues from Item A sales} \quad 281{,}818 \left\{\$600{,}000 \times \frac{1550}{3300}\right\}$$

$$\text{Revenues from Item B sales} \quad \$318{,}182 \left\{\$600{,}000 \times \frac{1750}{3300}\right\}$$

| Year 2 Closing Inventory | Units |
|---|---|
| Item A | 150 |
| Item B | 150 |

Thus, revenues from Item A sales for purposes of computing possession sales for the cost sharing option and revenues for the profit split option are $281,818.

(ii) *Cost identification.* The determination of the cost of possession product sales by the U.S. affiliate must be based on the LIFO inventory method of the U.S. affiliate. The LIFO cost of possession product sales will, for purposes of this section of the regulations, be determined by maintaining a separate LIFO cost for possession products in a taxpayer's opening and closing LIFO inventory and using this cost to calculate an independent cost of possession product sales. This separate LIFO cost for possession products in the LIFO pool of a taxpayer is to be determined as follows:

(A) Determine the base-year cost of possession products in ending inventory in a LIFO pool.

(B) Determine the percentage of the base-year cost of possession products in the pool as compared to the total base-year cost of all items in the pool.

(C) Multiply the percentage determined in step (B) of this subdivision (ii) by the ending LIFO inventory value of the pool to determine the deemed LIFO cost attributable to possession products in the pool.

(D) Subtract the LIFO cost of possession products in ending inventory in the pool (as calculated in step (C) of this subdivision (ii)) from the sum of:

(1) Possession product purchases for the year, plus

(2) The portion of the opening LIFO inventory value of the pool attributed to possession products (*i.e.*, the result obtained in step (C) of this subdivision (ii) for the prior year).

The number determined by this calculation is the LIFO cost of possession product sales from the taxpayer's LIFO pool.

*Example:* Assume that item A is a possession product and item B is a non-possession product and also assume the inventory and purchases with respect to the LIFO pool as provided below:

YEAR 1—ENDING INVENTORY

| | No. of units | Base-year cost/ unit | Base-year cost | Percent |
|---|---|---|---|---|
| Item A | 100 | $2.00 | $200 | 20 |
| Item B | 200 | 4.00 | 800 | 80 |

YEAR 1—LIFO VALUE

| | Base-year cost | Index | LIFO cost |
|---|---|---|---|
| Increment layer 2 | $300 | 3.0 | $900 |
| Increment layer 1 | 400 | 2.0 | 800 |
| Base layer | 300 | 1.0 | 300 |
| Pool total | $1,000 | | $2,000 |

YEAR 1—LIFO VALUE PER ITEM

| | Base-year cost | LIFO value |
|---|---|---|
| Total pool | $1,000 | $2,000 |
| Item A | 200 | 400 |
| Item B | 800 | 1,600 |

YEAR 2—PURCHASES

| | Total purchases |
|---|---|
| Item A | $6,000 |
| Item B | 4,000 |

YEAR 2—ENDING INVENTORY

| | No. of units | Base-year cost/unit | Base-year cost | Percent |
|---|---|---|---|---|
| Item A | 200 | $2.00 | $400 | 50 |
| Item B | 100 | 4.00 | 400 | 50 |

YEAR 2—LIFO VALUE

| | Base-year cost | Index | LIFO cost |
|---|---|---|---|
| Increment layer 2 | $100 | 3.0 | $300 |
| Increment layer 1 | 400 | 2.0 | 800 |
| Base layer | $300 | 1.0 | 300 |
| Pool total | 800 | | 1,400 |

The year 2 LIFO cost of possession product A sales will be calculated as follows:

(1) Base-year cost of item in year 2 ending inventory=$400

(2) Percentage of item A base-year cost to total base-year cost ($400 ÷ $800) = 50%

(3) LIFO value of item A ($1,400 × 50%) = $700

(4) LIFO cost of item A sales is determined by adding to the beginning inventory in year 2 the purchases of item A in year 2 and subtracting from this amount the ending inventory in year 2 ($400 + $6000 − $700 = $5700). The beginning inventory in year 2 is determined by multiplying the LIFO cost of the year 1 ending inventory by a percentage of item A base year cost to the total base-year cost in year 1. The ending inventory in year 2 is determined under (3) above.

*Q. 19:* If a possession product is purchased from a possessions corporation by a U.S. affiliate using the dollar-value LIFO method of costing its inventory and is included in a LIFO pool of the U.S. affiliate which includes products purchased from the possessions corporation in pre-TEFRA years, how should the LIFO index computation of the U.S. affiliate be made in the first year in which section 936(h) applies and in subsequent taxable years?

*A. 19:* The U.S. affiliate should treat the first taxable year for which section 936(h) applies as a new base year in accordance with procedures provided by regulations under section 472. Thus, the opening inventory for the first year for which section 936(h) applies (valuing possession products purchased from the possessions corporation on the basis of the cost of such possession products), would equal the new base year cost of the inventory of such pool of the U.S. affiliate. Increments and decrements at new base year cost would be valued for LIFO purposes pursuant to the procedures provided by regulations under section 472.

*Q. 20:* If the possessions corporation computes its income with respect to a product under the profit split method, with respect to which units of the product shall the profit split method apply?

*A. 20:* The profit split method shall apply to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold during the taxable year by members of the affiliated group (other than foreign affiliates) to unrelated parties or to foreign affiliates. In no event shall the profit split method apply to units of the product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(2) *Pre-TEFRA inventory.*

*Q. 1:* How is pre-TEFRA inventory to be determined if the profit split option is elected and the FIFO method of costing inventory is used by the U.S. affiliate?

*A. 1:* Pre-TEFRA inventory is inventory which was produced by the possessions corporation and transferred to a U.S. affiliate prior to the possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA inventory will not be included for purposes of the profit split option. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-

TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies and will not be included in the computation of combined taxable income for purposes of the profit split option. The treatment of pre-TEFRA inventory when FIFO costing is used by both the U.S. affiliate and the possessions corporation is illustrated by the following example in which FIFO unit costing is used:

*Example.* Assume the following:

| | X | | Y | |
|---|---|---|---|---|
| | Possessions corporation | | U.S. affiliate | |
| | Number of units | Cost per unit | Number of units | Cost per unit |
| Beginning inventory | 500 | $150 | 200 | $225 |
| Units produced during 1983 | 1,000 | 200 | ..... | ..... |
| Ending inventory | 400 | 200 | 300 | ..... |

In 1983, the beginning inventory of X, a possessions corporation, is 500 units with a unit cost of $150 and the beginning inventory of Y, the U.S. affiliate, is 200 units with a unit cost of $225, which represents the section 482 price paid by Y. Y's beginning inventory in 1983 represents purchases made in 1982 of products produced by X in that year. Y sells all the units it purchases from X to Z, a foreign affiliate. In 1983, X produces 1000 units at a unit cost of $200 and sells 1100 units to Y (the difference between 1500 units, representing X's 1983 beginning inventory (500) and the units produced by X in 1983 (1000), and X's ending inventory of 400 units). Of the 1100 units sold by X to Y in 1983 only 800 units (and not 1000 units) which were sold by Y to Z are taken into consideration in computing combined taxable income for 1983. Since FIFO costing by the possessions corporation is used, the cost is $150 per unit for the first 500 units and $200 per unit for the remaining 300 units. The 200 units sold by X to Y in 1982 are pre-TEFRA inventory and are not included in the computation of combined taxable income for 1983. They are also treated as the first units sold by Y to Z in 1983. This inventory has a unit cost of $225, which reflects the section 482 transfer price from X to Y in 1982. Y's 1983 ending inventory of 300 units will not be taken into consideration in computing the combined taxable income of X and Y for 1983 because the units have not been sold to a foreign affiliate or to persons who are not members of the affiliated group. In a subsequent year when the units are sold to Z, the cost to X and selling price to Z of these units will enter into the computation of combined taxable income for that year.

(c) *Covered Intangibles.*

*Q. 1:* What are ''covered intangibles'' under section 936(h)(5)(C)(i)(II)?

*A. 1:* The term ''covered intangibles'' means (1) intangible property developed in a possession solely by the possessions corporation and owned by it, (2) manufacturing intangible property (described in section 936(h)(3)(B)(i)) which is acquired by the possessions corporation from unrelated persons, and (3) any other intangible property (described in section 936(h)(3)(B) (ii) through (v), to the extent not described in section 936(h)(3)(B)(i)) which relates to sales of products or services to unrelated persons for ultimate consumption or use in the possession in which the possessions corporation conducts its business. The possessions corporation is treated as the owner of covered intangibles for purposes of obtaining a return thereon.

*Q. 2:* Do covered intangibles include manufacturing intangible property which is acquired by an affiliate and subsequently transferred to the possessions corporation?

*A. 2:* No. In order for a manufacturing intangible to be treated as a covered intangible, the intangible property must be acquired directly by the possessions corporation from an unrelated person unless the manufacturing intangible was acquired by an affiliate from an unrelated person and was transferred to the possessions corporation by the affiliate prior to September 3, 1982.

*Q. 3:* If a possessions corporation licenses a manufacturing intangible from an unrelated party, will the licensed intangible be treated as a covered intangible?

*A. 3:* No.

*Q. 4:* How is ultimate consumption or use determined for purposes of the definition of covered intangibles?

*A. 4:* A product will be treated as having its ultimate use or consumption in a possession if it is sold by the possessions corporation to a related or unrelated person in a possession and is not resold or used or consumed outside of the possession within one year after the date of the sale.

*Q. 5:* Are sales of products that relate to covered intangibles excluded from the cost sharing fraction?

*A. 5:* If no manufacturing intangibles other than covered intangibles are associated with the possession product, then sales of such product will be excluded from the cost sharing fraction. If both covered and non-covered manufacturing intangibles are associated with the possession product, then sales of such product will be included in the cost sharing fraction.

*Q. 6:* If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner of covered intangibles described in section 936(h)(5)(C)(i)(II)(*c*) related to the product in order for the possessions corporation to receive a full return with respect to such intangibles?

*A. 6:* No. For purposes of section 936(h), it is immaterial whether such covered intangibles are owned by the possessions corporation or by another member of the affiliated group. Moreover, if the legal owner of such covered intangibles which are subject to section 936(h)(5) is an affiliate of the possessions corporation, such person will not be required to charge an arm's-length royalty under section 482 to the possessions corporation.

[T.D. 8090, 51 FR 21532, June 13, 1986; 51 FR 27174, July 30, 1986, as amended by T.D. 8669, 61 FR 21367, May 10, 1996; 61 FR 39072, July 26, 1996; T.D. 8786, 63 FR 55025, Oct. 14, 1998]

### § 1.936–7 Manner of making election under section 936 (h)(5); special election for export sales; revocation of election under section 936(a).

(a) The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(b) *Manner of making election.*

*Q. 1*: How does a possessions corporation make an election to use the cost sharing method or profit split method?

*A. 1*: A possessions corporation makes an election to use the cost sharing or profit split method by filing Form 5712–A (''Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5)'') and attaching it to its tax return. Form 5712–A must be filed on or before the due date (including extensions) of the tax return of the possessions corporation for its first taxable year beginning after December 31, 1982. The electing corporation must set forth on the form the name and the taxpayer identification number or address of all members of the affiliated group (including foreign affiliates not required to file a U.S. tax return). All members of the affiliated group must consent to the election. For elections filed with respect to taxable years beginning before January 1, 2003, an authorized officer of the electing corporation must sign the statement of election and must declare that he has received a signed statement of consent from an authorized officer, director, or other appropriate official of each member of the affiliated group. Elections filed for taxable years beginning after December 31, 2002, must incorporate a declaration by the electing corporation that it has received a signed consent from an authorized officer, director, or other appropriate official of each member of the affiliated group and will be verified by signing the return. The election is not valid for a taxable year unless all affiliates consent. A failure to obtain an affiliate's written consent will not invalidate the election out if the possessions corporation made a good faith effort to obtain all the necessary consents or the failure to obtain the missing consent was inadvertent. Subsequently created or acquired affiliates are bound by the election. If an election out is revoked under section 936(h)(5)(F)(iii), a new election out with respect to that product area cannot be made without the consent of the Commissioner. The possessions corporation shall file an amended Form 5712–A with its timely filed (including extensions) income tax return to reflect any changes in the names or number of the members of the affiliated group for any taxable year after the first taxable year to which the election out applies. By consenting to the election out, all affiliates agree to provide information necessary to compute the cost sharing payment under the cost sharing method or combined taxable income under the profit split method, and failure to provide such information shall be treated as a request to revoke the election out under section 936(h)(5)(F)(iii).

*Q. 2:* May the ''election out'' under section 936(h)(5) be made on a product-by-product basis, or must it be made on a wide basis?

*A. 2:* An electing corporation is required to treat products in the same product area in the same manner. Similarly, all possessions corporations in the same affiliated group that produce any products or render any services in the same product area must make the same election for all products that fall within the same product area. However, §1.936–7(b) provides that the electing corporation may make a different election for export sales than for domestic sales. The electing corporation or corporations may also make different elections for products that fall within different product areas.

*Q. 3:* May the possessions corporation elect to define product area more narrowly than the 3-digit SIC code?

*A. 3:* No. Certain alternatives, such as the 4-digit SIC code, would not be permitted under the statute. However, other methods for defining product area may be considered by the Commissioner in the future.

*Q. 4:* May a possessions corporation make an election out under the cost sharing method with respect to a product area if the affiliated group incurs no research, development or experimental costs in the product area?

*A. 4:* Yes. In that case the cost sharing payment will be zero.

*Q. 5:* If the significant business presence test is not satisfied for a product or type of service within the product area covered by the election out under section 936(h)(5) what rules will apply with respect to that product?

*A. 5:* With respect to the product which does not satisfy the significant business presence test, the provisions of section 936 (h)(1) through (h)(4) will apply to the allocation of income. However, if a cost sharing or a profit split election has been made with respect to the product area, the cost sharing payment or the research and development floor under section 936(h)(5)(C)(ii)(II) will not be reduced.

*Q. 6:* Is a taxpayer permitted to make a change of election with respect to the cost sharing and profit split methods?

*A. 6:* In general, once the election is properly made, it is binding for the first year in which it applies and all subsequent years (including upon any later created or acquired affiliates), and revocation is only permitted with the consent of the Commissioner of Internal Revenue. However, a taxpayer will be permitted to change its election once from the cost sharing method to the profit split method or *vice versa*, or from the method permitted under section 936 (h)(1) through (h)(4) to cost sharing or profit split or *vice versa*, without the consent of the Commissioner if the change is made on the taxpayer's return for its first taxable year ending after June 13, 1986. Such change will apply to such taxable year and all subsequent taxable years, and, at the taxpayer's option, may also apply to all prior taxable years for which section 936(h) was in effect. A change of election will be treated as an election subject to the procedures set forth above and to section 481 of the Internal Revenue Code.

*Q. 7:* If the Commissioner determines that a possessions corporation does not meet the 80-percent possession source test or the 65-percent active trade or business test (the ''qualification tests'') for any taxable year beginning after 1982, under what circumstances is the possessions corporation permitted to make a distribution of property after the close of its taxable year to meet the qualification tests?

*A. 7:* A possessions corporation may make a pro rata distribution of property to its shareholders after the close of the taxable year if the Commissioner determines that the possessions corporation does not satisfy the qualification tests (a) by reason of the exclusion from gross income of intangible income under section 936(h)(1)(B) or section 936(h)(5)(C)(i)(II) or (b) by reason of the allocation to the shareholders of the possessions corporation of income under section 936(h)(5)(C)(ii)(III); provided, however, that the determination of the Commissioner does not contain a finding that the failure of such corporation to satisfy the qualification tests was due, in whole or in part, to fraud with intent to evade tax or willful neglect on the part of the possessions corporation. The possessions corporation must designate the distribution at the time the

distribution is made as a distribution to meet qualification requirements, and it will be subject to the provisions of section 936(h)(4). Such distributions will not qualify for the dividends received deduction.

*Q. 8:* If a possessions corporation owns stock in a subsidiary possessions corporation, any intangible property income allocated to the parent possessions corporation under section 936(h) will be treated as U.S. source income and taxable to the parent possessions corporation. Is the intangible property income taken into consideration in determining whether the parent possessions corporation meets the income tests of section 936(a)(2)?

*A. 8:* While taxable to the parent possessions corporation, the intangible property income does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B). This would also be the case if the subsidiary possessions corporation made a qualifying distribution under section 936(h)(4).

(c) *Separate election for export sales.*

*Q. 1:* What methods of computing income can a possessions corporation use under the separate election for export sales?

*A. 1:* The only two methods which are available under the separate election for export sales are the cost sharing method and the profit split method.

*Q. 2:* What is the definition of export sales for purposes of the separate election for export sales?

*A. 2:* The determination of export sales is based upon the destination of the product, *i.e.*, where it is to be used or consumed. If the product is sold to a U.S. affiliate, it will be treated as an export sale only if resold or otherwise transferred abroad to a foreign person (including a foreign affiliate or foreign branch of a U.S. affiliate) within one year from the date of sale to the U.S. affiliate for ultimate use or consumption outside the United States as provided under §1.954–3(a)(3)(ii).

*Q. 3:* Assume that a possessions corporation sells a product to both foreign affiliates and foreign branches of U.S. affiliates. In addition, it sells the product to its U.S. parent for resale in the U.S. The possessions corporation makes a profit split election for domestic sales and a cost sharing election of export sales. Will the sales to foreign branches of U.S. affiliates be treated as exports subject to the cost sharing method or as domestic sales subject to the profit split method?

*A. 3:* The sales to a foreign branch of a U.S. corporation are exports if for ultimate use or consumption outside of the United States as provided under §1.954–3(a)(3)(ii).

*Q. 4:* Under what circumstances may a possessions corporation make the separate election under section 936(h)(5)(F)(iv)(II) for computing its income from products exported to a foreign person when the income derived by such foreign person on the resale of such products is included in foreign base company income under section 954(a)?

*A. 4:* If the income derived by a foreign person on the resale of products manufactured, in whole or in part, by a possessions corporation is included in foreign base company income under section 954(a), then the possessions corporation may make the separate export election under section 936(h)(5)(F)(iv)(II) for computing its income from such products only if such foreign person has been formed or is availed of for substantial business reasons that are unrelated to an affiliated corporation's U.S. tax liability. For purposes of the proceding sentence, a foreign person will be considered to be formed or availed of for such substantial business reasons if the foreign person in the normal course of business purchases substantial quantities of products from both the possessions corporation and its affiliates for resale, and, in addition provides support services for affiliated companies such as centralized testing, marketing of products, management of local currency exposures, or other similar services. However, a foreign person that purchases and resells products only from a possessions corporation is presumed to be formed or availed of for other than such substantial business reasons, even if the foreign person provides additional services.

*Q. 5:* When will the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 be applicable to the export

sales of a product of a possessions corporation which makes a separate election for export sales?

*A. 5:* An electing corporation will be required to meet the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 with respect to export sales of its product in each taxable year in which the separate election for export sales is in effect.

(d) *Revocation of election under section 936(a).*

*Q. 1:* When may an election under section 936(a) be revoked?

*A. 1:* An election under section 936(a) may be revoked during the first ten years of section 936 status only with the consent of the Commissioner, and without the Commissioner's consent after that time. The Commissioner hereby consents to all requests for revocation that are made with respect to the taxapayer's first taxable year beginning after December 31, 1982 provided that the section 936(a) election was in effect for the corporation's last taxable year beginning before January 1, 1983, if the taxpayer agrees not to reelect section 936(a) prior to its first taxable year beginning after December 31, 1988. A taxpayer that wishes to revoke a section 936(a) election under the terms of the blanket revocation must attach a ''Statement of Revocation—Section 936'' to the taxpayer's timely filed return (including extensions) and must state that in revoking the election the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1988. Other requests to revoke not covered by the Commissioner's blanket consent should be addressed to the District Director having jurisdiction over the taxpayer's tax return.

[T.D. 8090, 51 FR 21545, June 13, 1986, as amended by T.D. 9100, 68 FR 70705, Dec. 19, 2003; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

### § 1.936–8T Qualified possession source investment income (temporary). [Reserved]

### § 1.936–9T Source of qualified possession source investment income (temporary). [Reserved]

### § 1.936–10 Qualified investments.

(a) *In general.* [Reserved]

(b) *Qualified investments in Puerto Rico.* [Reserved]

(c) *Qualified investment in certain Caribbean Basin countries*—(1) *General rule.* An investment of qualified funds described in this section shall be treated as a qualified investment of funds for use in Puerto Rico if the funds are used for a qualified investment in a qualified Caribbean Basin country. A qualified investment in a qualified Caribbean Basin country is a loan of qualified funds by a qualified financial institution (described in paragraph (c)(3) of this section) directly to a qualified recipient (described in paragraph (c)(9) of this section) or indirectly through a single financial intermediary for investment in active busines assets (as defined in paragraph (c)(4) of this section) in a qualified Caribbean Basin country (described in paragraph (c)(10)(ii) of this section) or for investment in development projects (as defined in paragraph (c)(5) of this section) in a qualified Caribbean Basin country, provided—

(i) The investment is authorized, prior to disbursement of the funds, by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to regulations issued by such Commissioner; and

(ii) The agreement, certification, and due diligency requirements under paragraphs (c)(11), (12), and (13) of this section are met.

A loan by a qualified financial institution shall not be disqualified merely because the loan transaction is processed by the central bank of issue of the country into which the loan is made pursuant to, and solely for purposes of complying with, the exchange control laws or regulations of such country. Further, a loan by a qualified financial institution shall not be disqualified merely because the loan is acquired by another person, provided such other person is also a qualified financial institution.

(2) *Termination of qualification*—(i) *In general.* An investment that, at any time after having met the requirements for a qualified investment in a qualified Caribbean Basin country under the terms of this paragraph (c), fails to meet any of the conditions enumerated in this paragraph (c) shall no

longer be considered a qualified investment in a qualified Caribbean Basin country from the time of such failure, unless the investment satisfies the requirements for a timely cure described in paragraph (c)(2)(ii) of this section. Such a failure includes, but is not limited to, the occurrence of any of the following events:

(A) Active business assets cease to qualify as such;

(B) Proceeds from the investment are diverted for the financing of assets, projects, or operations that are not active business assets or development projects or are not the assests or the project of the qualified recipient;

(C) The holder of the qualified recipient's obligation is not a qualified financial institution;

(D) The qualified recipient's qualified business activity ceases to qualify as such; or

(E) The qualified Caribbean Basin country ceases to be a country described in paragraph (c)(10)(ii) of this section.

(ii) *Timely cure*—(A) *In general.* A timely cure shall be considered to have been made if the event or events that cause disqualification of the investment are corrected within a reasonable period of time. For purposes of this section, a reasonable period of time shall not exceed 60 days after such event or events come to the attention of the qualified recipient or the qualified financial institution or should have some to their attention by the exercise of reasonable diligence.

(B) *Due diligence requirements.* A time cure of a failure to comply with the due diligence requirements of paragraphs (c)(11), (12), and (13) of this section shall be considered to be made if the failure to comply is due to reasonable cause and, upon request of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative), the qualified financial institution (and its trustee or agent), if any), the financial intermediary, or the qualified recipient establishes to the satisfaction of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative) that it has exercised due diligence in ensuring that the funds were property disbursed to a qualified recipient and applied by or on behalf of such qualified recipient to uses that qualify the investment as an investment in qualified business assets or a development project under the provisions of this paragraph (c).

(iii) *Assumption of qualified recipient's obligation.* An investment shall not cease to qualify merely because the qualified recipient's obligation to the qualified financial institution (or to a financial intermediary, if any) is assumed by another person, provided such other person assumes the qualified recipient's agreement and certification requirements under paragraph (c)(11)(i) of this section and is either—

(A) A qualified recipient on the date of assumption, in which case such person shall be treated for purposes of this section as the original qualified recipient and shall be subject to all the requirements of this section for continued qualification of the loan as a qualified investment in a qualified Caribbean Basin country; or

(B) An international organization, the principal purpose of which is to foster economic development in developing countries and which is described in section 1 of the International Organizations Immunities Act (22 U.S.C. 288), if the assumption of the obligation is pursuant to a bona fide guarantee agreement.

(3) *Qualified financial institution*—(i) *General rule.* For purposes of section 936(d)(4)(A) and this section, a qualified financial institution includes only—

(A) A banking, financing, or similar business defined in §1.864–4(c)(5)(i) that is an eligible institution described in paragraph (c)(3)(ii) of this section, but not including branches of such institution outside of Puerto Rico;

(B) A single-purpose entity described in paragraph (c)(3)(iii) of this section;

(C) The Government Development Bank for Puerto Rico;

(D) The Puerto Rico Economic Development Bank; and

(E) Such other entity as may be determined by the Commissioner by Revenue Procedure or other guidance published in the Internal Revenue Bulletin.

(ii) *Eligible institution.* An eligible institution means an institution—

(A) That is an entity organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch of an entity organized under the laws of another jurisdiction, if such entity is engaged in a banking, financing, or similar business defined in §1.864–4(c)(5)(i), and

(B) That is licensed as an eligible institution under Regulation No. 3582 (or any successor regulation) issued by the Commissioner of Financial Institutions of Puerto Rico (hereinafter ''Puerto Rican Regulation No. 3582'').

(iii) *Single-purpose entity.* A single-purpose entity is an entity that meets all of the following conditions:

(A) The entity is organized under the laws of the Commonwealth of Puerto Rico and is a corporation, a partnership or a trust, which conducts substantially all of its activities in Puerto Rico.

(B) The sole purpose of the entity is to use qualified funds from possessions corporations to make one or more qualified investments in a qualified Caribbean Basin country and the entity actually uses such funds only for such purpose.

(C) In the case of an entity that is a trust, one of the trustees is a qualified financial institution described in paragraph (c)(3)(i) of this section.

(D) The entity is licensed as an eligible institution under Puerto Rican Regulation No. 3582 (or any successor regulation).

(E) Any temporary investment by the entity for its own account of funds received from a possessions corporation, and the income from the investment thereof, and any temporary investment by the entity for its own account of principal and interest paid by a borrower to the entity, and the income from the investment thereof, are limited to investments in eligible activities, as described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(4) *Investments in active business assets*—(i) *In general.* For purposes of section 936(d)(4)(A)(i)(I) and this section and subject to the provisions of paragraph (c)(8) of this section, a loan qualifies as an investment in active business assets if—

(A) The amounts disbursed to a qualified recipient under the loan or bond issue are promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for capital expenditures for the construction, rehabilitation (including demolition associated therewith), improvement, or upgrading of qualified assets described in paragraphs (c)(4)(ii)(A), (B), (E), and (F) of this section, for the acquisition of qualified assets described in paragraphs (c)(4)(ii)(B), (C), (E), and (F) of this section, for the expenditures described in paragraphs (c)(4)(ii)(D), (E), and (F) of this section, and, if applicable, for the financing of incidental expenditures described in paragraph (c)(4)(iii) of this section;

(B) The qualified recipient owns the assets for United States income tax purposes and uses them in a qualified business activity (as defined in paragraph (c)(4)(iv)); and

(C) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of existing funding and the time periods within which funding for investments must be secured) are satisfied.

(ii) *Definition of qualified assets.* For purposes of this paragraph (c), qualified assets mean—

(A) Real property;

(B) Tangible personal property (such as furniture, machinery, or equipment) that is not property described in section 1221(1) and that is either new property or property which at no time during the period specified in paragraph (c)(4)(v) of this section was used in a business activity in the qualified Caribbean Basin country in which the property is to be used;

(C) Rights to intangible property that is a patent, invention, formula, process, design, pattern, know-how, or similar item, or rights under a franchise agreement, provided that such rights—

(*1*) Were not at any time during the period specified in paragraph (c)(4)(v)

of this section used in a business activity in the qualified Caribbean Basin country in which the rights are to be used,

(*2*) Are not rights the use of which gives rise, or would give rise if used, to United States source income, and

(*3*) Are not rights acquired by the qualified recipient from a person related (within the meaning of section 267(b), using ''10 percent'' instead of ''50 percent'' in the places where it appears) to the qualified recipient;

(D) Exploration and development expenditures incurred by a qualified recipient for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore, oil, gas, or other mineral in a qualified Caribbean Basin country, as well as for purposes of developing such deposit (within the meaning of section 616 of the Code and the regulations thereunder);

(E) Living plants and animals (other than crops, plants, and animals that are acquired primarily to hold as inventory by the qualified recipient for resale in the ordinary course of trade or business) acquired in connection with a farming business (as defined in §1.263–1T(c)(4)(i)), expenditures of a preparatory nature to prepare the land or area for farming (such as planting trees, drilling wells, clearing brush, leveling land, laying pipes, building roads, constructing tanks and reservoirs), expenditures for soil and water conservation of a type described in section 175(c)(1), and expenditures of a development nature incurred in connection with, and during, the preproductive period of property produced in a farming business (as defined in §1.263–1T(c)(4)(ii));

(F) Other assets or expenditures that are not described in paragraphs (c)(4)(ii)(A) through (E) of this section and that the Commissioner may, by Revenue Procedure or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified financial institution or qualified recipient upon its request, determine to be qualified assets.

(iii) *Incidental expenditures.* An amount in addition to the loan proceeds borrowed to make an investment in active business assets shall be considered an investment in active business assets if such amount is applied to finance expenditures that are incidental to making the investment in active business assets, provided such amount is disbursed at or about the same time the proceeds for making the investment in active business assets are disbursed. For purposes of this section, expenditures incidental to an investment in active business assets include only the following items:

(A) A reasonable amount of costs (other than the cost of credit enhancement or bond insurance premiums) associated with arranging the financing of an investment in active business assets, not to exceed 3.5 percent of the proceeds of the loan or bond issue.

(B) A reasonable amount of installation costs and other reasonable costs associated with placing an active business asset in service in the qualified business activity.

(C) An amount not in excess of 10 percent of the total amount of investment in qualified assets to finance the acquisition of inventory, and other working capital requirements, but if an investment is in connection with a manufacturing or farming business, the percentage limitation shall be 50 percent rather than 10 percent provided the excess over the 10 percent limitation is used to finance inventory property. For purposes of this paragraph (c), whether a business is a manufacturing business shall be determined under principles similar to those described in section 954(d)(1)(A) and the regulations thereunder; whether a business is a farming business shall be determined under §1.263–1T(c)(4)(i).

(D) An amount not in excess of 5 percent of the sum of the investment in active business assets and the costs described in paragraphs (c)(4)(iii)(A), (B), and (C) of this section for the refinancing of an existing debt of the qualified recipient if such refinancing is incidental to an investment in active business assets. For this purpose, the replacement of an existing loan arrangement shall not be considered the refinancing of an existing indebtedness to the extent that the funds under such loan arrangement have not yet been disbursed to the qualified recipient.

(iv) *Qualified business activity.* A qualified business activity is a lawful

industrial or commercial activity that is conducted as an active trade or business (under principles similar to those described in §1.367(a)–2T(b) (2) and (3)) in a qualified Caribbean Basin country. A trade or business for purposes of this paragraph (c)(4)(iv) is any business activity meeting the principles of section 367 of the Code and described in Divisions A through I (excluding group 43 in Division E (relating to the United States Postal Service) and groups 84 (relating to museums, art galleries, and botanical and zoological gardens), 86 (relating to membership organizations), and 88 (relating to private households in Division I) of the 1987 Standard Industrial Classification Manual issued by the Executive Office of the President, Office of Management and Budget, or in the comparable provisions of any successor Standard Industrial Classification Manual that is adopted by the Commissioner of Internal Revenue in a notice, regulation, or other document published in the Internal Revenue Cumulative Bulletin.

(v) *Period of use.* The period referred to in paragraphs (c)(4)(ii)(B) and (C) of this section shall be a five year period preceding the date of acquisition with the loan proceeds, if the date of acquisition is on or before May 13, 1991. If the date of acquisition is after May 13, 1991, then the period specified in this paragraph (c)(4)(v) shall be three years preceding the date of acquisition with the loan proceeds.

(5) *Investments in development projects*—(i) *In general.* Subject to the provisions of paragraph (c)(8) of this section, this paragraph (c)(5)(i) describes the requirements in order for a loan by a qualified financial institution to qualify as an investment in a development project for purposes of section 936(d)(4)(A)(i)(II) and for this section.

(A) The amounts disbursed under the loan or bond issue must be promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for one or more investments described in paragraph (c)(4)(i)(A) of this section and in any land, buildings, or other property functionally related and subordinate to a facility described in paragraph (c)(5)(ii) of this section (determined under principles similar to those described in §1.103–8(a)(3)), for use (under principles similar to those described in §1.367(a)–2T(b)(5)) in connection with one or more activities described in paragraph (c)(5)(i)(B) of this section.

(B) The activities referred to in paragraph (c)(5)(i)(A) of this section are—

(*1*) A development project described in paragraph (c)(5)(ii) of this section in a qualified Caribbean Basin country; or

(*2*) The performance in a qualified Caribbean Basin country of a non-commercial governmental function described in paragraph (c)(5)(iv) of this section;

(C) The qualified recipient must own the assets for United States income tax purposes;

(D) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of existing funding and time periods within which funding for investments must be secured) must be satisfied.

(ii) *Development project.* For purposes of this paragraph (c), a development project is one or more facilities in a qualified Caribbean Basin country that support economic development in that country and that satisfy the public use requirement of paragraph (c)(5)(iii) of this section. Examples of facilities that may meet the public use requirement include, but are not limited to—

(A) Transportation systems and equipment, including sea, surface, and air, such as roads, railways, air terminals, runways, harbor facilities, and ships and aircraft;

(B) Communications facilities;

(C) Training and education facilities related to qualified business activities;

(D) Industrial parks, including necessary support facilities such as roads; transmission lines for water, gas, electricity, and sewage; docks; plant sites preparations; power generation; sewage disposal; and water treatment;

(E) Sports facilities;

(F) Convention or trade show facilities;

(G) Sewage, solid waste, water, and electric facilities;

(H) Housing projects pursuant to a government program designed to provide affordable housing to low or moderate income families, based upon local standards; and

(I) Hydroelectric generating facilities.

(iii) *Public use requirement.* To satisfy the public use requirement in paragraph (c)(5)(ii) of this section, a facility must serve or be available on a regular basis for general public use, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of persons as determined under principles similar to those described in §1.103–8(a)(2).

(iv) *Non-commercial governmental functions.* For purposes of paragraph (c)(5)(i)(B) of this section, the term ''non-commercial governmental functions'' refers to activities that, under U.S. standards, are not customarily attributable to or carried on by private enterprises for profit and are performed for the general public with respect to the common welfare or which relate to the administration of some phase of government. For example, the operation of libraries, toll bridges, or local transportation services, and activities substantially equivalent to those carried out by the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service, are considered non-commercial governmental functions. For purposes of this section, non-commercial government functions shall not include military activities.

(v) [Reserved]

(6) *Prompt application of borrowed proceeds.* This paragraph (c)(6) provides rules for determining whether amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section.

(i) *In general.* Except as otherwise provided in paragraphs (c)(6)(ii) and (c)(7)(iii)(B) of this section, amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section if the amounts are fully expended for any of the purposes described in paragraphs (c)(4)(i)(A) or (c)(5)(i)(A) of this section no later than six months from the date of such disbursement and any temporary investment of such funds by the qualified recipient during such period complies with the rules of paragraph (c)(6)(iii)(A) of this section. Where the amounts disbursed are bond proceeds described in paragraph (c)(6)(iv)(A) of this section, the six-month period shall begin on the date of issuance of the bonds. In the event the qualified financial institution (or financial intermediary) invests any part of the bond proceeds before disbursement of those proceeds to the qualified recipient, all earnings from any such investment shall be paid to the qualified recipient or applied for its benefit.

(ii) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the six-month period described in paragraph (c)(6)(i) of this section shall be extended with respect to the amount of bond proceeds used to fund the project for such reasonable period of time as shall be necessary until completion of the project or until beginning of production (in the case of a farming business), but, in any event, not to exceed three years from the date of issuance of the bonds, and only if—

(A) The project that is financed out of bond proceeds was identified as of the date of issue;

(B) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of filing of the plan, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time;

(C) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or

disclosure purposes in relation to the issuance of bonds; and

(D) Any temporary investment of the bond proceeds complies with the rules of paragraph (c)(6)(iii)(A) and (B) of this section.

(iii) *Temporary investments*—(A) *During six-month period.* During the six-month period described in paragraph (c)(6)(i) of this section, during the first six months of the period described in paragraph (c)(6)(ii) of this section, and during the 30-day period described in paragraph (c)(7)(iii)(A) of this section, loan proceeds disbursed to a qualified recipient, bond proceeds, and income from the investment thereof, may be held in unrestricted yield investments, provided such yield reflects normal market yield for such type of investments and provided the income from such investments, if any, is or would be sourced either in Puerto Rico or in a country in which the investment in active business assets or development project is to be made.

(B) *During other periods.* During any other period, any temporary investment of bond proceeds, and of income from such investments, shall be limited to investments in eligible activities. For purposes of this paragraph (c)(6)(iii)(B), the term ''eligible activities'' shall mean those investments described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(iv) *Definitions*—(A) *Bond proceeds.* For purposes of this paragraph (c), bond proceeds shall mean the proceeds from the issuance of obligations by way of a public offering or a private placement by a qualified financial institution for investment in active business assets or a development project that has been identified at the time of issue and is described in a public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the issuance of the bonds.

(B) *Long term project.* For purposes of this section, the term long term project means—

(*1*) A project, whether or not under a contract, for the construction, rehabilitation, improvement, upgrading, or production of qualified assets, or for expenditures, described in paragraph (c)(4)(ii) of this section (other than paragraph (c)(4)(ii)(C) of this section), which is reasonably expected to require more than 12 months to complete; or

(*2*) The production of property in a farming business referred to in paragraph (c)(4)(ii)(E) of this section, which is reasonably expected to require a preproductive period in excess of 12 months.

(7) *Financing of previously incurred costs.* Loan or bond proceeds which are disbursed after a qualified recipient has paid or incurred part or all of the costs of acquiring active business assets or investing in a development project shall be considered to have been applied for such purposes only as provided in this paragraph (c)(7).

(i) *Replacement of temporary non-section 936 financing of a qualified investment.* This paragraph (c)(7)(i) prescribes the maximum time limits within which temporary non-section 936 financing of qualified investments may be replaced with section 936 funds without being considered a prohibited refinancing transaction. This paragraph (c)(7)(i) applies to the refinancing of costs incurred with respect to investments that, at the time the costs were first incurred, were either qualified investments in a qualified Caribbean Basin country or were investments by a qualified recipient in active business assets or a development project in a qualified Caribbean Basin country. This paragraph (c)(7)(i) applies also to the refinancing of costs incurred with respect to any other investment. However, in the latter case, the amount of costs that may be refinanced with section 936 funds is limited to the amount of costs that are incurred with respect to the investment after the investment becomes a qualified investment in a qualified Caribbean Basin country. For purposes of this paragraph (c)(7)(i), the time when costs are incurred shall be determined under principles similar to those applicable under section 461(h) dealing with the economic performance test for the accrual of deductible liabilities. This paragraph (c)(7)(i) applies only to the situations described in this paragraph (c)(7)(i).

(A) In the case of an investment in active business assets or a development

project, a loan shall be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after the date on which the qualified recipient takes possession of the asset or the facility or, if earlier, places the asset or the facility in service. However, in the case of a small project described in paragraph (c)(8)(v) of this section, the six-month period shall be one year.

(B) In the case of an investment in active business assets or a development project that is part of a long term project described in paragraph (c)(6)(iv)(B) of this section, a loan shall also be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after completion of the project or, in the case of a farming business, after the beginning of production, and in any event, no later than three years after the date on which the first payment is made toward the eligible costs of the project. The amount of the qualified investment may not exceed the sum of—

(*1*) The eligible costs relating to investments described in paragraph (c)(4)(i)(A) in the case of an investment in active business assets, or the eligible costs relating to investments described in paragraph (c)(5)(i) of this section in the case of a development project, but only to the extent of the costs that are incurred after the date described in paragraph (c)(7)(i)(D) of this section, and

(*2*) The portion of unpaid interest that would be required to be capitalized under U.S. tax rules and that accrued on prior temporary non-section 936 financing from the date described in paragraph (c)(7)(i)(D) of this section through the date the section 936 loan proceeds are disbursed or the section 936 obligations are issued.

(C) In order to qualify for the special rules of this paragraph (c)(7)(i), a plan must be filed with the Commissioner of Financial Institutions of Puerto Rico (or his delegate) stating the qualified recipient's intention to refinance the costs of the long term project with section funds.

(D) The date referred to in paragraph (c)(7)(i)(B) (*1*) and (*2*) of this section is a date that is the later of—

(*1*) The date the plan described in paragraph (c)(7)(i)(C) is filed, or

(*2*) The date the investment becomes a qualified investment by a qualified recipient in active business assets or a development project in a qualified Caribbean Basin country.

(ii) *Refinancing of section 936 financing.* A section 936 loan or bond issue used to finance a qualified investment described in paragraph (c)(1) of this section may be refinanced with section 936 funds through a new loan or bond issue to the extent of the remaining principal balance on such existing qualified financing, increased by the amount of unpaid interest accrued through the date the new loan proceeds are disbursed or the new obligations are issued and that would be required to be capitalized under U.S. tax rules.

(iii) *Prompt application of borrowed proceeds*—(A) *In general.* In the case of a loan or bond issue described in paragraph (c)(7)(i) or (ii) of this section, the rules of paragraph (c)(6) of this section shall apply but the six-month period described in paragraph (c)(6)(i) of this section shall be limited to 30 days from the date of disbursement of loan proceeds to the qualified recipient or from the date of issuance in the case of a bond issue.

(B) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the 30-day period described in paragraph (c)(7)(iii)(A) of this section shall be extended with respect to the amount of bond proceeds used for the permanent financing of the long term project for such reasonable period of time as shall be necessary until completion of the project or beginning of production (in the case of a farming business), but, in any event, not to exceed three years from the date of issuance of the bonds. For purposes of this paragraph (c)(7)(iii)(B), the period of time shall be considered reasonable only if—

(*1*) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a

farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of issue, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time; and

(*2*) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the bond issue.

(8) *Miscellaneous operating rules*—(i) *Sale and leaseback.* An asset that is acquired and leased back to the person from whom acquired does not constitute an investment in an active business asset or an investment in a development project.

(ii) *Use of asset in qualified business activity.* For purposes of paragraph (c)(4)(i)(B), an asset shall be considered used or held for use in a qualified business activity if it is used or held for use in such activity under principles similar to those described in §1.367(a)-2T(b)(5), or a successor provision.

(iii) *Definition of capital expenditures.* For purposes of this paragraph (c), capital expenditures mean those expenditures described in section 263(a) of the Code (without regard to paragraphs (A) through (G) of section 263(a)(1)), and those costs required to be capitalized under section 263A with respect to property described in section 263A(b)(1), relating to self-constructed assets.

(iv) *Loans through certain financial intermediaries.* A loan by a qualified financial institution shall not be disqualified from being an investment in active business assets or in a development project merely because the proceeds are first lent to a financial intermediary (as defined in paragraph (c)(8)(iv)(H) of this section) which, in turn, on-lends the proceeds directly to a qualified recipient, provided the requirements of this paragraph (c)(8)(iv) are satisfied.

(A) The loan to the qualified recipient must satisfy the requirements of paragraph (c)(4)(i) of this section in the case of an investment in active business assets, or of paragraph (c)(5)(i) of this section in the case of an investment in a development project.

(B) The qualified recipient and the active business assets or development project in which the proceeds are to be invested must be identified prior to disbursement of any part of the proceeds by the qualified financial institution to the financial intermediary.

(C) The effective interest rate charged by the qualified financial institution to the financial intermediary must not exceed the average interest rate paid by the qualified financial institution with respect to its eligible funds, increased by such number of basis points as is required to provide reasonable compensation to the qualified financial institution for services performed and risks assumed with respect to the loan to the financial intermediary that are not ordinarily required to be performed or assumed with respect to a deposit, loan, repurchase agreement or other transfer of eligible funds with another qualified financial institution. The average interest rate shall be the average rate, determined on a daily basis, paid by the qualified financial institution on its eligible funds over the most recent quarter preceding the date on which the rate on the loan to the financial intermediary is committed.

(D) The effective interest rate charged by the financial intermediary to the qualified recipient must not exceed the effective interest rate charged to the financial intermediary by the qualified financial institution, increased by such number of basis points as is required to provide reasonable compensation to the financial intermediary for services performed and risks assumed with respect to the loan to the qualified recipient.

(E) The financial intermediary must borrow from the qualified financial institution under substantially the same terms as it lends to the qualified recipient. In particular, both loans must have disbursement terms, repayment schedules and maturity dates for interest and principal amounts such that the financial intermediary does not retain for more than 48 hours any of the

funds disbursed by the qualified financial institution nor any of the funds paid by the qualified recipient in repayment of principal or interest on the loan.

(F) The financial institution and the financial intermediary must agree to comply with the due diligence requirements described in paragraphs (c)(11), (12), and (13) of this section;

(G) The time periods and temporary investments rules in paragraphs (c)(6) and (7) of this section must be complied with; and

(H) For purposes of this paragraph (c), the financial intermediary must be—

(*1*) An active trade or business which a person maintains in a qualified Caribbean Basin country and which consists of a banking, financing or similar business as defined in §1.864–4(c)(5)(i) (other than a central bank of issue); or

(*2*) A public international organization, the principal purpose of which is to foster economic development in developing countries and which is described in section 1 of the International Organizations Immunities Act (22 U.S.C. 288).

For purposes of paragraphs (c)(8)(iv)(C) and (D) of this section, the determination of whether compensation is reasonable shall be made in relation to normal commercial practices for comparable transactions carrying a similar degree of commercial, currency and political risk. Reasonable credit enhancement fees and other reasonable fees and amounts charged to the financial intermediary or the qualified recipient with respect to the loan transaction in addition to interest shall be added to the interest cost in determining the effective interest rate.

(v) *Small project.* For purposes of this paragraph (c), a small project shall be a project (including the acquisition of an asset) for which the total amount of section 936 funds used for its financing does not exceed $1,000,000 in the aggregate, or such other amount as the Commissioner may publish, from time to time, in the Internal Revenue Bulletin.

(9) *Qualified recipient.* For purposes of this section, a qualified recipient is any person described in paragraph (c)(9)(i) or (ii) of this section. The term ''person'' means a person described in section 7701(a)(1) or a government (within the meaning of §1.892–2T(a)(1)) of a qualified Caribbean Basin country.

(i) In the case of an investment described in paragraph (c)(4) of this section (relating to investments in active business assets), a qualified recipient is a person that carries on a qualified business activity in a qualified Caribbean Basin country, and complies with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(ii) In the case of an investment described in pargraph (c)(5) of this section (relating to investments in development projects), a qualified recipient is the borrower (including a person empowered by the borrower to authorize expenditures for the investment in the development project) that has authority to comply, and complies, with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(10) *Investments in a qualified Caribbean Basin country*—(i) *Rules for determining the place of an investment.* The rules of this paragraph (c)(10)(i) shall apply to determine the extent to which an investment in an active business asset or a development project will be considered made in qualified Caribbean Basin Country.

(A) An investment in real property is considered made in the qualified Caribbean Basin country in which the real property is located.

(B) Except as otherwise provided in this paragraph (c)(10)(i)(B), an investment in tangible personal property is considered made in a qualified Caribbean Basin Country so long as the tangible personal property is predominantly used in that country. Whether property is used predominantly in a qualified Caribbean Basin country shall be determined under principles similar to those described in §1.48–1(g)(1), (g)(2)(ii), (g)(2)(iv), (g)(2)(vi), (g)(2)(viii), and (g)(2)(x) (relating to investment tax credits for property used outside the United States) as in effect on December 31, 1985. A vessel, container, or

aircraft shall be considered for use predominantly in a qualified Caribbean Basin country in any year if it is used for transport to and from such country with some degree of frequency during that year and at least 30 percent of the income from the use of such vessel, container or aircraft for that year is sourced in such country under principles similar to those described in section 863(c)(1) and (2) (relating to source rules for certain transportation income). Cables and pipelines which are premanently installed as part of a communication or transportation system between a qualified Caribbean Basin country and another country or among several countries which include a qualified Caribbean Basin country shall be considered used in a qualified Caribbean Basin country to the extent of 50 percent of the portion of the facility that directly links the qualified country to another country or to a hub, unless it is established by notice or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified institution or qualified recipient upon request that it is appropriate to attribute a greater portion of the cost of the facility to the qualified Caribbean Basin country.

(C) An investment in rights to intangible property is considered made in a qualified Caribbean Basin country to the extent such rights are used in that country. Where rights to intangible property are used shall be determined under principles similar to those described in §1.954–2T(b)(3)(vii) or a successor provision.

(ii) *Qualified Caribbean Basin country*. For purposes of this section, the term ''qualified Caribbean Basin country'' means any beneficiary country (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act, Public Law 98–67 (Aug. 5, 1983), 97 Stat. 384, 19 U.S.C. 2702(a)(1)(A)), which meets the requirements of section 274(h)(6)(A)(i) and (ii) and the U.S. Virgin Islands, and includes the territorial waters and continental shelf thereof.

(11) *Agreements and certifications by qualified recipients and financial intermediaries*—(i) *In general*. In order for an investment to be considered a qualified investment under section 936(d)(4) and paragraph (c)(1) of this section, a qualified recipient must certify to the qualified financial institution (or to the financial intermediary, if the loan is made through a financial intermediary) on the date of closing of the loan agreement and on each anniversary date thereof, that it is a qualified recipient described in paragraph (c)(9) of this section. In addition, the qualified recipient must agree in the loan agreement with the qualified financial institution (or with the financial intermediary, if the loan is made through a financial intermediary)—

(A) To use the funds at all times during the period the loan is outstanding solely for the purposes and in the manner described in paragraph (c)(4) of this section (regarding investment in active business assets) or in paragraph (c)(5) of this section (regarding investment in development projects);

(B) To comply with the requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and paragraph (c)(7) of this section (regarding the refinancing of existing funding and the time periods within which funding for investments must be secured);

(C) To notify the Assistant Commissioner (International), the qualified financial institution (or the financial intermediary, if the loan is made through a financial intermediary), and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section if it no longer is a qualified recipient or if, for any other reason, the investment has ceased to qualify as a qualified investment described in paragraph (c)(1) of this section, promptly upon the occurrence of such disqualifying event; and

(D) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records that are sufficient to verify

that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement.

(ii) *Certification by a financial intermediary.* In the case of a loan by a qualified financial institution to a financial intermediary, the financial intermediary must certify to the qualified financial institution (using the procedures described in paragraph (c)(11)(i) of this section) that it is a financial intermediary described in paragraph (c)(8)(iv)(H) of this section, and must furnish to the qualified financial institution a copy of the qualified recipient's certification described in paragraph (c)(11)(i) of this section and of its loan agreement with the qualified recipient. In addition, the financial intermediary must agree in the loan agreement with the qualified financial institution:

(A) To comply with the requirements of paragraph (c)(8)(iv) of this section; and

(B) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used in conformity with the terms of the loan agreements.

(12) *Certification requirements.* In order for an investment to be considered a qualified investment under section 936(d)(4), section 936(d)(4)(C)(i) requires that both the person in whose trade or business such investment is made and the financial institution certify to the Secretary of the Treasury and the Commissioner of Financial Institutions of Puerto Rico that the proceeds of the loan will be promptly used to acquire active business assets or to make other authorized expenditures. This certification requirement is satisfied as to the qualified financial institution, the financial intermediary (if any), and the qualified recipient if the qualified financial institution submits a certificate to both the Assistant Commissioner (International) and to the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon authorization of the investment by the Commissioner of Financial Institutions and, in any event, prior to the first disbursement of the loan proceeds to the qualified recipient or to the financial intermediary (if any), in which the qualified financial institution—

(i) Represents that, as of the date of the certification, the qualified recipient and the financial intermediary (if any) have complied with the requirements described in paragraph (c)(11) of this section;

(ii) Describes the important terms of the loan to the financial intermediary (if any) and to the qualified recipient, including the amount of the loan, the nature of the investment, the basis for its qualification as an investment in active business assets or a development project under this section, the identity of the financial intermediary (if any) and of the qualified recipient, the qualified Caribbean Basin country involved, and the nature of the collateral or other security used, including any guarantee;

(iii) Agrees to permit examination by the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient; and

(iv) In the case of a single-purpose entity that is a qualified financial institution, discloses the name and address of the entity's trustee or agent, if any, that assists the qualified financial institution in the performance of its due diligence requirement under paragraph (c) of this section, and represents that the trustee or agent has agreed with the qualified financial institution to permit examination by the Assistant Commissioner (International) (or by the office of any District Director

authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records of such trustee or agent that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient.

(13) *Continuing due diligence requirements.* In order to maintain the qualification for an investment under paragraph (c)(1) of this section, the continuing due diligence requirements described in this paragraph (c)(13) must be satisfied.

(i) *Requirements of qualified recipient.* A qualified recipient must—

(A) Submit annually to the qualified financial institution or to the financial intermediary from which its qualified funds were obtained a copy of its most recent annual financial statement accompanied by an opinion of an independent accountant familiar with the financials of the qualified recipient disclosing the amount of the loan, the current outstanding balance of the loan, describing the assets financed with such loan and the qualified business activity in which such assets are used or the development project for which the loan is used, and stating that there are no reasons to doubt that the loan proceeds have been properly used and continue to be properly used, and

(B) Act in a manner consistent with its representations and agreements described in paragraph (c)(11) of this section.

(ii) *Requirements of qualified financial institutions.* Except as otherwise provided in paragraph (c)(13)(iii) of this section, a qualified financial institution described in paragraph (c)(3) of this section must maintain in its records and have available for inspection the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section. In addition, the qualified financial institution is required to notify the Assistant Commissioner (International) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. For purposes of this paragraph (c)(13)(ii), multiple loans for investment in a single qualified business activity or development project will be aggregated in determining what due diligence requirements apply.

(A) In the case of a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection:

(*1*) The loan application or other similar document;

(*2*) The financial statements of the qualified recipient filed as part of the loan application;

(*3*) The statement required by section 6.4.3(a)(iii) of Puerto Rican Regulation No. 3582 or any successor thereof, signed by the qualified recipient (or its duly authorized representative), acknowledging the receipt of the loan proceeds, describing the assets financed with such loan and the business activity in which such assets are to be used or the development project for which the funds will be utilized, the collateral to be provided for the transaction including any guarantee, and the basis for its qualification as a qualified recipient;

(*4*) The loan documents; and

(*5*) In the case of a qualified financial institution that is a single-purpose entity, a copy of the agreement with the entity's trustee or agent, if any, described in paragraph (c)(12)(iv) of this section.

(B) In the case of a disbursement concerning a project that is not a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection, in addition to the documents required by paragraph (c)(13)(ii)(A) of this section:

(*1*) A memorandum of credit prepared by an officer of the qualified financial institution (or, in the case of a single purpose entity, an agent of the entity or a trustee for the entity, if any) and signed by the officer of the qualified financial institution, containing the details of the investigation and review that the qualified financial institution,

or its trustee or agent, if any, conducted in order to evaluate whether the investment is qualified under paragraph (c)(1) of this section and the opinion of the officer of the qualified financial institution, or the opinion of an officer of the agent of, or of the trustee for, the qualified financial institution, if any, that there is no reasonable ground for belief that the qualified funds will be diverted to a use that is not permitted under the provisions of this section; in making this investigation and review, factors that must be utilized are ones similar to those listed in Puerto Rico Regulation No. 3582, section 6.4.2;

(*2*) The annual financial statement of the qualified recipient; and

(*3*) The written report of an officer of the qualified financial institution, or of an officer of an agent of, or of the trustee for, the qualified financial institution, if any, documenting discussions, both before and after the disbursement of the loan proceeds, with each recipient's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(iii) *Requirements in the case of a financial intermediary.* Where a qualified financial institution lends funds to a financial intermediary which are on-lent to a qualified recipient—

(A) The obligation to maintain the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section shall apply only to the financial intermediary and not to the qualified financial institution and the provisions of paragraph (c)(13)(ii)(A) or (B) of this section shall be read so as to impose on the financial intermediary any obligation imposed on the qualified financial institution.

(B) The financial intermediary shall forward annually to the qualified financial institution a copy of the documentation it is required to maintain in its records pursuant to the provisions of this paragraph (c)(13)(iii) and shall notify the Assistant Commissioner (International), the Commissioner of Financial Institutions of Puerto Rico (or his delegate) and the qualified financial institution pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. The qualified financial institution must maintain in its records and have available for inspection the documentation furnished by the financial intermediary pursuant to this paragraph (c)(13)(iii)(B).

(C) The qualified financial institution shall cause one of its officers (or one of the officers of its agent or trustee, if any) to prepare a written report documenting his analysis of the documentation furnished by the financial intermediary pursuant to paragraph (c)(13)(iii)(B) of this section, his discussions, both before and after the disbursement of the loan proceeds, with the financial intermediary's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds, and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(14) *Procedures for notices and certifications.* Notices and certifications to the Assistant Commissioner (International) required under paragraphs (c)(11), (12) and (13) of this section shall be addressed to the attention of the Assistant Commissioner (International), Office of Taxpayer Service and Compliance, IN:C, 950 L'Enfant Plaza South, SW., Washington, DC 20024. Notices and certifications to the Commissioner of Financial Institutions of Puerto Rico required under paragraphs (c)(11), (12),

and (13) of this section shall be addressed as follows: Commissioner of Financial Institutions, GPO Box 70324, San Juan, Puerto Rico 00936.

(15) *Effective date.* This paragraph (c) is effective May 13, 1991. It is applicable to investments by a possessions corporation in a financial institution that are used by a financial institution for investments in accordance with a specific authorization granted by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) after September 22, 1989. However, the taxpayer may choose to apply §1.936–10T(c) for periods before June 12, 1991.

[T.D. 8350, 56 FR 21927, May 13, 1991]

### § 1.936–11 New lines of business prohibited.

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A) and this section, that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(b) *New line of business*—(1) *In general.* A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related.* To determine whether a new activity is closely related to a pre-existing business of the possessions corporation all the facts and circumstances must be considered, including those set forth in paragraphs (b)(2)(i)(A) through (G) of this section.

(i) *Factors.* The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The new activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The new activity markets products and services to the same class of customers;

(C) The new activity is of a type that is normally conducted in the same business location;

(D) The new activity requires the use of similar operating assets;

(E) The new activity's economic success depends on the success of the pre-existing business;

(F) The new activity is of a type that would normally be treated as a unit with the pre-existing business' in the business accounting records; and

(G) The new activity and the pre-existing business are regulated or licensed by the same or similar governmental authority.

(ii) *Safe harbors.* An activity is not a new line of business if—

(A) If the activity is within the same six-digit North American Industry Classification System (NAICS) code (or four-digit Standard Industrial Classification (SIC) code). The similarity of the NAICS or SIC codes may not be relied upon to determine whether the activity is closely related to a pre-existing business where the code indicates a miscellaneous category;

(B) If the new activity is within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity also satisfy at least three of the factors listed in paragraphs (b)(2)(i)(A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1),Q&A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the possession on or before October 13, 1995; and

(B) The existing credit claimant had elected the benefits of the Puerto Rico

and possession tax credit pursuant to an election which was in effect for the taxable year that included October 13, 1995.

(ii) *Acquisition of an existing credit claimant.* (A) If all the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, the acquiring corporation may make a section 936(e) election for the taxable year in which the assets are acquired with the following effects—

(*1*) The acquiring corporation will be treated as an existing

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non-affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) For purposes of this section the assets of a trade or business are determined at the time of acquisition provided that the transferee actively conducts the trade or business acquired.

(D) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Leasing of Assets.* (i) The leasing of assets (and employees to operate leased assets) will not, for purposes of this section, be considered a new line of business of the existing credit claimant if—

(A) the existing credit claimant used the leased assets in an active trade or business for at least five years;

(B) the existing credit claimant does not through its own officers or staff of employees perform management or operational functions (but not including operational functions performed through leased employees) with respect to the leased assets; and

(C) the existing credit claimant does not perform marketing functions with respect to the leasing of the assets.

(ii) Any income from the leasing of assets not considered a new line of business pursuant to paragraph (b)(4)(i) of this section will not be income from the active conduct of a trade or business (and, therefore, the existing credit claimant may not receive a possession tax credit with respect to such income).

(5) *Timing rule.* The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general.* A new line of business is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more than 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more than 15 percent of its assets (assets test).

(2) *Gross income test.* The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for

the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation.* The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception.* A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not permit use of this exception.

(d) *Examples.* The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

*Example 1.* X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i)(A), (C), and (E) of this section. The manufacture of the pills by X Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(B).

*Example 2.* X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand for its products was high, X Corp. expanded when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(A).

*Example 3.* X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. The manufacture of Device B is treated as a unit with the manufacture of Device A in X Corp.'s accounting records. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and Electrotherapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotherapeutic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The

safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i)(A), (B), (C), (D), (F), and (G) of this section.

*Example 4.* X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the seven factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

*Example 5.* X Corp., a calendar year taxpayer, is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant for 1998 and all years subsequent.

(e) *Loss of status as existing credit claimant.* An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning on or after January 25, 2000.

(2) *Election for retroactive application.* Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

[T.D. 8868, 65 FR 3815, Jan. 25, 2000]

### § 1.937–1 Bona fide residency in a possession.

(a) *Scope*—(1) *In general.* Section 937(a) and this section set forth the rules for determining whether an individual qualifies as a bona fide resident of a particular possession (the relevant possession) for purposes of subpart D, part III, Subchapter N, Chapter 1 of the Internal Revenue Code as well as section 865(g)(3), section 876, section 881(b), paragraphs (2) and (3) of section 901(b), section 957(c), section 3401(a)(8)(C), and section 7654(a).

(2) *Definitions.* For purposes of this section and §§ 1.937–2 and 1.937–3—

(i) *Possession* means one of the following United States possessions: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands. When used in a geographical sense, the term comprises only the territory of each such possession (without application of sections 932(c)(3) and 935(c)(2) (as in effect before the effective date of its repeal)).

(ii) *United States*, when used in a geographical sense, is defined in section 7701(a)(9), and without application of sections 932(a)(3) and 935(c)(1) (as in effect before the effective date of its repeal).

(b) *Bona fide resident*—(1) *General rule.* An individual qualifies as a bona fide resident of the relevant possession if such individual satisfies the requirements of paragraphs (c) through (e) of this section with respect to such possession.

(2) *Special rule for members of the Armed Forces.* A member of the Armed Forces of the United States who qualified as a bona fide resident of the relevant possession in a prior taxable year is deemed to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year if such individual otherwise is unable to satisfy such requirements by reason of being absent from such possession or present in the United States during such year solely in compliance with military orders. Conversely, a member of the Armed Forces of the United States who did not qualify as a bona fide resident of the relevant possession in a prior taxable year is not considered to have satisfied the requirements of paragraphs (c) through (e) of this section for a subsequent taxable year by reason of being present in such possession solely in compliance with military orders. *Armed Forces of the United States* is defined (and members of the Armed Forces are described) in section 7701(a)(15).

(3) *Juridical persons.* Except as provided in §1.881–5(f):

(i) Only natural persons may qualify as bona fide residents of a possession; and

(ii) The rules governing the tax treatment of bona fide residents of a possession do not apply to juridical persons (including corporations, partnerships, trusts, and estates).

(4) *Transition rule.* For taxable years beginning before October 23, 2004, and ending after October 22, 2004, an individual is considered to qualify as a bona fide resident of the relevant possession if that individual would be a bona fide resident of the relevant possession by applying the principles of §§1.871–2 through 1.871–5.

(5) *Special rule for cessation of bona fide residence in Puerto Rico.* See paragraph (f)(2)(ii) of this section for a special rule applicable to a citizen of the United States who ceases to be a bona fide resident of Puerto Rico during a taxable year.

(c) *Presence test*—(1) *In general.* A United States citizen or resident alien individual (as defined in section 7701(b)(1)(A)) satisfies the requirements of this paragraph (c) for a taxable year if that individual—

(i) Was present in the relevant possession for at least 183 days during the taxable year;

(ii) Was present in the relevant possession for at least 549 days during the three-year period consisting of the taxable year and the two immediately preceding taxable years, provided that the individual was also present in the relevant possession for at least 60 days during each taxable year of the period;

(iii) Was present in the United States for no more than 90 days during the taxable year;

(iv) During the taxable year had earned income (as defined in §1.911–3(b)) in the United States, if any, not exceeding in the aggregate the amount specified in section 861(a)(3)(B) and was present for more days in the relevant possession than in the United States; or

(v) Had no significant connection to the United States during the taxable year. See paragraph (c)(5) of this section.

(2) *Special rule for alien individuals.* A nonresident alien individual (as defined in section 7701(b)(1)(B)) satisfies the requirements of this paragraph (c) for a taxable year if during that taxable year that individual satisfies the substantial presence test of §301.7701(b)–1(c) of this chapter (except for the substitution of the name of the relevant possession for the term *United States* where appropriate).

(3) *Days of presence.* For purposes of paragraph (c)(1) of this section—

(i) An individual is considered to be present in the relevant possession on:

(A) Any day that the individual is physically present in that possession at any time during the day;

(B) Any day that an individual is outside of the relevant possession to receive, or to accompany on a full-time basis a parent, spouse, or child (as defined in section 152(f)(1)) who is receiving, qualifying medical treatment as defined in paragraph (c)(4) of this section; and

(C) Any day that an individual is outside the relevant possession because the individual leaves or is unable to return to the relevant possession during any—

(*1*) 14-day period within which a major disaster occurs in the relevant possession for which a Federal Emergency Management Agency Notice of a Presidential declaration of a major disaster is issued in the FEDERAL REGISTER; or

(*2*) Period for which a mandatory evacuation order is in effect for the geographic area in the relevant possession in which the individual's place of abode is located.

(ii) An individual is considered to be present in the United States on any day that the individual is physically present in the United States at any time during the day. Notwithstanding the preceding sentence, the following days will not count as days of presence in the United States:

(A) Any day that an individual is temporarily present in the United States under circumstances described in paragraph (c)(3)(i)(B) or (C) of this section;

(B) Any day that an individual is in transit between two points outside the United States (as described in §301.7701(b)–3(d) of this chapter), and is physically present in the United States for fewer than 24 hours;

(C) Any day that an individual is temporarily present in the United States as a professional athlete to compete in a charitable sports event (as described in §301.7701(b)–3(b)(5) of this chapter);

(D) Any day that an individual is temporarily present in the United States as a student (as defined in section 152(f)(2)); and

(E) In the case of an individual who is an elected representative of the relevant possession, or who serves full time as an elected or appointed official or employee of the government of the relevant possession (or any political subdivision thereof), any day spent serving the relevant possession in that role.

(iii) If, during a single day, an individual is physically present—

(A) In the United States and in the relevant possession, that day is considered a day of presence in the relevant possession;

(B) In two possessions, that day is considered a day of presence in the possession where the individual's tax home is located (applying the rules of paragraph (d) of this section).

(4) *Qualifying medical treatment*—(i) *In general.* The term *qualifying medical treatment* means medical treatment provided by (or under the supervision of) a physician (as defined in section 213(d)(4)) for an illness, injury, impairment, or physical or mental condition that satisfies the documentation and production requirements of paragraph (c)(4)(iii) of this section and that involves—

(A) Any period of inpatient care in a hospital or hospice and any period immediately before or after that inpatient care to the extent it is medically necessary; or

(B) Any temporary period of inpatient care in a residential medical care facility for medically necessary rehabilitation services;

(ii) *Inpatient care.* The term *inpatient care* means care requiring an overnight stay in a hospital, hospice, or residential medical care facility, as the case may be.

(iii) *Documentation and production requirements.* In order to satisfy the documentation and production requirements of this paragraph, an individual must, with respect to each qualifying medical treatment, prepare (or obtain), maintain, and, upon a request by the Commissioner (or the person responsible for tax administration in the relevant possession), make available within 30 days of such request:

(A) Records that provide—

(*1*) The patient's name and relationship to the individual (if the medical treatment is provided to a person other than the individual);

(*2*) The name and address of the hospital, hospice, or residential medical

care facility where the medical treatment was provided;

(*3*) The name, address, and telephone number of the physician who provided the medical treatment;

(*4*) The date(s) on which the medical treatment was provided; and

(*5*) Receipt(s) of payment for the medical treatment;

(B) Signed certification by the providing or supervising physician that the medical treatment was qualified medical treatment within the meaning of paragraph (c)(4)(i) of this section, and setting forth—

(*1*) The patient's name;

(*2*) A reasonably detailed description of the medical treatment provided by (or under the supervision of) the physician;

(*3*) The dates on which the medical treatment was provided; and

(*4*) The medical facts that support the physician's certification and determination that the treatment was medically necessary; and

(C) Such other information as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter).

(5) *Significant connection.* For purposes of paragraph (c)(1)(v) of this section—

(i) The term *significant connection to the United States* means—

(A) A permanent home in the United States;

(B) Current registration to vote in any political subdivision of the United States; or

(C) A spouse or child (as defined in section 152(f)(1)) who has not attained the age of 18 whose principal place of abode is in the United States other than—

(*1*) A child who is in the United States because the child is living with a custodial parent under a custodial decree or multiple support agreement; or

(*2*) A child who is in the United States as a student (as defined in section 152(f)(2)).

(ii) *Permanent home*—(A) *General rule.* For purposes of paragraph (c)(5)(i)(A) of this section, except as provided in paragraph (c)(5)(ii)(B) of this section, the term *permanent home* has the same meaning as in §301.7701(b)–2(d)(2) of this chapter.

(B) *Exception for rental property.* If an individual or the individual's spouse owns property and rents it to another person at any time during the taxable year, then notwithstanding that the rental property may constitute a permanent home under §301.7701(b)–2(d)(2) of this chapter, it is not a permanent home under this paragraph (c)(5)(ii) unless the taxpayer uses any portion of it as a residence during the taxable year under the principles of section 280A(d). In applying the principles of section 280A(d) for this purpose, an individual is treated as using the rental property for personal purposes on any day determined under the principles of section 280A(d)(2) or on any day that the rental property (or any portion of it) is not rented to another person at fair rental for the entire day. The rental property is not used for personal purposes on any day on which the principal purpose of the use of the rental property is to perform repair or maintenance work on the property. Whether the principal purpose of the use of the rental property is to perform repair or maintenance work is determined in light of all the facts and circumstances including, but not limited to, the following: The amount of time devoted to repair and maintenance work, the frequency of the use for repair and maintenance purposes during a taxable year, and the presence and activities of companions.

(iii) For purposes of this paragraph (c)(5), the term *spouse* does not include a spouse from whom the individual is legally separated under a decree of divorce or separate maintenance.

(d) *Tax home test*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, an individual satisfies the requirements of this paragraph (d) for a taxable year if that individual did not have a tax home outside the relevant possession during any part of the taxable year. For purposes of section 937 and this section, an individual's tax home is determined under the principles of section 911(d)(3) without regard to the second sentence thereof. Thus, under section 937, 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 the business, or because the individual is not engaged in carrying on any trade or business within the meaning of section 162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense.

(2) *Exceptions*—(i) *Year of move.* See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a bona fide resident of the relevant possession during a taxable year.

(ii) *Special rule for seafarers.* For purposes of section 937 and this section, an individual is not considered to have a tax home outside the relevant possession solely by reason of employment on a ship or other seafaring vessel that is predominantly used in local and international waters. For this purpose, a vessel is considered to be predominantly used in local and international waters if, during the taxable year, the aggregate amount of time it is used in international waters and in the waters within three miles of the relevant possession exceeds the aggregate amount of time it is used in the territorial waters of the United States, another possession, and a foreign country.

(iii) *Special rule for students and government officials.* Any days described in paragraphs (c)(3)(ii)(D) and (E) of this section are disregarded for purposes of determining whether an individual has a tax home outside the relevant possession under paragraph (d)(1) of this section during any part of the taxable year.

(e) *Closer connection test*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, an individual satisfies the requirements of this paragraph (e) for a taxable year if that individual did not have a closer connection to the United States or a foreign country than to the relevant possession during any part of the taxable year. For purposes of this paragraph (e)—

(i) The principles of section 7701(b)(3)(B)(ii) and §301.7701(b)–2(d) of this chapter apply (without regard to the final sentence of §301.7701(b)–2(b) of this chapter); and

(ii) An individual's connections to the relevant possession are compared to the aggregate of the individual's connections with the United States and foreign countries.

(2) *Exception for year of move.* See paragraph (f) of this section for a special rule applicable to an individual who becomes or ceases to be a bona fide resident of the relevant possession during a taxable year.

(f) *Year of move*—(1)*Move to a possession.* For the taxable year in which an individual's residence changes to the relevant possession, the individual satisfies the requirements of paragraphs (d)(1) and (e)(1) of this section if—

(i) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is not a bona fide resident of the relevant possession;

(ii) For each of the last 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(iii) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is a bona fide resident of the relevant possession.

(2) *Move from a possession*—(i) *General rule.* Except for a bona fide resident of Puerto Rico to whom §1.933–1(b) and paragraph (f)(2)(ii) of this section apply, for the taxable year in which an individual ceases to be a bona fide resident of the relevant possession, the individual satisfies the requirements of paragraphs (d)(1) and (e)(1) of this section if—

(A) For each of the 3 taxable years immediately preceding the taxable year of the change of residence, the individual is a bona fide resident of the relevant possession;

(B) For each of the first 183 days of the taxable year of the change of residence, the individual does not have a tax home outside the relevant possession or a closer connection to the United States or a foreign country than to the relevant possession; and

(C) For each of the 3 taxable years immediately following the taxable year of the change of residence, the individual is not a bona fide resident of the relevant possession.

(ii) *Year of move from Puerto Rico.* Notwithstanding an individual's failure to satisfy the presence, tax home, or closer connection test prescribed under paragraph (b)(1) of this section for the taxable year, the individual is a bona fide resident of Puerto Rico for that part of the taxable year described in paragraph (f)(2)(ii)(E) of this section if the individual—

(A) Is a citizen of the United States;

(B) Is a bona fide resident of Puerto Rico for a period of at least 2 taxable years immediately preceding the taxable year;

(C) Ceases to be a bona fide resident of Puerto Rico during the taxable year;

(D) Ceases to have a tax home in Puerto Rico during the taxable year; and

(E) Has a closer connection to Puerto Rico than to the United States or a foreign country throughout the part of the taxable year preceding the date on which the individual ceases to have a tax home in Puerto Rico.

(g) *Examples.* The principles of this section are illustrated by the following examples:

*Example 1. Presence test.* H, a U.S. citizen, is engaged in a profession that requires frequent travel. H spends 195 days of each of the years 2005 and 2006 in Possession N. In 2007, H spends 160 days in Possession N. Under paragraph (c)(1)(ii), H satisfies the presence test of paragraph (c) of this section with respect to Possession N for taxable year 2007. Assuming that in 2007 H does not have a tax home outside of Possession N and does not have a closer connection to the United States or a foreign country under paragraphs (d) and (e) of this section respectively, then regardless of whether H was a bona fide resident of Possession N in 2005 and 2006, H is a bona fide resident of Possession N for taxable year 2007.

*Example 2. Presence test.* W, a U.S. citizen, lives for part of the taxable year in a condominium, which she owns, located in Possession P. W also owns a house in State N where she lives for 120 days every year to be near her grown children and grandchildren. W is retired and her income consists solely of pension payments, dividends, interest, and Social Security benefits. For 2006, W is only present in Possession P for a total of 175 days because of a 70-day vacation to Europe and Asia. Thus, for taxable year 2006, W is not present in Possession P for at least 183 days, is present in the United States for more than 90 days, and has a significant connection to the United States by reason of her permanent home. However, under paragraph (c)(1)(iv) of this section, W still satisfies the presence test of paragraph (c) of this section with respect to Possession P because she has no earned income in the United States and is present for more days in Possession P than in the United States.

*Example 3. Presence test.* T, a U.S. citizen, was born and raised in State A, where his mother still lives in the house in which T grew up. T is a sales representative for a company based in Possession V. T lives with his wife and minor children in their house in Possession V. T is registered to vote in Possession V and not in the United States. In 2006, T spends 120 days in State A and another 120 days in foreign countries. When traveling on business to State A, T often stays at his mother's house in the bedroom he used when he was a child. T's stays are always of short duration, and T asks for his mother's permission before visiting to make sure that no other guests are using the room and that she agrees to have him as a guest in her house at that time. Therefore, under paragraph (c)(5)(ii) of this section, T's mother's house is not a permanent home of T. Assuming that no other accommodations in the United States constitute a permanent home with respect to T, then under paragraphs (c)(1)(v) and (c)(5) of this section, T has no significant connection to the United States. Accordingly, T satisfies the presence test of paragraph (c) of this section for taxable year 2006.

*Example 4. Alien resident of possession—presence test.* F is a citizen of Country G. F's tax home is in Possession C and F has no closer connection to the United States or a foreign country than to Possession C. F is present in Possession C for 123 days and in the United States for 110 days every year. Accordingly, F is a nonresident alien with respect to the United States under section 7701(b), and a bona fide resident of Possession C under paragraphs (b), (c)(2), (d), and (e) of this section.

*Example 5. Seafarers—tax home.* S, a U.S. citizen, is employed by a fishery and spends 250 days at sea on a fishing vessel in 2006. When not at sea, S resides with his wife at a house they own in Possession G. The fishing vessel upon which S works departs and arrives at various ports in Possession G, other possessions, and foreign countries, but is in international and local waters (within the meaning of paragraph (d)(2) of this section) for 225 days in 2006. Under paragraph (d)(2) of this section, for taxable year 2006, S will not be considered to have a tax home outside Possession G for purposes of section 937 and this section solely by reason of S's employment on board the fishing vessel.

*Example 6. Seasonal workers—tax home and closer connection.* P, a U.S. citizen, is a permanent employee of a hotel in Possession I, but works only during the tourist season. For the remainder of each year, P lives with

her husband and children in Possession Q, where she has no outside employment. Most of P's personal belongings, including her automobile, are located in Possession Q. P is registered to vote in, and has a driver's license issued by, Possession Q. P does her personal banking in Possession Q and P routinely lists her address in Possession Q as her permanent address on forms and documents. P satisfies the presence test of paragraph (c) of this section with respect to both Possession Q and Possession I, because, among other reasons, under paragraph (c)(1)(iii) of this section she does not spend more than 90 days in the United States during the taxable year. P satisfies the tax home test of paragraph (d) of this section only with respect to Possession I, because her regular place of business is in Possession I. P satisfies the closer connection test of paragraph (e) of this section with respect to both Possession Q and Possession I, because she does not have a closer connection to the United States or to any foreign country (and possessions generally are not treated as foreign countries). Therefore, P is a bona fide resident of Possession I for purposes of the Internal Revenue Code.

*Example 7. Closer connection to United States than to possession.* Z, a U.S. citizen, relocates to Possession V in a prior taxable year to start an investment consulting and venture capital business. Z's wife and two teenage children remain in State C to allow the children to complete high school. Z travels back to the United States regularly to see his wife and children, to engage in business activities, and to take vacations. He has an apartment available for his full-time use in Possession V, but he remains a joint owner of the residence in State C where his wife and children reside. Z and his family have automobiles and personal belongings such as furniture, clothing, and jewelry located at both residences. Although Z is a member of the Possession V Chamber of Commerce, Z also belongs to and has current relationships with social, political, cultural, and religious organizations in State C. Z receives mail in State C, including brokerage statements, credit card bills, and bank advices. Z conducts his personal banking activities in State C. Z holds a State C driver's license and is registered to vote in State C. Based on the totality of the particular facts and circumstances pertaining to Z, Z is not a bona fide resident of Possession V because he has a closer connection to the United States than to Possession V and therefore fails to satisfy the requirements of paragraphs (b)(1) and (e) of this section.

*Example 8. Year of move to possession.* D, a U.S. citizen, files returns on a calendar year basis. From January 2003 through May 2006, D resides in State R. In June 2006, D moves to Possession N, purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, 2006 is in Possession N, and during that period (which totals at least 183 days) D does not have a closer connection to the United States or a foreign country than to Possession N. For the remainder of 2006, and throughout years 2007 through 2009, D continues to live and work in Possession N and maintains a closer connection to Possession N than to the United States or any foreign country. D satisfies the tax home and closer connection tests for 2006 under paragraphs (d)(2), (e)(2), and (f)(1) of this section. Accordingly, assuming that D also satisfies the presence test in paragraph (c) of this section, D is a bona fide resident of Possession N for all of taxable year 2006.

*Example 9. Year of move from possession (other than Puerto Rico).* J, a U.S. citizen, files returns on a calendar year basis. From January 2007 through December 2009, J is a bona fide resident of Possession C because she satisfies the requirements of paragraph (b)(1) of this section for each year. J continues to reside in Possession C until September 6, 2010, when she accepts new employment and moves to State H. J's principal place of business from January 1 through September 5, 2010 is in Possession C, and during that period (which totals at least 183 days) J does not have a closer connection to the United States or a foreign country than to Possession C. For the remainder of 2010 and throughout years 2011 through 2013, D continues to live and work in State H and is not a bona fide resident of Possession C. J satisfies the tax home and closer connection tests for 2010 with respect to Possession C under paragraphs (d)(2)(i), (e)(2), and (f)(2)(i) of this section. Accordingly, assuming that J also satisfies the presence test of paragraph (c) of this section, J is a bona fide resident of Possession C for all of taxable year 2010.

*Example 10. Year of move from Puerto Rico.* R, a U.S. citizen who files returns on a calendar year basis satisfies the requirements of paragraphs (b) through (e) of this section for years 2006 and 2007. From January through April 2008, R continues to reside and maintain his principal place of business in and closer connection to Puerto Rico. On May 5, 2008, R moves and changes his principal place of business (tax home) to State N and later that year establishes a closer connection to the United States than to Puerto Rico. R does not satisfy the presence test of paragraph (c) for 2008 with respect to Puerto Rico. Moreover, because R had a tax home outside of Puerto Rico and establishes a closer connection to the United States in 2008, R does not satisfy the requirements of paragraph (d)(1) or (e)(1) of this section for 2008. However, because R was a bona fide resident of Puerto Rico for at least two taxable years before his change of residence to State N in 2008, he is a bona fide resident of Puerto Rico from January 1 through May 4, 2008 under

paragraphs (b)(5) and (f)(2)(ii) of this section. See section 933(2) and §1.933–1(b) for rules on attribution of income.

(h) *Information reporting requirement.* The following individuals are required to file notice of their new tax status in such time and manner as the Commissioner may prescribe by notice, form, instructions, or other publication (see §601.601(d)(2) of this chapter):

(1) Individuals who take the position for U.S. tax reporting purposes that they qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file Federal income tax returns as citizens or residents of the United States who did not so qualify.

(2) Citizens and residents of the United States who take the position for U.S. tax reporting purposes that they do not qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file income tax returns (with the Internal Revenue Service, the tax authorities of a possession, or both) as individuals who did so qualify.

(3) Bona fide residents of Puerto Rico or a section 931 possession (as defined in §1.931–1T(c)(1)) who take a position for U.S. tax reporting purposes that they qualify as bona fide residents of that possession for a tax year subsequent to a tax year for which they were required to file income tax returns as bona fide residents of the United States Virgin Islands or a section 935 possession (as defined in §1.935–1T(a)(3)(i)).

(i) *Effective date.* Except as provided in this paragraph (i), this section applies to taxable years ending after January 31, 2006. Paragraph (h) of this section also applies to a taxpayer's 3 taxable years immediately preceding the taxpayer's first taxable year ending after October 22, 2004. Taxpayers also may choose to apply this section in its entirety to all taxable years ending after October 22, 2004 for which the statute of limitations under section 6511 is open.

[T.D. 9248, 71 FR 5001, Jan. 31, 2006, as amended by T.D. 9297, 71 FR 66234, Nov. 14, 2006]

## §1.937–2T Income from sources within a possession (temporary).

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is considered to be from sources within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including section 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code, as well as section 7654(a) of the 1954 Internal Revenue Code (until the effective date of its repeal). Paragraphs (c)(1)(ii) and (c)(2) of this section do not apply, however, for purposes of sections 932(a) and (b) and 935(a)(3) (as in effect before the effective date of its repeal). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term *United States* where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws. These rules also do not affect the determination of whether income is considered to be from sources without the United States for purposes of the Internal Revenue Code.

(b) *In general.* Except as provided in paragraphs (c) through (i) of this section, the principles of sections 861 through 865 and the regulations thereunder (relating to the determination of the gross and the taxable income from sources within and without the United States) generally shall be applied in determining the gross and the taxable income from sources within and without the relevant possession. In the application of such principles, the name of the relevant possession shall be used instead of the term *United States*, the term *bona fide resident* of followed by the name of the relevant possession shall be used instead of the term *United States resident*, and the term *domestic* shall be construed to mean created or organized in such possession.

(c) *U.S. income*—(1) *In general.* Except as provided in paragraph (d) of this section, income from sources within the relevant possession shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(i) The income is received in exchange for consideration provided to another person; and

(ii) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Income from certain sales of inventory property.* For special rules that apply to determine the source of income from certain sales of inventory property, see §1.863–3(f).

(e) *Income from services*—(1) *No de minimis rule.* In applying the principles of section 861 and the regulations thereunder pursuant to paragraph (b) of this section, the exception in section 861(a)(3) shall not apply.

(2) *Service in the Armed Forces.* In the case of a member of the Armed Forces of the United States, the following rules shall apply for determining the source of compensation for services performed in compliance with military orders:

(i) If the individual is a bona fide resident of a possession and such services are performed in the United States or in another possession, the compensation constitutes income from sources within the possession of which the individual is a bona fide resident (and not from sources within the United States or such other possession).

(ii) If the individual is not a bona fide resident of a possession and such services are performed in a possession, the compensation constitutes income from sources within the United States (and not from sources within such possession).

(f) *Gains from certain dispositions of property*—(1) *Property of former U.S. residents.* (i) Income from sources within the relevant possession shall not include gains from the disposition of property described in paragraph (f)(1)(ii) of this section by an individual described in paragraph (f)(1)(iii) of this section. See also section 1277(e) of Public Law 99–514 (100 Stat. 2985) (providing that gains from the disposition of certain property by individuals who acquired residency in certain possessions shall be considered to be from sources within the United States).

(ii) Property is described in this paragraph (f)(1)(ii) when the following conditions are satisfied—

(A) The property is of a kind described in section 731(c)(3)(C)(i) or 954(c)(1)(B); and

(B) The property was owned by the individual before such individual became a bona fide resident of the relevant possession.

(iii) An individual is described in this paragraph (f)(1)(iii) when the following conditions are satisfied—

(A) For the taxable year for which the source of the gain must be determined, the individual is a bona fide resident of the relevant possession; and

(B) For any of the 10 years preceding such year, the individual was a citizen or resident of the United States (other than a bona fide resident of the relevant possession).

(iv) If an individual described in paragraph (f)(1)(iii) of this section exchanges property described in paragraph (f)(1)(ii) of this section for other property in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, such other property shall also be considered property described in paragraph (f)(1)(ii) of this section.

(v) If an individual described in paragraph (f)(1)(iii) of this section owns, directly or indirectly, at least 10 percent (by value) of any entity to which property described in paragraph (f)(1)(ii) of this section is transferred in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, any gain recognized upon a disposition of the property by such entity shall be treated as income from sources outside the relevant possession if any gain recognized upon a direct or indirect disposition of the individual's interest in such entity would have been so treated

under paragraph (f)(1)(iv) of this section.

(2) *Special rules under section 865 for possessions*—(i) Except as provided in paragraph (f)(1) of this section—

(A) Gain that is considered to be derived from sources outside of the United States under section 865(g)(3) shall be considered income from sources within Puerto Rico; and

(B) Gain that is considered to be derived from sources outside of the United States under section 865(h)(2)(B) shall be considered income from sources within the possession in which the liquidating corporation is created or organized.

(ii) In applying the principles of section 865 and the regulations thereunder pursuant to paragraph (b) of this section, the rules of section 865(g) shall not apply, but the special rule of section 865(h)(2)(B) shall apply with respect to gain recognized upon the liquidation of corporations created or organized in the United States.

(g) *Dividends*—(1) *Dividends from certain possessions corporations*—(i) *In general.* Except as provided in paragraph (g)(1)(ii) of this section, with respect to any possessions shareholder, only the possessions source ratio of any dividend paid or accrued by a corporation created or organized in a possession (possessions corporation) shall be treated as income from sources within such possession. For purposes of this paragraph (g)—

(A) The possessions source ratio shall be a fraction, the numerator of which equals the gross income of the possessions corporation from sources within the possession in which it is created or organized (applying the rules of this section) for the testing period, and the denominator of which equals the total gross income of the corporation for the testing period; and

(B) The term possessions shareholder means any individual who is a bona fide resident of the possession in which the corporation is created or organized and who owns, directly or indirectly, at least 10 percent of the total voting stock of the corporation.

(ii) *Dividends from corporations engaged in the active conduct of a trade or business in the relevant possession.* The entire amount of any dividend paid or accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized when the following conditions are met—

(A) 80 percent or more of the gross income of the corporation for the testing period was derived from sources within such possession (applying the rules of this section) or was effectively connected with the conduct of a trade or business in such possession (applying the rules of § 1.937–3T); and

(B) 50 percent or more of the gross income of the corporation for the testing period was derived from the active conduct of a trade or business within such possession.

(iii) *Testing period.* For purposes of this paragraph (g)(1), the term *testing period* means the 3-year period ending with the close of the taxable year of the payment of the dividend (or for such part of such period as the corporation has been in existence).

(iv) *Subsidiary look-through rule.* For purposes of this paragraph (g)(1), if a possessions corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, such possessions corporation shall be treated as if it—

(A) Directly received its proportionate share of the income of such other corporation; and

(B) Actively conducted any trade or business actively conducted by such other corporation.

(2) *Dividends from other corporations.* In applying the principles of section 861 and the regulations thereunder pursuant to paragraph (b) of this section, the special rules relating to dividends for which deductions are allowable under section 243 or 245 shall not apply.

(h) *Income inclusions.* For purposes of determining whether an amount described in section 904(h)(1)(A) constitutes income from sources within the relevant possession—

(1) If the individual owns (directly or indirectly) at least 10 percent of the total voting stock of the corporation from which such amount is derived, the principles of section 904(h)(2) shall apply. In the case of an individual who is not a possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), the preceding sentence shall

apply only if the corporation qualifies as a *United States-owned foreign corporation* for purposes of section 904(h); and

(2) In all other cases, the amount shall be considered income from sources in the jurisdiction in which the corporation is created or organized.

(i) *Interest*—(1) *Interest from certain possessions corporations*—(i) *In general.* Except as provided in paragraph (i)(1)(ii) of this section, with respect to any possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), interest paid or accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized to the extent that such interest is allocable to assets that generate, have generated, or could reasonably have been expected to generate income from sources within such possession (under the rules of this section) or income effectively connected with the conduct of a trade or business within such possession (under the rules of §1.937–3T). For purposes of the preceding sentence, the principles of §§1.861–9 through 1.861–12 shall apply.

(ii) *Interest from corporations engaged in the active conduct of a trade or business in the relevant possession.* The entire amount of any interest paid or accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized when the conditions of paragraphs (g)(1)(ii) (A) and (B) of this section are met (applying the rules of paragraphs (g)(1) (iii) and (iv) of this section).

(2) *Interest from partnerships.* Interest paid or accrued by a partnership shall be treated as income from sources within a possession only to the extent that such interest is allocable to income effectively connected with the conduct of a trade or business in such possession. For purposes of the preceding sentence, the principles of §1.882–5 shall apply (as if the partnership were a foreign corporation and as if the trade or business in the possession were a trade or business in the United States).

(j) *Indirect ownership.* For purposes of this section, the rules of section 318(a)(2) shall apply except that the language ''5 percent'' shall be used instead of ''50 percent'' in section 318(a)(2)(C).

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

*Example 1.* X, a U.S. citizen, resides in State N and acquires the stock of Corporation C, a domestic corporation, in 2000. X moves to the Northern Mariana Islands (NMI) in 2003. In 2004, while a bona fide resident of the NMI, X recognizes gain on the sale of the Corporation C stock. Pursuant to section 1277(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (October 22, 1986), this gain is treated as income from sources within the United States for all purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI), and not as income from sources in the NMI.

*Example 2.* X, a U.S. citizen, resides in State F and acquires a 5 percent interest in Partnership P in 2003. X moves to the U.S. Virgin Islands (USVI) in 2004. In 2006, while a bona fide resident of the USVI, X recognizes gain on the sale of the interest in Partnership P. Pursuant to paragraph (f)(1) of this section, the gain shall not be treated as income from sources within the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)).

*Example 3.* X, a bona fide resident of Possession I, a section 931 possession (as defined in §1.931-1T(c)(1)), is engaged in a trade or business in the United States through an office in State H. In 2005, this office materially participates in the sale of inventory property in Possession I, such that the income from these inventory sales is considered effectively connected to this trade or business in the United States under section 864(c)(4)(B)(iii). This income shall not be treated as income from sources within Possession I for purposes of section 931(a)(1) pursuant to paragraph (c)(1)(ii) of this section, but nonetheless shall continue to be treated as income from sources without the United States under section 862 (for example, for purposes of section 904).

*Example 4.* (i) X, a bona fide resident of Possession I, owns 25 percent of the outstanding shares of A Corp, a corporation organized under the laws of Possession I. In 2006, X receives a dividend of $70x from A Corp. During 2004 through 2006, A Corp has gross income from the following sources:

| Year | Possession I sources | Sources outside possession I |
|---|---|---|
| 2004 | $10x | $20x |
| 2005 | 20x | 10x |
| 2006 | 25x | 15x |

(ii) A Corp owns 50 percent of the outstanding shares of B Corp, a corporation organized under the laws of Country FC. During 2004 through 2006, B Corp has gross income from the following sources:

| Year | Possession I sources | Sources outside possession I |
|---|---|---|
| 2004 | $10x | $6x |
| 2005 | 14x | 8x |
| 2006 | 10x | 4x |

(iii) A Corp is treated as having received 50 percent of the gross income of B Corp. Therefore, for 2004 through 2006, the gross income of A Corp is from the following sources:

| Year | Possession I sources | Sources outside possession I |
|---|---|---|
| 2004 | $15x | $23x |
| 2005 | 27x | 14x |
| 2006 | 30x | 17x |
| Totals | 72x | 54x |

(iv) Pursuant to paragraph (g) of this section, the portion of the dividend of $70x that X receives from Corp A in 2006 that is treated as income from sources within Possession I is 72/126 of $70x, or $40x.

*Example 5.* X is a U.S. citizen and a bona fide resident of the Northern Mariana Islands (NMI). In 2005, X receives compensation for services performed as a member of the crew of a fishing boat. Ten percent of the services for which X receives compensation are performed in the NMI, and 90 percent of X's services are performed in international waters. X is a ''United States person'' as defined in section 7701(a)(30)(A). Accordingly, pursuant to section 863(d)(1)(A), the compensation that X receives for services performed in international waters is treated as income from sources within the United States for purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI). Under the principles of section 861(a)(3) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in the NMI is treated as income from sources within the NMI.

(l) *Effective date.* Except as otherwise provided in this paragraph (l), this section applies to income earned in tax years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (f) of this section applies to dispositions after April 11, 2005. Paragraphs (c)(2), (g)(1), (h), and (i) of this section apply to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18942, Apr. 11, 2005]

### § 1.937–3T Income effectively connected with the conduct of a trade or business in a possession (temporary).

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is effectively connected with the conduct of a trade or business within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including sections 881(b) and 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code. Paragraph (c) of this section does not apply, however, for purposes of section 881(b). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term *United States* where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws.

(b) *In general.* Except as provided in paragraphs (c) and (d) of this section, the principles of section 864(c) and the regulations thereunder (relating to the determination of income, gain or loss which is effectively connected with the conduct of a trade or business within the United States) shall generally be applied in determining whether income is effectively connected with the conduct of a trade or business within the relevant possession (except for the substitution of the name of the relevant possession for the term *United States* where appropriate), without regard to whether the taxpayer qualifies as a nonresident alien individual or a foreign corporation with respect to such possession. For purposes of the preceding sentence, all income other than income from sources within the relevant possession (as determined under the rules of §1.937–2T) shall be considered income from sources without the relevant possession, and subject to the rules of this section, the principles of section 864(c)(4) shall apply for purposes of determining whether such income constitutes income effectively

connected with the conduct of a trade or business in the relevant possession.

(c) *U.S. income*—(1) *In general.* Except as provided in paragraph (d) of this section, income considered to be effectively connected with the conduct of a trade or business within the relevant possession shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(i) The income is received in exchange for consideration provided to another person; and

(ii) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Income from certain sales of inventory property.* Paragraph (c) of this section shall not apply to income from sales of inventory property described in §1.863–3(f).

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

*Example 1.* X is a bona fide resident of Possession I, a section 931 possession (as defined in §1.931–1T(c)(1)). X has an office in Possession I from which X conducts a business consisting of the development and sale of specialized computer software. A purchaser of software will frequently pay X an additional amount to install the software on the purchaser's operating system and to ensure that the software is functioning properly. X performs the installation services at the purchaser's place of business which may be in Possession I, in the United States, or in another country. The provision of such services is not *de minimis* and constitutes a separate transaction under the rules of §1.861–18. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, the compensation that X receives for personal services performed outside of Possession I is not considered to be effectively connected with the conduct of a trade or business in Possession I for purposes of section 931(a)(2).

*Example 2.* (i) F Bank is organized under the laws of Country FC and operates an active banking business from offices in the U.S. Virgin Islands (USVI). In connection with this banking business, F Bank makes loans to and receives interest payments from borrowers who reside in the USVI, in the United States, and in Country FC.

(ii) Under the principles of section 861(a)(1) as applied pursuant to §1.937–2T(b), interest payments received by F Bank from borrowers who reside in the United States or in Country FC constitute income from sources outside of the USVI. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, interest income from sources outside of the USVI generally may constitute income that is effectively connected with the conduct of a trade or business within the USVI for purposes of the Internal Revenue Code. However, interest payments received by F Bank from borrowers who reside in the United States constitute income from sources within the United States under section 861(a)(1). Accordingly, under paragraph (c)(1) of this section, such interest income shall not be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)). Interest payments received by F Bank from borrowers who reside in Country FC, however, may be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (including section 934(b)).

(iii) To the extent that, as described in section 934(a), the USVI administers income tax laws that are identical (except for the substitution of the name of the USVI for the term *United States* where appropriate) to those in force in the United States, interest payments received by F Bank from borrowers who reside in the United States or in Country FC may be treated as income that is effectively connected with the conduct of a trade or business in the USVI for purposes of F Bank's income tax liability to the USVI under mirrored section 882.

*Example 3.* (i) G is a partnership that is organized under the laws of, and that operates an active financing business from offices in, Possession I. Interests in G are owned by D, a bona fide resident of Possession I, and N, an alien individual who resides in Country FC. Pursuant to a pre-arrangement, G loans $x to T, a business entity organized under the laws of Country FC, and T in turn loans $y to E, a U.S. resident. In accordance with the arrangement, E pays interest to T, which in turn pays interest to G.

(ii) The arrangement constitutes a conduit arrangement under paragraph (c)(2) of this

section, and the interest payments received by G are treated as income from sources within the United States for purposes of paragraph (c)(1) of this section. Accordingly, the interest received by G shall not be treated as effectively connected with the conduct of a trade or business in Possession I for purposes of the Internal Revenue Code (including sections 931(a)(2) and 934(b), if applicable with respect to D). Whether such interest constitutes income from sources within the United States for other purposes of the Internal Revenue Code under generally applicable conduit principles will depend on the facts and circumstances. See, for example, *Aiken Indus., Inc.* v. *Commissioner*, 56 T.C. 925 (1971).

(iii) If Possession I administers 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, the interest received by G may be treated as income effectively connected with the conduct of a trade or business in Possession I under mirrored section 864(c)(4) for purposes of determining the Possession I territorial income tax liability of N under mirrored section 871.

(f) *Effective date.* Except as otherwise provided in this paragraph (f), this section applies to income earned in taxable years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (c)(2) of this section applies to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18944, Apr. 11, 2005; 70 FR 32490, June 3, 2005]

CHINA TRADE ACT CORPORATIONS

### § 1.941–1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

### § 1.941–2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C. chapter 4).

(b) The term ''special dividend'' means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) ''Taxable income derived from sources within Formosa and Hong Kong'' is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the

taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

### § 1.941–3 Illustration of principles.

The application of section 941 may be illustrated by the following example:

*Example.* (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to $100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941(b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

| | |
|---|---|
| Taxable income | $200,000 |
| Normal tax (section 11 (b)) | 60,000 |
| Surtax (section 11 (c)) | 38,500 |
| Total income tax | 98,500 |

(3) Second computation; allowing the special deduction from taxable income.

| | |
|---|---|
| Taxable income | $200,000 |

Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

| | |
|---|---|
| Special deduction from taxable income | $200,000 |
| Amount of income subject to tax under section 11 | None |

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowable and the corporation has no income tax liability for 1954.

### § 1.943–1 Withholding by a China Trade Act corporation.

Dividends paid by a China Trade Act corporation to a nonresident alien individual, foreign partnership, or foreign corporation are subject to withholding of tax at source under § 1.1441–1. However, see paragraph (c) of § 1.1441–4 for exemption applicable to dividends paid to residents of Formosa or Hong Kong.

[T.D. 6908, 31 FR 16769, Dec. 31, 1966]

## CONTROLLED FOREIGN CORPORATIONS

### § 1.951–1 Amounts included in gross income of United States shareholders.

(a) *In general.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957) for an uninterrupted period of 30 days or more (determined under paragraph (f) of this section) during any taxable year of such corporation beginning after December 31, 1962, every person—

(1) Who is a United States shareholder (as defined in section 951(b) and paragraph (g) of this section) of such corporation at any time during such taxable year, and

(2) Who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends, the sum of—

(i) Such shareholder's pro rata share (determined under paragraph (b) of this section) of the corporation's subpart F income (as defined in section 952) for such taxable year of the corporation,

(ii) Such shareholder's pro rata share (determined under paragraph (c)(1) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such taxable year of the corporation,

(iii) Such shareholder's pro rata share (determined under paragraph (c)(2) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in

foreign base company shipping operations for such taxable year of the corporation, and

(iv) The amount determined under section 956 with respect to such shareholder for such taxable year of the corporation (but only to the extent not excluded from gross income under section 959(a)(2)).

(3) For purposes of determining whether a United States shareholder which is a domestic corporation is a personal holding company under section 542 and §1.542–1, the character of the amount includible in gross income of such domestic corporation under this paragraph shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation. See paragraph (a) of §1.957–2 for special limitation on the amount of subpart F income in the case of a controlled foreign corporation described in section 957(b). See section 970(a) and §1.970–1 which provides for the reduction of subpart F income of export trade corporations.

(b) *Limitation on a United States shareholder's pro rata share of subpart F income*—(1) *In general.* For purposes of paragraph (a)(2)(i) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's subpart F income for the taxable year of such corporation is—

(i) The amount which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in such corporation's taxable year, on which such corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount which bears the same ratio to its subpart F income for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year, reduced by—

(ii) The amount of distributions received by any other person during such taxable year as a dividend with respect to such stock, but only to the extent that such distributions do not exceed the dividend which would have been received by such other person if the distributions by such corporation to all its shareholders had been the amount which bears the same ratio to the subpart F income of such corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire taxable year.

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

*Example 1.* A, a United States shareholder, owns 100 percent of the only class of stock of M, a controlled foreign corporation throughout 1963. Both A and M Corporation use the calendar year as a taxable year. For 1963, M Corporation derives $100 of subpart F income, has $100 of earnings and profits, and makes no distributions. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i).

*Example 2.* The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A sells 60 percent of such stock to B, a nonresident alien, on May 26, 1963. Thus, M Corporation is a controlled foreign corporation for the period January 1, 1963, through May 26, 1963. A must include $40 ($100×146/365) in his gross income for 1963 under section 951(a)(1)(A)(i).

*Example 3.* The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A holds 60 percent of such stock on December 31, 1963, having acquired such interest on May 26, 1963, from B, a nonresident alien, who owned such interest from January 1, 1963. Before A's acquisition of such stock, M Corporation had distributed a dividend of $15 to B in 1963 with respect to such stock. A must include $21 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

| | | |
|---|---|---|
| Corporation M's Subpart F income for 1963 | | $100 |
| Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 5–26–63) during which M Corporation is not a controlled foreign corporation ($100×146/365) | | 40 |
| Subpart F income for 1963 as limited by section 951(a)(2)(A) | | 60 |
| A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $60) | | 36 |
| Less: Reduction under section 951(a)(2)(B) for dividends received by B during 1963 with respect to the stock acquired by A in M Corporation: | | |
| (i) Dividend received by B | 15 | |

| | | |
|---|---|---|
| (ii) B's pro rata share of the amount which bears the same ratio to M Corporation's subpart F income for 1963 ($100) as the period during which A did not own (within the meaning of section 958(a)) his stock (146 days) bears to the entire taxable year (365 days) (60 percent of ($100×146/365)) | 24 | |
| (iii) Amount of reduction (lesser of (i) or (ii)) | | 15 |
| A's pro rata share of Subpart F income as determined under section 951(a)(2) | | 21 |

*Example 4.* A, a United States shareholder, owns 100 percent of the only class of stock of P, a controlled foreign corporation throughout 1963, and P owns 100 percent of the only class of stock of R, a controlled foreign corporation throughout 1963. A and Corporations P and R each use the calendar year as a taxable year. For 1963, R Corporation derives $100 of subpart F income, has $100 of earnings and profits, and distributes a dividend of $20 to P Corporation. Corporation P has no income for 1963 other than the dividend received from R Corporation. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i) as subpart F income of R Corporation for such year. Such subpart F income is not reduced under section 951(a)(2)(B) for the dividend of $20 paid to P Corporation because there was no part of the year 1963 during which A did not own (within the meaning of section 958(a)) the stock of R Corporation. By reason of the application of section 959(b), the $20 distribution from R Corporation to P Corporation is not again includible in the gross income of A under section 951(a).

*Example 5.* The facts are the same as in example 4, except that instead of holding the stock of R Corporation for the entire year, P Corporation acquires 60 percent of the only class of stock of R Corporation on March 14, 1963, from C, a nonresident alien, after R Corporation distributes in 1963 a dividend of $35 to C with respect to the stock so acquired by P Corporation. The stock interest so acquired by P Corporation was owned by C from January 1, 1963, until acquired by P Corporation. A must include $36 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

| | | |
|---|---|---|
| Corporation R's Subpart F income for 1963 | | $100 |
| Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 3–14–63) during which R Corporation is not a controlled foreign corporation ($100×73/365) | | 20 |
| Subpart F income for 1963 as limited by section 951(a)(2)(A) | | 80 |
| A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $80) | | 48 |
| Less: Reduction under section 951(a)(2)(B) for dividends received by C during 1963 with respect to the stock indirectly acquired by A in R Corporation: | | |
| (i) Dividend received by C | 35 | |
| (ii) C's pro rata share of the amount which bears the same ratio to R Corporation's Subpart F income for 1963 ($100) as the period during which A did not indirectly own (within the meaning of section 958(a)(2)) his stock (73 days) bears to the entire taxable year (365 days) (60 percent of ($100×73/365)) | 12 | |
| (iii) Amount of reduction (lesser of (i) or (ii)) | | 12 |
| A's pro rata share of Subpart F income as determined under section 951 (a)(2) | | 36 |

(c) *Limitation on a United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investments*—(1) *Investments in less developed countries.* For purposes of paragraph (a)(2)(ii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3), as in effect before the enactment of the Tax Reduction Act of 1975, and paragraph (c) of §1.955–1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of §1.955–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(2) *Investments in foreign base company shipping operations.* For purposes of paragraph (a)(2)(iii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3) and paragraph (c) of §1.955A–1) for such taxable year as the

part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of §1.955A–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(d) [Reserved]

(e) *Pro rata share defined*—(1) *In general.* For purposes of paragraphs (b) and (c) of this section, a United States shareholder's pro rata share of the controlled foreign corporation's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, or previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, respectively, for any taxable year is his pro rata share determined under §1.952–1(a), §1.955–1(c), or §1.955A–1(c), respectively.

(2) *One class of stock.* If a controlled foreign corporation for a taxable year has only one class of stock outstanding, each United States shareholder's pro rata share of such corporation's subpart F income or withdrawal for the taxable year under paragraph (e)(1) of this section shall be determined by allocating the controlled foreign corporation's earnings and profits on a per share basis.

(3) *More than one class of stock*—(i) *In general.* Subject to paragraphs (e)(3)(ii) through (e)(3)(v) of this section, if a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income or withdrawal for the taxable year taken into account with respect to any one class of stock for purposes of paragraph (e)(1) of this section shall be that amount which bears the same ratio to the total of such subpart F income or withdrawal for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year (not reduced by actual distributions during the year) were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation (the hypothetical distribution date), bear to the total earnings and profits of such corporation for such taxable year.

(ii) *Discretionary power to allocate earnings to different classes of stock*—(A) *In general.* Subject to paragraph (e)(3)(iii) of this section, the rules of this paragraph apply for purposes of paragraph (e)(1) of this section if the allocation of a controlled foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation (discretionary distribution rights). First, the earnings and profits of the corporation are allocated under paragraph (e)(3)(i) of this section to any class or classes of stock with non-discretionary distribution rights (*e.g.*, preferred stock entitled to a fixed return). Second, the amount of earnings and profits allocated to a class of stock with discretionary distribution rights shall be that amount which bears the same ratio to the remaining earnings and profits of such corporation for such taxable year as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock with discretionary distribution rights of such corporation, determined on the hypothetical distribution date. For purposes of the preceding sentence, in the case where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same on the hypothetical distribution date, the allocation of earnings and profits to such classes shall be made as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share.

(B) *Special rule for redemption rights.* For purposes of paragraph (e)(3)(ii)(A) of this section, discretionary distribution rights do not include rights to redeem shares of a class of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)).

(iii) *Special allocation rule for stock with mixed distribution rights.* For purposes of paragraphs (e)(3)(i) and (e)(3)(ii) of this section, in the case of a class of stock with both discretionary and non-discretionary distribution rights, earnings and profits shall be allocated to the non-discretionary distribution rights under paragraph (e)(3)(i) of this section and to the discretionary distribution rights under paragraph (e)(3)(ii) of this section. In such a case, paragraph (e)(3)(ii) of this section will be applied such that the value used in the ratio will be the value of such class of stock solely attributable to the discretionary distribution rights of such class of stock.

(iv) *Dividend arrearages.* For purposes of paragraph (e)(3)(i) of this section, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962, or the date on which such stock was issued, whichever is later.

(v) *Earnings and profits attributable to certain section 304 transactions.* For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has more than one class of stock outstanding and the corporation has earnings and profits and subpart F income for a taxable year attributable to a transaction described in section 304, and such transaction is part of a plan a principal purpose of which is the avoidance of Federal income taxation, the amount of such earnings and profits allocated to any one class of stock shall be that amount which bears the same ratio to the remainder of such earnings and profits as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock of the corporation, determined on the hypothetical distribution date.

(4) *Scope of hypothetical distribution*—(i) *Redemption rights.* Notwithstanding the terms of any class of stock of the controlled foreign corporation or any agreement or arrangement with respect thereto, no amount shall be considered to be distributed as part of the hypothetical distribution with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent that a distribution of such amount would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), a distribution in liquidation, or a return of capital.

(ii) *Certain cumulative preferred stock.* For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has one or more classes of preferred stock with cumulative dividend rights, such stock shall be considered for the purposes of this section as stock with discretionary distribution rights. As a result, the provisions of paragraph (e)(3)(ii) of this section shall apply for purposes of allocating earnings and profits to such stock, except that earnings and profits shall first be allocated to the stock under paragraph (e)(3)(i) of this section to the extent of any dividends paid with respect to the stock during the taxable year. Additional earnings and profits will be allocated to the stock only in an amount equal to the excess (if any) of the amount of earnings and profits allocated to the stock under paragraph (e)(3)(ii) of this section over the amount of such dividends. Notwithstanding the foregoing, if a class of redeemable preferred stock with cumulative dividend rights has a mandatory redemption date, and all dividend arrearages with respect to such stock compound at least annually at a rate that is not lower than the applicable Federal rate (as defined in section 1274(d)(1)) (AFR) that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date, based on a comparable compounding assumption, such stock shall not be considered for purposes of this section as stock with discretionary distribution rights.

(5) *Restrictions or other limitations on distributions*—(i) *In general.* A restriction or other limitation on distributions of earnings and profits by a controlled foreign corporation will not be taken into account, for purposes of this section, in determining the amount of earnings and profits that shall be allocated to a class of stock of the controlled foreign corporation or the amount of the United States shareholder's pro rata share of the controlled foreign corporation's subpart F income or withdrawal for the taxable year.

(ii) *Definition.* For purposes of this section, a *restriction or other limitation on distributions* includes any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation to a United States shareholder, other than currency or other restrictions or limitations imposed under the laws of any foreign country as provided in section 964(b).

(iii) *Exception for certain preferred distributions.* The right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate, a stated return expressed in terms of a certain amount of dollars or foreign currency, or otherwise) with respect to a class of stock the distribution of which is a condition precedent to a further distribution of earnings or profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation on the distribution of earnings and profits by a controlled foreign corporation under paragraph (e)(5) of this section.

(iv) *Illustrative list of restrictions and limitations.* Except as provided in paragraph (e)(5)(iii) of this section, restrictions or other limitations on distributions include, but are not limited to—

(A) An arrangement that restricts the ability of the controlled foreign corporation to pay dividends on a class of shares of the corporation owned by United States shareholders until a condition or conditions are satisfied (*e.g.*, until another class of stock is redeemed);

(B) A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or

(C) An arrangement that conditions the ability of the controlled foreign corporation to pay dividends to its shareholders on the financial condition of the controlled foreign corporation.

(6) *Examples.* The application of this section may be illustrated by the following examples:

*Example 1.* (i) *Facts.* FC1, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of one class of stock. Corp E, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 60 shares. Corp H, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 40 shares. FC1, Corp E, and Corp H each use the calendar year as a taxable year. Corp E and Corp H are shareholders of FC1 for its entire 2005 taxable year. For 2005, FC1 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). FC1 makes no distributions during that year.

(ii) *Analysis.* FC1 has one class of stock. Therefore, under paragraph (e)(2) of this section, FC1's earnings and profits are allocated on a per share basis. Accordingly, for the taxable year 2005, Corp E's *pro rata* share of FC1's subpart F income is $60x (60 / 100 × $100x) and Corp H's *pro rata* share of FC1's subpart F income is $40x (40 / 100 × $100x).

*Example 2.* (i) *Facts.* FC2, a controlled foreign corporation within the meaning of section 957(a), has outstanding 70 shares of common stock and 30 shares of 4-percent, nonparticipating, voting, preferred stock with a par value of $10x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC2. Corp A, a domestic corporation and a United States shareholder of FC2, within the meaning of section 951(b), owns all of the common shares. Individual B, a foreign individual, owns all of the preferred shares. FC2 and Corp A each use the calendar year as a taxable year. Corp A and Individual B are shareholders of FC2 for its entire 2005 taxable year. For 2005, FC2 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC2 distributes as a dividend $12x to Individual B with respect to Individual B's preferred shares. FC2 makes no other distributions during that year.

(ii) *Analysis.* FC2 has two classes of stock, and there are no restrictions or other limitations on distributions within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2005, $12x would be distributed with respect to Individual B's preferred shares and the remainder, $38x, would be distributed with respect to Corp A's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp A's *pro rata* share of FC1's subpart F income is $38x for taxable year 2005.

*Example 3.* (i) *Facts.* The facts are the same as in *Example 2*, except that the shares owned by Individual B are Class B common shares and the shares owned by Corp A are Class A common shares and the board of directors of FC2 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. The value of the Class A common shares on the last day of FC2's 2005 taxable year is $680x and the value of the Class B common shares on that date is $300x. The board of directors of FC2 determines that FC2 will not make any distributions in 2005 with respect to the Class A and B common shares of FC2.

(ii) *Analysis.* The allocation of FC2's earnings and profits between its Class A and Class B common shares depends solely on the exercise of discretion by the board of directors of FC2. Therefore, under paragraph (e)(3)(ii)(A) of this section, the allocation of earnings and profits between the Class A and Class B common shares will depend on the value of each class of stock on the last day of the controlled foreign corporation's taxable year. On the last day of FC2's taxable year 2005, the Class A common shares had a value of $9.30x/share and the Class B common shares had a value of $10x/share. Because each share of the Class A and Class B common stock of FC2 has substantially the same value on the last day of FC2's taxable year, under paragraph (e)(3)(ii)(A) of this section, for purposes of allocating the earnings and profits of FC2, the Class A and Class B common shares will be treated as one class of stock. Accordingly, for FC2's taxable year 2005, the earnings and profits of FC2 are allocated $35x (70 / 100 × $50x) to the Class A common shares and $15x (30 / 100 × $50x) to the Class B common shares. For its taxable year 2005, Corp A's *pro rata* share of FC2's subpart F income will be $35x.

*Example 4.* (i) *Facts.* FC3, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock and 10 shares of 5-percent nonparticipating, voting preferred stock with a par value of $50x per share. The value of the Class A shares on the last day of FC3's 2005 taxable year is $800x. The value of the Class B shares on that date is $200x. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors of FC3, and the board of directors of FC3 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. Corp D, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class A shares. Corp N, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class B shares. Corp S, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the preferred shares. FC3, Corp D, Corp N, and Corp S each use the calendar year as a taxable year. Corp D, Corp N, and Corp S are shareholders of FC3 for all of 2005. For 2005, FC3 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC3 distributes as a dividend $25x to Corp S with respect to the preferred shares. The board of directors of FC3 determines that FC3 will make no other distributions during that year.

(ii) *Analysis.* The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Pursuant to paragraph (e)(3)(i) of this section, if the total $100x of earnings were distributed on December 31, 2005, $25x would be distributed with respect to Corp S's preferred shares and the remainder, $75x would be distributed with respect to Corp D's Class A shares and Corp N's Class B shares. The allocation of that $75x between its Class A and Class B shares depends solely on the exercise of discretion by the board of directors of FC3. The value of the Class A shares ($8x/share) and the value of the Class B shares ($2x/share) are not substantially the same on the last day of FC3's taxable year 2005. Therefore for FC3's taxable year 2005, under paragraph (e)(3)(ii)(A) of this section, the earnings and profits of FC3 are allocated $60x ($800 / $1,000 × $75x) to the Class A shares and $15x ($200 / $1,000 × $75x) to the Class B shares. For the 2005 taxable year, Corp D's *pro rata* share of FC3's subpart F income will be $60x, Corp N's *pro rata* share of FC3's subpart F income will be $15x and Corp S's *pro rata* share of FC3's subpart F income will be $25x.

*Example 5.* (i) *Facts.* FC4, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of participating, voting, preferred stock and 200 shares of common stock. The owner of a share of preferred stock is entitled to an annual dividend equal to 0.5-percent of FC4's retained earnings for the taxable year and also is entitled to additional dividends when declared by the board of directors of FC4. The common shareholders are entitled to

dividends when declared by the board of directors of FC4. The board of directors of FC4 has discretion to pay dividends to the participating portion of the preferred shares (after the payment of the preference) and the common shares. The value of the preferred shares on the last day of FC4's 2005 taxable year is $600x ($100x of this value is attributable to the discretionary distribution rights of these shares) and the value of the common shares on that date is $400x. Corp E, a domestic corporation and United States shareholder of FC4, within the meaning of section 951(b), owns all of the preferred shares. FC5, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the common shares. FC 4 and Corp E each use the calendar year as a taxable year. Corp E and FC5 are shareholders of FC4 for all of 2005. For 2005, FC4 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC4's retained earnings are equal to its earnings and profits. FC4 distributes as a dividend $20x to Corp E that year with respect to Corp E's preferred shares. The board of directors of FC4 determines that FC4 will not make any other distributions during that year.

(ii) *Analysis.* The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. The allocation of FC4's earnings and profits between its preferred shares and common shares depends, in part, on the exercise of discretion by the board of directors of FC4 because the preferred shares are shares with both discretionary distribution rights and non-discretionary distribution rights. Paragraph (e)(3)(i) of this section is applied first to determine the allocation of earnings and profits of FC4 to the non-discretionary distribution rights of the preferred shares. If the total $100x of earnings were distributed on December 31, 2005, $20x would be distributed with respect to the non-discretionary distribution rights of Corp E's preferred shares. Accordingly, $20x would be allocated to such shares under paragraphs (e)(3)(i) and (iii) of this section. The remainder, $80x, would be allocated under paragraph (e)(3)(ii)(A) and (e)(3)(iii) of this section between the preferred and common shares by reference to the value of the discretionary distribution rights of the preferred shares and the value of the common shares. Therefore, the remaining $80x of earnings and profits of FC4 are allocated $16x ($100x / $500x × $80x) to the preferred shares and $64x ($400x / $500x × $80) to the common shares. For its taxable year 2005, Corp E's *pro rata* share of FC4's subpart F income will be $36x ($20x + $16x).

*Example 6.* (i) *Facts.* FC6, a controlled foreign corporation within the meaning of section 957(a), has outstanding 10 shares of common stock and 400 shares of 2-percent nonparticipating, voting, preferred stock with a par value of $1x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC6. Corp M, a domestic corporation and a United States shareholder of FC6, within the meaning of section 951(b), owns all of the common shares. FC7, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the preferred shares. Corp M and FC7 cause the governing documents of FC6 to provide that no dividends may be paid to the common shareholders until FC6 cumulatively earns $100,000x of income. FC6 and Corp M each use the calendar year as a taxable year. Corp M and FC7 are shareholders of FC6 for all of 2005. For 2005, FC6 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC6 distributes as a dividend $8x to FC7 with respect to FC7's preferred shares. FC6 makes no other distributions during that year.

(ii) *Analysis.* The agreement restricting FC6's ability to pay dividends to common shareholders until FC6 cumulatively earns $100,000x of income is a restriction or other limitation, within the meaning of paragraph (e)(5) of this section, and will be disregarded for purposes of calculating Corp M's *pro rata* share of subpart F income. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2005, $8x would be distributed with respect to FC7's preferred shares and the remainder, $42x, would be distributed with respect to Corp M's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp M's *pro rata* share of FC6's subpart F income is $42x for taxable year 2005.

*Example 7.* (i) *Facts.* FC8, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 10 shares of 4-percent voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC8 has the right to redeem at any time, in whole or in part, the preferred stock. FP, a foreign corporation, owns all of the preferred shares. Corp G, a domestic corporation wholly owned by FP and a United States shareholder of FC8, within the meaning of section 951(b), owns all of the common shares. FC8 and Corp G each use the calendar year as a taxable year. FP and Corp G are shareholders of FC8 for all of 2005. For 2005, FC8 has $100x of earnings and profits, and income of $100x with respect to which amounts

are required to be included in gross income of a United States shareholder under section 951(a). In 2005, FC8 distributes as a dividend $20x to FP with respect to FP's preferred shares. FC8 makes no other distributions during that year.

(ii) *Analysis.* Pursuant to paragraph (e)(3)(ii)(B) of this section, the redemption rights of the preferred shares will not be treated as a discretionary distribution right under paragraph (e)(3)(ii)(A) of this section. Further, if FC8 were treated as having redeemed any preferred shares under paragraph (e)(3)(i) of this section, the redemption would be treated as a distribution to which section 301 applies under section 302(d) due to FP's constructive ownership of the common shares. However, pursuant to paragraph (e)(4) of this section, no amount of earnings and profits would be allocated to the preferred shareholders on the hypothetical distribution date, under paragraph (e)(3)(i) of this section, as a result of FC8's right to redeem, in whole or in part, the preferred shares. FC8's redemption rights with respect to the preferred shares cannot affect the allocation of earnings and profits between FC8's shareholders. Therefore, the redemption rights are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Additionally, the nondiscretionary distribution rights of the preferred shares are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Therefore, if the total $100x of earnings were distributed on December 31, 2005, $20x would be distributed with respect to FP's preferred shares and the remainder, $80x, would be distributed with respect to Corp G's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp G's *pro rata* share of FC8's subpart F income is $80 for taxable year 2005.

*Example 8.* (i) *Facts.* FC9, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of $100x per share. Individual J, a United States shareholder of FC9, within the meaning of section 951(b), who uses the calendar year as a taxable year, owns 30 shares of the common stock, and 15 shares of the preferred stock during tax year 2005. The remaining 10 common shares and 45 preferred shares of FC9 are owned by Individual N, a foreign individual. Individual J and Individual N are shareholders of FC9 for all of 2005. For taxable year 2005, FC9 has $1,000x of earnings and profits, and income of $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a).

(ii) *Analysis.* The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $1,000x of earnings and profits were distributed on December 31, 2005, $360x (0.06 × $100x × 60) would be distributed with respect to FC9's preferred stock and $640x ($1,000x minus $360x) would be distributed with respect to its common stock. Accordingly, of the $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), $180x ($360x / $1,000x × $500x) is allocated to the outstanding preferred stock and $320x ($640x / $1,000x × $500x) is allocated to the outstanding common stock. Therefore, under paragraph (e)(3)(i) of this section, Individual J's *pro rata* share of such amounts for 2005 is $285x [($180x × 15 / 60) + ($320x × 30 / 40)].

*Example 9.* (i) *Facts.* In 2006, FC10, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of common stock and 100 shares of 6-percent, voting, preferred stock with a par value of $10x per share. All of the common stock is held by Corp H, a foreign corporation, which invested $1000x in FC10 in exchange for the common stock. All of the preferred stock is held by Corp J, a domestic corporation, which invested $5000x in FC10 in exchange for the preferred stock. Corp H is unrelated to Corp J. In 2006, FC10 borrows $3000x from a bank and invests $5000x in preferred stock issued by FC11, a foreign corporation the common stock of which is owned by Corp J. Corp J's adjusted basis in its FC 11 common stock is $5000x. FC11, which has no current or accumulated earnings and profits, distributes the $5000x to Corp J. Subsequently, in 2007, FC10 sells the FC11 preferred stock to FC12, a wholly-owned foreign subsidiary of FC11 that has $5000x of accumulated earnings and profits, for $5000x in a transaction described in section 304. FC10 repays the bank loan in full. For 2007, FC10 has $5000x of earnings and profits, all of which is subpart F income attributable to a section 304 dividend arising from FC10's sale of the FC11 preferred stock to FC12. At all relevant times, the value of the common stock of FC10 is $1000x and the value of the preferred stock of FC10 is $5000x.

(ii) *Analysis.* The acquisition and sale of the FC11 preferred stock by FC10 was part of a plan a principal purpose of which was the avoidance of Federal income tax by depleting the earnings and profits of FC12 and allowing FC11 to make a distribution to Corp J that it characterizes entirely as a return of basis. FC10 has $5000x of earnings and profits for 2007 attributable to a dividend from a section 304 transaction which was part of such plan. Under paragraph (e)(3)(v) of this section, these earnings and profits are allocated to the common and preferred stock of FC10 in accordance with the relative value of each class of stock ($1000x and $5000x, respectively). Thus, for taxable year 2007, $833x (⅙

× $5000x = $833x) of these earnings and profits is allocated to FC10's common stock and $4167x (5/6 × $5000x = $4167x) is allocated to its preferred stock.

(7) *Effective dates.* Except as provided in paragraphs (e)(3)(v) and (e)(4)(ii) of this section, this paragraph (e) applies for taxable years of a controlled foreign corporation beginning on or after January 1, 2005. However, if the application of this paragraph (e) for purposes of a related Internal Revenue Code provision, such as section 1248, results in an allocation to the stock of such corporation of earnings and profits that have already been allocated to the stock for an earlier year under the prior rules of §1.951–1(e), as contained in 26 CFR part 1 revised April 1, 2005, then the prior rules will continue to apply to the extent necessary to avoid such duplicative allocation.

(f) *Determination of holding period.* For purposes of sections 951 through 964, the holding period of an asset (including stock of a controlled foreign corporation) shall be determined by excluding the day on which such asset is acquired and including the day on which such asset is disposed of. The application of this paragraph may be illustrated by the following example:

*Example.* On June 30, 1963, United States person E acquires 70 of the 100 shares of the only class of stock of foreign corporation A from nonresident alien B, who until such time owns all such 100 shares. E sells 10 shares of stock of such corporation on November 30, 1963, and 60 shares on December 31, 1963, to nonresident alien F. Corporation A is a controlled foreign corporation for the period beginning with July 1, 1963, and extending through December 31, 1963. As to the 10 shares of stock sold on November 30, 1963, E is treated as not owning such shares at any time after November 30, 1963, nor before July 1, 1963. As to the remaining 60 shares of stock, E is treated as not owning them before July 1, 1963, or after December 31, 1963.

(g) *United States shareholder defined*—(1) *In general.* For purposes of sections 951 through 964, the term ''United States shareholder'' means, with respect to a foreign corporation, a United States person (as defined in section 957(d)) who owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(2) *Percentage of total combined voting power owned by United States person*—(i) *Meaning of combined voting power.* In determining for purposes of subparagraph (1) of this paragraph whether a United States person owns the requisite percentage of voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances in each case. In any case where—

(*a*) A foreign corporation has more than one class of stock outstanding, and

(*b*) One or more United States persons own (within the meaning of section 958) shares of any one class of stock which possesses the power to elect, appoint, or replace a person, or persons, who with respect to such corporation, exercise the powers ordinarily exercised by a member of the board of directors of a domestic corporation,

the percentage of the total combined voting power with respect to such corporation owned by any such United States person shall be his proportionate share of the percentage of the persons exercising the powers ordinarily exercised by members of the board of directors of a domestic corporation (described in (*b*) of this subdivision) which such class of stock (as a class) possesses the power to elect, appoint, or replace. In all cases, however, a United States person will be deemed to own 10 percent or more of the total combined voting power with respect to a foreign corporation if such person owns (within the meaning of section 958) 20 percent or more of the total number of shares of a class of stock of such corporation possessing one or more powers enumerated in paragraph (b)(1) of §1.957–1. Whether a foreign corporation is a controlled foreign corporation for purposes of sections 951 through 964 shall be determined by applying the rules of section 957 and §§1.957–1 through 1.957–4.

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

*Example 1.* Foreign corporation S has two classes of capital stock outstanding, consisting of 60 shares of class A stock and 40

shares of class B stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any dividend distributions by S Corporation. The owners of a majority of the class A stock are entitled to elect 7 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 3 of the 10 directors. Thus, the class A stock (as a class) possesses 70 percent of the total combined voting power of all classes of stock entitled to vote of S Corporation, and the class B stock (as a class) possesses 30 percent of such voting power. D, a United States person, owns 31 shares of the class A stock and thus owns 36,167 percent (31/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, D is a United States shareholder of S Corporation under section 951(b). For purposes of section 957, S Corporation is a controlled foreign corporation by reason of D's ownership of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of §1.957–1. E, a United States person, owns eight shares of the class A stock and thus owns 9.333 percent (8/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. Since E owns only 9.333 percent of such voting power and less than 20 percent of the number of shares of the class A stock, he is not a United States shareholder of S Corporation under section 951(b). F, a United States person, owns 14 shares of the class B stock and thus owns 10.5 percent (14/40×30 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, F is a United States shareholder of S Corporation under section 951(b).

*Example 2.* Foreign corporation R has three classes of stock outstanding, consisting of 10 shares of class A stock, 20 shares of class B stock, and 300 shares of class C stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any distribution by R Corporation. The owners of a majority of the class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. The class C stock is not entitled to vote. D, E, and F, United States persons, each own 2 shares of the class A stock and 100 shares of the class C stock. As owners of a majority of the class A stock, D, E, and F elect 6 members of the board of directors. D, E, and F are United States shareholders of R Corporation under section 951(b) since each owns 20 percent of the total number of shares of the class A stock which possesses the power to elect a majority of the board of directors of R Corporation. For purposes of section 957, R Corporation is a controlled foreign corporation by reason of the ownership by D, E, and F of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of §1.957–1.

[T.D. 6795, 30 FR 935, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 9222, 70 FR 49866, Aug. 25, 2005; 70 FR 67906, Nov. 9, 2005; T.D. 9251, 71 FR 8944, Feb. 22, 2006]

### §1.951–2 Coordination of subpart F with election of a foreign investment company to distribute income.

A United States shareholder who for his taxable year is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247(a) and the regulations thereunder is in effect for the taxable year of such company which ends with or within such taxable year of such shareholder shall not be required to include any amount in his gross income for his taxable year under paragraph (a) of §1.951–1 with respect to such company for that taxable year of such company.

[T.D. 6795, 30 FR 937, Jan. 29, 1965]

### §1.951–3 Coordination of subpart F with foreign personal holding company provisions.

A United States shareholder (as defined in section 951(b)) who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding company income for the taxable year of a foreign personal holding company (as defined in section 552) which for that taxable year is a controlled foreign corporation (as defined in section 957) shall not be required to include in his gross income for his taxable year under section 951(a) and paragraph (a) of §1.951–1 any amount attributable to the earnings and profits of such corporation for that taxable year of such corporation. If a foreign corporation is both a foreign personal holding company and a controlled foreign corporation for the same period which is only a part of its taxable year, then, for purposes of applying the immediately preceding sentence, such corporation shall be deemed to be, for such part of such year, a foreign personal holding company and not a controlled foreign corporation and the

earnings and profits of such corporation for the taxable year shall be deemed to be that amount which bears the same ratio to its earnings and profits for the taxable year as such part of the taxable year bears to the entire taxable year. The application of this section may be illustrated by the following examples:

*Example 1.* A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation M which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation N. A and Corporations M and N use the calendar year as a taxable year. During 1963, N Corporation derives $40,000 of gross income all of which is foreign personal holding company income within the meaning of section 553; thus, N Corporation is a foreign personal holding company for such year within the meaning of section 552(a). For 1963, N Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $30,000, derives $25,000 of subpart F income, and has earnings and profits of $32,000. During 1963, M Corporation derives $100,000 of gross income (including as a dividend under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income), 65 percent of which is foreign personal holding company income within the meaning of section 553. Therefore, M Corporation is a foreign personal holding company for such year. For 1963, M Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $90,000, determined by taking into account under section 552(c)(1) N Corporation's $30,000 of undistributed foreign personal holding company income for such year; in addition, M Corporation derives $50,000 of subpart F income and has earnings and profits of $92,000. Neither M Corporation nor N Corporation makes any actual distributions during 1963. A is required under section 551(b) to include in his gross income for 1963 as a dividend the $90,000 of M Corporation's undistributed foreign personal holding company income for such year. For 1963, A is not required to include in his gross income under section 951(a) any of the $50,000 subpart F income of M Corporation or of the $25,000 subpart F income of N Corporation.

*Example 2.* The facts are the same as in example 1, except that only 45 percent of M Corporation's gross income (determined by including under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income) is foreign personal holding company income within the meaning of section 553; accordingly, M Corporation is not a foreign personal holding company for 1963. Since for such year M Corporation is not a foreign personal holding company, the undistributed foreign personal holding company income ($30,000) of N Corporation is not required under section 555(b) to be included in the gross income of M Corporation for 1963; as a result, such income is not required under section 551(b) to be included in the gross income of A for such year even though N Corporation is a foreign personal holding company for that year. For 1963, A is required to include $75,000 in his gross income under section 951(a)(1)(A)(i) and paragraph (a) of §1.951–1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation.

*Example 3.* The facts are the same as in example 1, except that in 1963 N Corporation actually distributes $30,000 to M Corporation and M Corporation, in turn, actually distributes $90,000 to A. Under section 556 the undistributed foreign personal holding company income of both M corporation and N Corporation is thus reduced to zero; accordingly, no amount is included in the gross income of A under section 551(b) by reason of his interest in corporations M and N. A must include $75,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and paragraph (a) of §1.951–1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation. Of the $90,000 distribution received by A from M Corporation, $75,000 is excludable from his gross income under section 959(a)(1) as previously taxed earnings and profits; the remaining $15,000 is includible in his gross income for 1963 as a dividend.

*Example 4.* (a) A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation P, organized on January 1, 1963. Both A and P Corporation use the calendar year as a taxable year. During 1963, 1964, and 1965, P Corporation is not a foreign personal holding company as defined in section 552(a); in each of such years, P Corporation derives dividend income of $10,000 which constitutes foreign personal holding company income (within the meaning of §1.954–2) but under 26 CFR 1.954–1(b)(1) (Revised as of April 1, 1975) excludes such amounts from foreign base company income as dividends received from, and reinvested in, qualified investments in less developed countries. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(2) of §1.955–1 are $40,000. For 1966, P Corporation is a foreign personal holding company, has predistribution earnings and profits of $10,000, derives $10,000 of income which is both foreign personal holding company income within the meaning of section 553 and subpart F income within the meaning of section 952, distributes $8,000 to A, and has undistributed foreign personal holding company income of $2,000 within the meaning of

section 556. In addition, for 1966 P Corporation has a withdrawal (determined under section 955(a) as in effect before the enactment of the Tax Reduction Act of 1975 but without regard to its earnings and profits for such year) of $25,000 of previously excluded subpart F income from investment in less developed countries. A is required under section 551(b) to include in his gross income for 1966 as a dividend the $2,000 undistributed foreign personal holding company income. The $8,000 distribution is includible in A's gross income for 1966 under sections 61(a)(7) and 301 as a distribution to which section 316(a)(2) applies. Corporation P's $25,000 withdrawal of previously excluded subpart F income from investment in less developed countries is includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of §1.951–1.

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

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

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

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

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

### §1.952–1 Subpart F income defined.

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

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

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

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

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

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

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

multiplied by

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

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

(4) The sum of the amount of any illegal bribes, kickbacks, or other payments paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a controlled foreign corporation where it is paid by an officer, director, employee,

shareholder or agent of such corporation for the benefit of such corporation. For purposes of this section, the principles of section 162(c) and the regulations thereunder shall apply. In the case of payments made after September 3, 1982, a payment is illegal if the payment would be unlawful under the Foreign Corrupt Practices Act of 1977 if the payor were a United States person. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

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

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

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

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

(3) *Rule applicable under section 956 (b)(2).* For purposes only of paragraph (b)(1))(viii) of §1.956–2, an item of income derived by a controlled foreign corporation from sources within the United States with respect to which for the taxable year a tax is imposed in accordance with section 882(a) shall be considered described in section 952(b) whether or not such item of income would have constituted subpart F income for such year.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

$30,000; and $20,000 is includible in A's gross income for such year under section 951(a)(1)(A)(i).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(iii) *Allocation of deficit.* If one or more foreign corporations (whether or not a controlled foreign corporation) includible in a chain of foreign corporations has a deficit in earnings and profits (determined under section 964(a) and § 1.964–1) for the taxable year, the amount of deficit taken into account

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

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

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

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

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

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

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

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

[In percent]

| | A | B | C | D | E | F | G | H |
|---|---|---|---|---|---|---|---|---|
| A chain: | | | | | | | | |
| Direct interest | 100 | | | | | | | |
| (100%×80%) | | 80 | | | | | | |
| (100%×80%) | | | 80 | | | | | |
| (80%×75%) | | | | 60 | | | | |
| (80%×75%) | | | | | 60 | | | |
| (80%×50%) | | | | | | | 40 | |
| (80%×50%) | | | | | | | | 40 |

[In percent]

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

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

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

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

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

| | *Amount of reduction* |
|---|---|
| A chain: | |
| A Corporation ($12,000×$18,000/$30,000) | $7,200 |
| D Corporation ($12,000×$3,000/$30,000) | 1,200 |
| E Corporation ($12,000×$9,000/$30,000) | 3,600 |
| Total | 12,000 |
| B chain: | |
| D Corporation ($2,500×$750/$750) | $2,500 |
| Limitation: M Corporation's pro-rata share of D Corporation's earnings and profits | 750 |
| Allocation of used deficit ($750) to M Corporation's pro rata share of the deficits of corporations B and G: | |
| B Corporation ($750×($1,500/$2,500)) | $450 |
| G Corporation ($750×($1,000/$2,500)) | 300 |
| Total | 750 $750 |
| F chain: | |
| F Corporation ($500×$20,250/$22,500) | 450 |
| E Corporation ($500×$2,250/$22,500) | 50 |
| Total | 500 |

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

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

(h) Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1963 which is includible in its gross income for

such year under section 951(a)(1)(A)(i) and §1.951–1 is determined as follows:

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

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

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

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

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

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

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

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

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

(3) *Recapture of subpart F income reduced by operation of earnings and profits limitation.* Any amount in a category of subpart F income described in section 952(a) or, in the case of foreign

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

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

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

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

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

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

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

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

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

each separate category. See section 904(d)(3)(D).

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

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

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

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

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

(ii) For purposes of determining the amount and type of income included in A's

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

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

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

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

(iii) For purposes of computing post-1986 undistributed earnings in each separate category the rules of sections 902 and 960, including the rules of §1.960–1(i), apply. Under §1.960–1(i), the shipping limitation deficit of (200u) is allocated proportionately to reduce general limitation earnings of 400u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 160u to 240u (400u general limitation earnings/500u total earnings in positive separate categories

× (200u) shipping deficit=160u reduction), and passive limitation earnings are reduced by 40u to 60u (100u passive earnings/500u total earnings in positive separate categories × (200u) shipping deficit=40u reduction). Five-twelfths of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the subpart F inclusion (25u inclusion/60u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 400u of general limitation earnings (275u opening balance + 125u current earnings), 75u of passive limitation earnings (100u of foreign personal holding company income −25u inclusion), and a (200u) deficit in shipping limitation earnings.

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

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

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

(5) *Effective date.* Paragraph (e) of this section and this paragraph (f) apply to taxable years of a controlled foreign corporation beginning after March 3, 1997.

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

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

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

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

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

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

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

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

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

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

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

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

(*a*) The sum of—

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

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

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

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

(b) *Determination of taxable income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the taxable income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 63.

(2) *Insurance taxable income.* The taxable income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies shall, subject to the special rules of paragraph (c) of this section, be determined by treating such corporation as a domestic corporation taxable under subchapter L of chapter 1 of the Code and by applying the principles of §§ 1.953–4 and 1.953–5 for determining taxable income.

(c) *Special rules for purposes of this section*—(1) *Nonapplication of certain provisions.* Except where otherwise distinctly expressed, the provisions of subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Internal Revenue Code shall not apply and, for taxable

years of a controlled foreign corporation beginning after March 3, 1997, the provisions of section 103 of the Internal Revenue Code shall not apply.

(2) *Application of principles of § 1.964–1.* The determinations with respect to a foreign corporation shall be made as follows:

(i) *Books of account.* The books of account to be used shall be those regularly maintained by the corporation for the purpose of accounting to its shareholders.

(ii) *Accounting principles.* Except as provided in subparagraphs (3) and (4) of this paragraph, the accounting principles to be employed are those described in paragraph (b) of §1.964–1. Thus, in applying accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of foreign affiliates, no adjustment need be made unless such adjustment will have a material effect, within the meaning of paragraph (a) of §1.964–1.

(iii) *Translation into United States dollars*—(*a*) *In general.* Except as provided in (*b*) of this subdivision, the amounts determined in accordance with subdivision (ii) of this subparagraph shall be translated into United States dollars in accordance with the principles of paragraph (d) of §1.964–1.

(*b*) *Special rule.* In any case in which the value of the foreign currency in relation to the United States dollar fluctuates more than 10 percent during any translation period (within the meaning of paragraph (d)(6) of §1.964–1), the subpart F income and non-subpart F income shall be separately translated as if each constituted all the income of the controlled foreign corporation for the translation period.

(iv) *Tax accounting methods.* The tax accounting methods to be employed are those established or adopted by or on behalf of the foreign corporation under paragraph (c) of §1.964–1. Thus, such accounting methods must be consistent with the manner of treating inventories, depreciation, and elections referred to in subdivisions (ii), (iii), and (iv) of paragraph (c)(1) of §1.964–1 and used for purposes of such paragraph; however, if, in accordance with paragraph (c)(6) of §1.964–1, a foreign corporation receives foreign base company income before any elections are made or before an accounting method is adopted by or on behalf of such corporation under paragraph (c)(3) of §1.964–1, the determinations of whether an exclusion set forth in section 954(b) applies shall be made as if no elections had been made and no accounting method had been adopted.

(v) *Exchange gain or loss*—(*a*) Exchange gain or loss, determined in accordance with the principles of §1.964–1(e), shall be taken into account for purposes of determining gross income and taxable income.

(*b*) Exchange gain or loss shall be treated as foreign base company shipping income (or as a deduction allocable thereto) to the extent that it is attributable to foreign base company shipping operations. The extent to which exchange gain or loss is attributable to foreign base company shipping operations may be determined under any reasonable method which is consistently applied from year to year. For example, the extent to which the exchange gain or loss is attributable to foreign base company shipping operations may be determined on the basis of the ratio which the foreign based company shipping income of the corporation for the taxable year bears to its total gross income for the taxable year, such ratio to be determined without regard to this subdivision (v).

(*c*) The remainder of the exchange gain or loss shall be allocated between subpart F income and non-subpart F income under any reasonable method which is consistently applied from year to year. For example, such remainder may be allocated to subpart F income in the same ratio that the gross subpart F income (exclusive of foreign base company shipping income) of the corporation for the taxable year bears to its total gross income (exclusive of foreign base company shipping income) for the taxable year, such ratio to be determined without regard to this subdivision (v).

(3) *Necessity for recognition of gain or loss.* Gross income of a foreign corporation (including an insurance company) includes gain or loss only if such gain or loss would be recognized under the provisions of the Internal Revenue

Code if the foreign corporation were a domestic corporation taxable under section 11 (subject to the modifications of subparagraph (1) of this paragraph). See section 1002. However, a foreign corporation shall not be treated as a domestic corporation for purposes of determining whether section 367 applies.

(4) *Gross income and gross receipts.* The term ''gross income'' may not have the same meaning as the term ''gross receipts''. For example, in a manufacturing, merchandising, or mining business, gross income means the total sales less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

(5) *Treatment of capital loss and net operating loss.* In determining taxable income of a foreign corporation for any taxable year—

(i) *Capital loss carryback and carryover.* The capital loss carryback and carryover provided by section 1212(a) shall not be allowed.

(ii) *Net operating loss deduction.* The net operating loss deduction under section 172(a) or the operations loss deduction under section 812 shall not be allowed.

(6) *Corporations which have insurance income.* For purposes of paragraphs (a)(2) and (b)(2) of this section, in determining whether a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies, it is immaterial that—

(i) The corporation would be exempt from taxation as an organization described in section 501(a),

(ii) The corporation would not be taxable as an insurance company to which subchapter L of the Code applies, or

(iii) The corporation would be subject to the alternative tax for small mutual insurance companies provided by section 821(c).

[T.D. 6795, 30 FR 941, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22516, May 19, 1983; T.D. 8704, 62 FR 20, Jan. 2, 1997]

### § 1.953–1 Income from insurance of United States risks.

(a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year includes its income derived from the insurance of United States risks for such taxable year. See section 952(a)(1). A controlled foreign corporation shall have income derived from the insurance of United States risks for such purpose of it has taxable income, as determined under § 1.953–4 or § 1.953–5, which is attributable to the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in § 1.953–2 or § 1.953–3, and if it satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of this section. It is immaterial for purposes of this section whether the person insured or the beneficiary of any insurance, annuity, or reinsurance contract is, as to such corporation, a related person or a United States shareholder. For definition of the term ''controlled foreign corporation'' for purposes of taking into account income derived from the insurance of United States risks under section 953, see section 957 (a) and (b) and §§ 1.957–1 and 1.957–2.

(b) *5-percent minimum premium requirement.* A controlled foreign corporation shall not have income derived from the insurance of United States risks for purposes of this section unless the premiums received by such corporation during the taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with the United States risks exceed 5 percent of the total premiums which are received by such corporation during such taxable year and which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks.

(c) *General definitions.* For purposes of §§ 1.953–1 to 1.953–6, inclusive—

(1) *Reinsurance, etc.* The terms ''reinsurance'', ''insurance'', and ''annuity contract'' have the same meaning which they have for purposes of applying section 809(c)(1) or section 832(b)(4), as the case may be.

(2) *Premiums.* The term ''premiums'' means the items taken into account for

the taxable year under section 809(c)(1), or the amount computed for the taxable year under section 832(b)(4) without the application of subparagraph (B) thereof, as the case may be; except that, for purposes of determining the amount of premiums received in applying paragraph (b) of this section or paragraph (a) of §1.953–3, advance premiums and deposits shall not be taken into account.

(3) *Insurance company*. The term ''insurance company'' has the same meaning which it has for purposes of applying section 801(a), determined by applying the principles of paragraph (a) of §1.801–3.

(4) *Related person*. The term ''related person'', when used with respect to a controlled foreign corporation, shall have the meaning assigned to it by paragraph (e) of §1.954–1.

(5) *Policy period*. With respect to any insurance or annuity contract under which a corporation is potentially liable at any time during its taxable year, the term ''policy period'' means with respect to such year each period of coverage under the contract if such period begins or ends with or within the taxable year, except that, if such period of coverage is more than one year, such term means such of the following periods as are applicable, each one of which is a policy period with respect to the taxable year:

(i) The one-year period which begins with the effective date of the contract and begins or ends with or within the taxable year,

(ii) The one-year period which begins with an anniversary of the contract and begins or ends with or within the taxable year, and

(iii) The period of less than one year if such period begins with an anniversary of the contract, ends with the date on which coverage under the contract terminates, and begins or ends with or within the taxable year.

For such purposes, the effective date of the contract is the date on which coverage under the contract begins, and the anniversary of the contract is the annual return of the effective date. The period of coverage under a contract is the period beginning with the effective date of the contract and ending with the date on which the coverage under the contract expires; except that, if the risk under the contract has been transferred by assumption reinsurance, the period of coverage shall end with the effective date of such transfer or, if the contract is canceled, with the effective date of cancellation. For this purpose, the term ''assumption reinsurance'' shall have the meaning provided by paragraph (a)(7)(ii) of §1.809–5. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A issues to domestic corporation M an insurance contract which provides coverage for the 2½ year period beginning on July 1, 1963. Corporation A uses the calendar year as the taxable year. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to June 30, 1964. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to A Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

*Example 2.* The facts are the same as in example 1 except that M Corporation cancels the contract on August 31, 1963. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to August 31, 1963.

*Example 3.* The facts are the same as in example 1 except that on January 15, 1965, A Corporation cedes insurance under the contract to controlled foreign corporation B, which also uses the calendar year as the taxable year. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to both A Corporation and B Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

*Example 4.* Controlled foreign corporation C, which uses the calendar year as the taxable year, issues to domestic corporation N an insurance contract which covers the marine risks in connection with shipping a machine to Europe. The contract does not specify the dates during which the machine is covered, but provides coverage from the time the machine is delivered alongside a named vessel in Hoboken, New Jersey, until the machine is delivered alongside such vessel in Liverpool, England. Such deliveries in New Jersey and England take place on February 1, and February 28, 1963, respectively. For 1963, the policy period under such contract as to C Corporation is February 1, to February 28, 1963.

(6) *Foreign country*. The term ''foreign country'' includes, where not otherwise

expressly provided, a possession of the United States.

[T.D. 6781, 29 FR 18201, Dec. 23, 1964]

### § 1.953–2 Actual United States risks.

(a) *In general.* For purposes of paragraph (a) of § 1.953–1, the term ''United States risks'' means risks described in section 953(a)(1)(A)—

(1) In connection with property in the United States (as defined in paragraph (b) of this section),

(2) In connection with liability arising out of activity in the United States (as defined in paragraph (c) of this section), or

(3) In connection with the lives or health of residents of the United States (as defined in paragraph (d) of this section).

For purposes of section 953(a), the term ''United States'' is used in a geographical sense and includes only the States and the District of Columbia. Therefore, the reinsuring or the issuing of insurance or annuity contracts by a controlled foreign corporation in connection with property located in a foreign country or a possession of the United States, in connection with activity in a foreign country or a possession, or in connection with the lives or health of citizens of the United States who are not residents of the United States will not give rise to income to which paragraph (a) of § 1.953–1 applies, unless the income derived by the controlled foreign corporation from such contracts constitutes income derived in connection with risks which are deemed to be United States risks, as defined in § 1.953–3.

(b) *Property in the United States.* The term ''property in the United States'' means property, as defined in subparagraph (1) of this paragraph, which is in the United States, within the meaning of subparagraph (2) of this paragraph.

(1) *Property defined.* The term ''property'' means any interest of an insured in tangible (including real and personal) or intangible property. Such interests include, but are not limited to, those of an owner, landlord, tenant, mortgagor, mortgagee, trustee, beneficiary, or partner. Thus, for example, if insurance is issued against loss from fire and theft with respect to an insured's home and its contents, such risks are risks in connection with property, whether the insured is the owner or lessee and whether the contents include furniture or cash and securities. Furthermore, if insurance is issued against all risks of damage or loss with respect to the automobile of an insured, such risks are risks in connection with property, whether the risks insured against may be caused by the insured, another person, or natural forces.

(2) *United States location*—(i) *In general.* Property will be considered property in the United States when it is exclusively located in the United States. Conversely, property will be considered property not in the United States when it is exclusively located outside the United States. In addition, property which is ordinarily located in, but temporarily located outside, the United States will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property cannot be allocated to, or apportioned between, risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States. If such premium can be so allocated or apportioned on a reasonable basis, however, such property will be considered property not in the United States when it is actually located outside the United States. However, property will not be considered property in the United States if it is neither property which is exclusively located in the United States nor property which is ordinarily located in, but temporarily located outside, the United States. The rules prescribed in subdivision (ii) of this subparagraph shall apply in determining whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States. The rules prescribed in subdivisions (iii) through (x)

of this subparagraph shall apply in determining whether property is, or will be considered, exclusively located in or outside the United States and whether property is, or will be considered, ordinarily located in the United States; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision and subdivision (ii) of this subparagraph. The determinations required by this subparagraph shall be made with respect to the location of property during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with respect to such taxable year, such determinations shall be made separately with respect to the location of property during each such policy period.

(ii) *Premium allocation or apportionment.* Whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall depend on the intention of the parties to the insurance contract, as determined from its provisions and the facts and circumstances preceding its execution. Contract provisions on the basis of which the premium reasonably may be so allocated or apportioned include, but are not limited to, provisions which separately describe each risk covered, the period of coverage of each risk, the special warranties for each risk, the premium for each risk (or the basis for determining such premium), and the conditions of paying the premium for each risk. For purposes of this subdivision, it shall be unnecessary formally to make a separate policy with respect to each risk covered or with respect to each clause attached to the policy, provided that the intention of the parties to the contract is reasonably clear. For example, if in the ordinary course of carrying on an insurance business an insurance policy is issued which covers fire, theft, and water damage risks incurred when property is actually located in the United States and marine risks incurred when such property is actually located outside the United States and which, pursuant to accepted insurance principles, properly describes the premium rates as percentages of the amount of coverage as ''.825% plus .3% fire, etc. risks plus .12% water risks = 1.245%'', a reasonable basis exists to allocate a $124.50 premium paid for $10,000 of such coverage to $82.50 for foreign risks and $42.00 ($30.00+ $12.00) to United States risks.

(iii) *Property in general—(a) Ordinary and temporary location.* Except as otherwise provided in subdivisions (iv) through (x) of this subparagraph, the determination of whether property is ordinarily located in the United States will depend on all the facts and circumstances in each case. Property is ordinarily located in the United States if its location in the United States is regular, usual, or often occurring. However, in all cases property will be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of more than 50 percent of the days in the applicable policy period whereas property will, under no circumstances, be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of not more than 30 percent of the days in the applicable policy period. Property which is ordinarily located in the United States is temporarily located outside the United States when it is actually located outside the United States. For purposes of determining the number and percent of the days in an applicable policy period, the term ''day'' means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight; in determining the location of property for such purposes, an amount of time which is at least one-half of such a day, but less than the entire day, shall be considered a day, and an amount of time which is less than one-half of such a day shall not be considered a day.

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

*Example 1.* Controlled foreign corporation A issues to domestic corporation M a comprehensive blanket or floater insurance policy which, for one year, covers inventory

samples which M Corporation regularly ships from the United States in order to encourage sales. Such shipments are made on the condition that they be returned to the United States within 5 days after they are received. During the one-year policy period, such samples are sent from, and returned to, the United States 50 times, and during such one-year period are actually located in the United States for an aggregate of 120 days. Since the location of the samples in the United States during such one-year period is often recurring, they are property ordinarily located in, but temporarily located outside, the United States. Therefore, they will be considered property in the United States even though for such one-year period their location in the United States is not regular or usual and is not for an aggregate of more than 50 percent of the days in the policy period. However, if, by considering such factors as the terms and premium schedule of the insurance contract as well as the number, value, and duration of the location in and outside the United States, of such samples, the premium which is attributable to the issuing of such contract can be allocated to, or apportioned between, risks occurring when such samples are actually located in the United States and risks occurring when they are actually located outside the United States, such samples will be considered property not in the United States when they are actually located outside the United States.

*Example 2.* A machine, located for several years in a foreign branch of a United States manufacturer, is permanently transferred to the home office of such manufacturer, where it arrives on January 1, 1963, and remains for the remainder of 1963. Under a separate insurance contract issued by a controlled foreign corporation, which uses the calendar year as the taxable year, such machine is insured against damage for the three-year period commencing on May 1, 1962. Because of the change in location of the machine, the premiums are increased as of January 1, 1963. Since the machine is in the United States from January 1, 1963, to April 30, 1963, its location in the United States is regular and usual during the policy period of May 1, 1962, to April 30, 1963. Accordingly, the machine is ordinarily located in the United States for such policy period. However, since the premium which is attributable to the issuing of such contract is allocable to risks occurring when the machine is actually located in, and when it is actually located outside, the United States, such machine will be considered property not in the United States from May 1, 1962, through December 31, 1962.

(iv) *Commercial motor vehicles, ships, aircraft, railroad rolling stock, and containers.* Any motor vehicle, ship, aircraft, railroad rolling stock, or any container transported thereby, which is used exclusively in the commercial transportation of persons or property to or from the United States (including such transportation from one place to another in the United States) and is ordinarily located in the United States will be considered property in the United States both when such property is ordinarily located in, and when such property is temporarily located outside, the United States. Whether such property is used in the transportation of persons or property to or from the United States and is ordinarily located in the United States are issues to be determined from all the facts and circumstances in each case. However, in all cases such transportation property will be considered ordinarily located in the United States if either more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States more than 50 percent of the time during such period. Further, such transportation property will not at any time be considered property in the United States if either not more than 30 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States for not more than 30 percent of the time during such period. Nevertheless, if not more than 30 percent of the miles traversed during the applicable policy period in the use of such transportation property are traversed within the United States, such property will be considered ordinarily located in the United States if it is located in the United States more than 50 percent of the time during such period Moreover, if such transportation property is located in the United States for not more than 30 percent of the time during the applicable policy period, such property will be considered ordinarily located in the United States if more than 50 percent of the miles traversed during such period in the use of such property are traversed within the United States. If such transportation property is considered property in the United States because more than 50 percent of the miles traversed during the applicable policy period in

the use of such property are traversed within the United States, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a mileage basis. If, however, such property is considered property in the United States because such property is located in the United States more than 50 percent of the time during the applicable policy period, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a time basis.

(v) *Noncommercial motor vehicles, ships, aircraft, and railroad rolling stock.* Except as provided in subdivision (iv) of this subparagraph, any motor vehicle, ship or boat, aircraft, or railroad rolling stock which at any time is actually located in the United States and which either (*a*) is registered with the United States, a State (including any political subdivision thereof), or any agency thereof or (*b*), if not so registered, is owned by a citizen, resident, or corporation of the United States will be considered property which is ordinarily located in the United States. Unless the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property considered ordinarily located in the United States is specifically allocated under the contract to risks incurred when such property is actually located in the United States and to risks incurred when it is actually located outside the United States, such property will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States; under no circumstances will such property be considered outside the United States on the basis of any apportionment of such premium.

(vi) *Property exported or imported by railroad or motor vehicle.* Any property which is exported from, or imported to, the United States by railroad or motor vehicle will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States. For example, if an insurance contract reinsured or issued in connection with property exported from the United States by motor vehicle covers risks commencing when such property is loaded on the motor vehicle at the United States warehouse and terminating when such property is unloaded at the foreign warehouse, and if the premium payable with respect to risks incurred when the property is in the United States and risks incurred when the property is in the foreign country is not separately stated, such property will be considered property in the United States only until such property is actually located outside the United States, provided that the premium can be properly apportioned (for example) on the basis of time or mileage, between risks incurred when the property is actually located in the United States and risks incurred when it is actually located outside the United States. If in such case the premium is not so apportionable, such property will be considered property in the United States both when such property is ordinarily located in, and when it is temporarily located outside, the United States.

(vii) *Property exported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is exported from the United States by ship or aircraft covers risks all of which terminate when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property in the United States. If such insurance contract covers risks all of which commence when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property not in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property ordinarily located in the United States which, after such property is placed aboard such ship or aircraft at the United States port of exit, is temporarily located outside the United States. The

application of this subdivision may be illustrated by the following example:

*Example.* A controlled foreign corporation issues an insurance contract in connection with property exported from the United States by ship. The contract covers risks commencing after such property is removed from the United States warehouse and terminating when such property is unloaded at the foreign port of entry. Assuming that the premium payable with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit for shipment from the United States or with respect to the steps in handling such property during such coverage, such as transporting the property to the United States port of exit, unloading the property there, placing the property aboard the ship, holding the property aboard the ship in port, the actual voyage, and unloading the property at the foreign port of entry, is separately stated in, or is determinable from, such contract, the property will be considered property in the United States only until such property is placed aboard the ship at the United States port of exit for shipment from the United States. Assuming, however, that the premiums payable with respect to such steps, or with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit, are not allocable or apportionable under the contract, such property will be considered property in the United States both before and after such property is placed aboard the ship at the United States port of exit.

(viii) *Property imported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is imported to the United States by ship or aircraft covers risks all of which terminate when such property is unloaded at the United States port of entry, such property will be considered property not in the United States. If such insurance contract covers risks all of which commence after such property is unloaded at the United States port of entry, such property will be considered property in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is unloaded at the United States port of entry, such property will be considered property ordinarily located in the United States which, before such property is unloaded at the United States port of entry, is temporarily located outside the United States. For an illustration pertaining to the allocation or apportionment of the premium, see the example in subdivision (vii) of this subparagraph.

(ix) *Shipments originating and terminating in the United States.* Any property which is shipped from one place in the United States to another place in the United States, on or over a foreign country, the high seas, or the coastal waters of the United States will be considered property actually located at all times in the United States. For example, property which is shipped from New York City to Los Angeles via the Panama Canal or from San Francisco to Hawaii or Alaska will be considered property actually located at all times in the United States.

(x) *Shipments originating and terminating in a foreign country.* Any property which is shipped by any means, or a combination of means, of transportation from one foreign country to another foreign country, or from a contiguous foreign country to the same contiguous foreign country, on or over the United States will be considered property exclusively located outside the United States. Notwithstanding the foregoing, any property which is shipped by any means, or a combination of means, of transportation from one contiguous foreign country to another contiguous foreign country on or over the United States will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States.

(c) *Liability from United States activity.* The term ''liability arising out of activity in the United States'' means a loss, as described in subparagraph (1) of this paragraph, or a liability, as described in subparagraph (2) of this paragraph, which could arise from activity performed in the United States, as defined in subparagraph (3) of this paragraph.

(1) *Loss described.* The term ''loss'' includes all loss of an insured which could arise from the occurrence of the event insured against except that such term does not include any loss in connection with property described in

paragraph (b) of this section. For example, such term includes, in the case of a promoter of outdoor sporting events, the loss which could arise from the cancellation of such an event because of inclement weather.

(2) *Liability described.* The term ''liability'' includes all liability of an insured in tort, contract, property, or otherwise. It includes, for example, the liability of a principal for the acts of his agent, of a husband for the acts of his spouse, and of a parent for the acts of his child. The term not only includes the direct liability which may be incurred, for example, by a tortfeasor to the person harmed, but also the indirect liability which may be incurred, for example, by a manufacturer to the purchaser at retail for a breach of warranty.

(3) *Activity in the United States*—(i) *In general.* A loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on in the United States. Conversely, a loss or liability will be considered a loss or liability which could not arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on outside the United States. In addition, a loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity ordinarily carried on in, but partly carried on outside, the United States. If the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with an activity ordinarily carried on in, but partly carried on outside, the United States can, on a reasonable basis, be allocated to, or apportioned between, the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States, such loss or liability will be considered a loss or liability which could not arise from activity performed in the United States to the extent the loss or liability would result, if at all, from that activity carried on outside the United States. However, a loss or liability will not be considered a loss or liability which could arise from an activity performed in the United States if such loss or liability would result, if at all, from an activity which is neither exclusively carried on in the United States nor ordinarily carried on in, but partly carried on outside, the United States. The principles of paragraph (b)(2)(ii) of this section for allocating or apportioning a premium on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall apply for allocating or apportioning a premium on a reasonable basis to or between the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States. The rules prescribed in subdivisions (ii) through (vi) of this subparagraph shall apply in determining whether an activity is, or will be considered, exclusively carried on in or outside the United States and whether an activity is, or will be considered, ordinarily carried on in the United States and in determining what is the activity which is performed by the insured from which a loss or liability results or could result; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision. The determinations required by this subparagraph shall be made with respect to the location of an activity of the insured performed during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with respect to such taxable year, such determinations shall be made separately with respect to the location of the activity during each such policy period.

(ii) *Substantial activity carried on in the United States.* The term ''activity'' is used in its broadest sense and includes the performance of an act unlawfully undertaken, the wrongful performance of an act lawfully undertaken, and the wrongful failure to perform an act lawfully required to be undertaken. With respect to a loss described in subparagraph (1) of this

paragraph, the term ''activity'' includes the occurrence of the event insured against. The determination of whether an activity ordinarily is carried on in, but is partly carried on outside, the United States will depend on all the facts and circumstances in each case. An activity ordinarily is carried on in the United States if a substantial amount of such activity is carried on in the United States. Factors which will be taken into account in determining whether a substantial amount of activity is carried on in the United States are those which are connected with the activity and include, but are not limited to, the location of the insured's assets, the place where personal services are performed, and the place where sales occur, but only if such assets, services, and sales are connected with the activity. In all cases an activity will be considered substantially carried on in the United States if more than 50 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. On the other hand, an activity will, under no circumstances, be considered substantially carried on in the United States if not more than 30 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. For this purpose, the mean of the value of the total assets at the beginning and end of the policy period shall be used, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be (*a*) face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by an insured using the cash receipts and disbursements method of accounting and (*b*) adjusted basis in the case of all other assets. Personal services shall be measured by the amount of compensation paid or accrued for such services, and sales shall be measured by the volume of gross sales. An activity is carried on partly outside the United States if it is carried on, whether substantially or in substantially, outside the United States.

(iii) *Manufacturing, producing, constructing, or assembling activity.* If a person who manufactures, produces, constructs, or assembles property is liable with regard to the consumption or use of such property, such liability will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling such property. If such person manufactures, produces, constructs, or assembles more than one type of product, the liability with regard to the consumption or use of one of such products will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling that particular product. For example, the liability of a building contractor, which constructs apartment buildings only in the United States, for the improper construction of, or the failure to construct, an apartment building, will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States. In further illustration, the liability (which is covered by a single policy of insurance) of a domestic corporation, which assembles refrigerators exclusively in the United States and manufactures automobiles both in a foreign country and in the United States through substantial activity carried on in each of such countries, for the negligent manufacturing of a part for one of the automobiles by the foreign branch, will be considered to result from an activity ordinarily carried on in, but partly carried on outside, the United States and will be considered a liability which could arise from activity performed in the United States.

(iv) *Selling activity.* If a person is liable with regard to selling activity performed, such liability will be considered, except as provided in subdivisions (iii), (v), and (vi) of this subparagraph, to result from such selling activity. A person will be considered to be engaged in selling activity if such person engages in an activity resulting in the sale of property. Thus, it is immaterial that, under the Code, such activity would not constitute engaging in or carrying on a trade or business in the

country in which such activity is carried on, the property in the goods does not pass in such country, or delivery of the property is not made in such country. For example, if a foreign wholesale distributor, which manages its entire business operations in a foreign country and sells its inventory exclusively in the United States—its only contact in the United States being the promotion of such sales to United States retail outlets by advertising in trade publications and distributing sales catalogues—is liable for a breach of warranty with regard to the sale of property to a United States retail outlet, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(v) *Liability from service or driving activity—(a) In general.* If a person is liable with regard to any service activity performed, or is liable with regard to driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, such liability will be considered to result from such service or driving activity. For example, if an oil company which drills for oil exclusively in a foreign country is liable with regard to the negligent handling by its employees of explosives in the course of such drilling there, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which services machinery exclusively in a foreign country under servicing contracts is liable with regard to the negligent repairing of a machine under such a contract, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States.

(*b*) *Location of activities in connection with transportation property.* For purposes of (*a*) of this subdivision, service or driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, will be considered activity performed in the United States if the activity is carried on at a time when such property is or will be considered, in accordance with subdivision (iv) or (v) of paragraph (b)(2) of this section, actually in the United States or ordinarily located in the United States. However, if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service or driving activity which is carried on at a time when such property is, or will be considered, ordinarily located in the United States can be allocated to, or apportioned between, the risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States, such liability will be considered a liability which could arise from activity performed in the United States only when such property is actually located in the United States. Any allocation or apportionment of premium under the preceding sentence shall be made in accordance with the rules of allocation and apportionment provided in subdivision (iv) or (v) of paragraph (b)(2) of this section. For example, if a person is liable with regard to the performance of services outside the United States in the operation of a motor vehicle which is used exclusively in the commercial transportation of persons to and from the United States and which, because more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States, is considered ordinarily located in the United States, such liability will be considered to be a liability which could not arise from activity performed in the United States only to the extent that the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service activity is apportioned on a mileage basis between the risks incurred when such motor vehicle is actually located in the United States and when such vehicle is

actually located outside the United States. See paragraph (b)(2)(iv) of this section. In further illustration, if a person is liable with regard to his negligent driving of a motor vehicle which is not used exclusively in the commercial transportation of persons or property, which is registered with any State, and which is driven both in the United States and a foreign country, such liability will be considered a liability which could arise from activity performed in the United States, unless the premium which is attributable to the reinsuring or issuing of an insurance contract in connection with such driving performed in such motor vehicle ordinarily located in the United States is specifically allocated under the contract to risks incurred with respect to driving performed in, and to risks incurred with respect to driving performed outside, the United States. See paragraph (b)(2)(v) of this section.

(*c*) *Illustration*. The application of this subdivision may be further illustrated by the following example:

*Example*. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations are insurance companies and use the calendar year as the taxable year. Corporation M is exclusively engaged in issuing to owners of commercial rental property which is located in the United States insurance contracts which cover any harm which may be caused in 1963 by the tortious conduct of the owners' employees in managing and maintaining such property. The owners insured under such contracts include both residents and nonresidents of the United States. In 1963, M Corporation cedes to A Corporation one-half of the insurance contracts issued by M Corporation in that year, including the contracts issued to nonresidents. Income of A Corporation derived in 1963 from reinsuring the risks of M Corporation is income from the insurance of United States risks since all the insurance contracts reinsured by it are in connection with a liability which could arise from service activity performed in the United States.

(vi) *Liability from delivery of property*. If the person who is obligated to deliver property is liable with regard to such delivery, such liability will be considered to result from the activity performed of delivering such property. For example, if a corporation which exports all of its inventory from the United States to foreign countries or possessions of the United States is liable with regard to its failure to make delivery outside the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which exports all of its inventory from a foreign country to the United States is liable with regard to its improper delivery in the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(d) *Lives or health of United States residents*. Risks in connection with the lives or health of residents of the United States include those risks which are the subject of insurance contracts referred to in section 801(a), relating to the definition of a life insurance company. If the insured is a resident of the United States at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of the United States for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of the United States, the risk shall cease to be a risk in connection with the life or health of a resident of the United States for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. Conversely, if the insured is a resident of a particular foreign country at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of such foreign country for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of such foreign country, the

risk shall cease to be a risk in connection with the life or health of a resident of such particular foreign country for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. In determining the country of residence of an insured, the principles of §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter, relating to the determination of residence and nonresidence in the United States and of foreign residence, shall apply. Citizens of the United States are not residents of the United States merely because of their citizenship. The application of this paragraph may be illustrated by the following example:

*Example.* Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Corporation A uses the calendar year as the taxable year and is engaged in the life insurance business in foreign country X. In 1963, A Corporation issues ordinary life insurance contracts on the lives of residents of the United States, including one issued on February 1, 1963, to R, a citizen of foreign country Y and a resident of the United States on such date. All activity in connection with the issuing of such contracts is transacted by mail. On May 1, 1963, R abandons his United States residence and establishes residence in foreign country Z. There are no circumstances known to A Corporation that R has changed his residence until R, on March 1, 1964, actually notifies A Corporation of that change. Income of A Corporation for the policy period of February 1, 1963, to January 31, 1964, from issuing such insurance contracts is income derived from the insurance of United States risks. However, income of A Corporation derived for the policy period of February 1, 1964, to January 31, 1965, from R's insurance contract is not income derived from the insurance of United States risks.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6781, 29 FR 18202, Dec. 23, 1964, as amended by T.D. 7736, 45 FR 76143, Nov. 18, 1980; T.D. 8411, 57 FR 15241, Apr. 27, 1992]

### § 1.953–3 Risks deemed to be United States risks.

(a) *Artificial arrangements.* For purposes of paragraph (a) of § 1.953–1, the term ''United States risks'' also includes under section 953(a)(1)(B) risks which are deemed to be United States risks. They are risks (other than United States risks described in section 953(a)(1)(A) and § 1.953–2) which a controlled foreign corporation reinsures under an insurance or annuity contract, or with respect to which a controlled foreign corporation issues any insurance or annuity contract, in accordance with any arrangement whereby another corporation which is not a controlled foreign corporation receives an amount of premiums (for reinsuring or issuing any insurance or annuity contract in connection with the United States risks described in section 953(a)(1)(A) and § 1.953–2) which is substantially equal to the amount of premiums which the controlled foreign corporation receives under its contracts. Arrangements to which this rule applies include those entered into by the controlled foreign corporation, by its United States shareholders, or by a related person.

(b) *Evidence of arrangements.* The determination of the existence of an arrangement referred to in paragraph (a) of this section shall depend on all the facts and circumstances in each case. In making this determination, it will be recognized that arrangements of this type generally are orally entered into outside the United States and that direct evidence of such an arrangement is not ordinarily available. Therefore, in determining the existence of such an arrangement, consideration will be given to whether or not there is substantial similarity between the type, location, profit margin expected, and loss experience of the risks which the corporation which is not a controlled foreign corporation insures or reinsures and the risks which the controlled foreign corporation insures or reinsures. Further, consideration will be given to the existence of prior similar arrangements between, and the identity of the directors or shareholders of, the corporation which is not a controlled foreign corporation, its shareholders, or related persons and the controlled foreign corporation, its shareholders, or related persons. However, the absence of such prior arrangements or identity of directors or shareholders will not of itself establish the nonexistence of an arrangement referred to in paragraph (a) of this section. In determining whether the

amounts received by the controlled foreign corporation and the corporation which is not a controlled foreign corporation are substantially equal, the period in which the controlled foreign corporation receives premiums need not be the same as, or identical in length with, that of the corporation which is not a controlled foreign corporation nor limited to a taxable year of the controlled foreign corporation.

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

*Example 1.* Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Foreign corporation B is a wholly owned subsidiary of foreign corporation R. All corporations use the calendar year as the taxable year. Corporations M and R, which are not related persons, agree that from July 1, 1963, through December 31, 1963, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1964, through June 30, 1964, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums received by A Corporation and B Corporation, respectively, as a result of the agreement are substantially equal. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

*Example 2.* Assume the same facts as in example 1, except that M and R Corporations also agree, as part of their arrangement, that from July 1, 1964, through December 31, 1964, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1965, through June 30, 1965, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums derived by B Corporation from July 1, 1963, through December 31, 1963, under the agreement is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1964, through June 30, 1964, and the amount of premiums derived by B Corporation from July 1, 1964, through December 31, 1964, is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1965, through June 30, 1965. However, the aggregate amount of premiums received by B Corporation under the arrangement is substantially equal to the aggregate amount of premiums received by A Corporation. The income of A Corporation derived in 1964 and 1965 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

*Example 3.* Assume the same facts as in example 1, except that foreign corporation C is also a wholly owned subsidiary of R Corporation. Assume that C Corporation uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that from July 1, 1963, through December 31, 1963, B Corporation and C Corporation together will reinsure the United States risks described in section 953(a)(1)(A) of M Corporation. The amount of premiums received by B Corporation in respect of such United States risks is equal to one-third of the amount received by A Corporation in respect of the risks which are not United States risks described in section 953(a)(1)(A), and the amount of premiums received by C Corporation in respect of such United States risks is equal to two-thirds of the amount so received by A Corporation. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

*Example 4.* Assume the same facts as in example 3, except that controlled foreign corporation D is also a wholly owned subsidiary of M Corporation and uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that in 1964 R Corporation will pay premiums of $300,000 to A Corporation and $700,000 to D Corporation to reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A), and that in 1963 M Corporation will pay premiums of $400,000 to B Corporation and $600,000 to C Corporation to reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A). The income of A Corporation and D Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

*Example 5.* Controlled foreign corporation A is a wholly owned subsidiary of domestic insurance corporation M. Controlled foreign corporation B is a wholly owned subsidiary of domestic insurance corporation N. All corporations use the calendar year as the taxable year. As a result of an arrangement between M Corporation and N Corporation, in 1963 A Corporation reinsures all the United States risks described in section 953(a)(1)(A) of N Corporation, and B Corporation reinsures all the United States risks described in section 953(a)(1)(A) of M Corporation. The premiums and other consideration received by A Corporation and B Corporation in respect of such reinsurance are not substantially equal. The income of A Corporation and B Corporation in 1962 from reinsuring the risks of N Corporation and M Corporation, respectively, is income derived from

the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance or United States risks described in section 953(a)(1)(B).

*Example 6.* Assume the same facts as in example 5, except that B Corporation is not a controlled foreign corporation. The income of A Corporation in 1963 from reinsuring the risks of N Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance of United States risks described in section 953(a)(1)(B).

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

### § 1.953–4 Taxable income to which section 953 applies.

(a) *Taxable income defined*—(1) *Life insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies, the term ''taxable income'' means for purposes of paragraph (a) of §1.953–1 the gain from operations, as defined in section 809(b) and as modified by this section, derived from, and attributable to, the insurance of United States risks. For purposes of determining such taxable income, the provisions of section 802(b) (relating to the definition of life insurance company taxable income) shall not apply. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(2) *Mutual and other insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies or a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies, the term ''taxable income'' means for purposes of paragraph (a) of §1.953–1 taxable income, as defined in section 832(a) and as modified by this section, derived from, and attributable to, the insurance of United States risks. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(3) *Corporations not qualifying as insurance companies.* For special rules applicable under this section in the case of a controlled foreign corporation which, if it were a domestic corporation, would not qualify as an insurance company, see §1.953–5.

(b) *Certain provisions inapplicable.* In determining taxable income under this section, the following provisions of subchapter L of the Code shall not apply:

(1) Section 809(d)(4), relating to the operations loss deduction;

(2) Section 809(d)(5), relating to certain nonparticipating contracts;

(3) Section 809(d)(6), relating to certain accident and health insurance and group life insurance;

(4) Section 809(d)(10), relating to small business deduction;

(5) Section 817(b), relating to gain on property held on December 31, 1958, and certain substituted property acquired after 1958; and

(6) Section 832(c)(5), relating to capital losses.

(c) *Computation of reserves required by law*—(1) *Law applicable in determining reserves.* The reserves which will be taken into account as reserves required by law under section 801(b)(2), both in determining for any taxable year whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section and in determining taxable income of such corporation for the taxable year under paragraph (a) of this section, shall be the following reserves:

(i) *Reserves required by the law of a State.* The reserves which are required by the law of the State or States to which the insurance business of the controlled foreign corporation is subject, but only with respect to its United States business, if any, which is taxable under section 819(a).

(ii) *Reserves deemed to be required.* To the extent of such controlled foreign corporation's insurance business not taxable under section 819(a)—

(*a*) Except as provided in (*b*) of this subdivision (ii), the reserves which would result if such reserves were determined by applying the minimum

standards of the law of New York as if such controlled foreign corporation were an insurance company transacting all of its insurance business (other than its United States business which is taxable under section 819(a)) for such taxable year in such State, and

(*b*) With respect to all risks covered by insurance ceded to such controlled foreign corporation by an insurance company to which apply the provisions of subchapter L of the Code (determined without regard to section 501(a)) and in respect of which an election is made by or on behalf of such controlled foreign corporation to determine its reserves in accordance with this subdivision (b), the amount of reserves against such risks which would result if all of such reserves were determined by applying the law of the State, to which the risks in the hands of such insurance company are subject, as if such controlled foreign corporation were an insurance company engaged in reinsuring such risks in such State.

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, the following rules shall apply:

(i) *Life insurance reserves computed on preliminary term basis.* For purposes of determining under paragraph (a) of this section the taxable income of a controlled foreign corporation, an election may be made by or on behalf of such corporation that the amount of reserves which are taken into account as life insurance reserves with respect to contracts for which reserves are computed on a preliminary term basis shall be determined as provided in section 818(c). This election shall apply, subject to section 818(c), to all life insurance reserves of the controlled foreign corporation, whether or not reserves applicable to the United States business taxable under section 819(a). However, reserves determined as provided in section 818(c) shall not be taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section.

(ii) *Actual reserves required.* (*a*) A controlled foreign corporation will be considered to have a reserve only to the extent the reserve has been actually held during the taxable year for which such reserve is claimed.

(*b*) For determining when reserves are required by the law of a State, see paragraph (b) of §1.801–5 of this chapter.

(iii) *Total reserves to be taken into account.* The total reserves of a controlled foreign corporation shall be taken into account in determining whether such corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section. Therefore, in making such determination, the reserves which, under subparagraph (1)(i) of this paragraph, are required by the law of any State shall be taken into account together with the reserves which, under subparagraph (1)(ii) of this paragraph, are deemed to be required. Moreover, reserves applicable to the reinsuring or the issuing of insurance or annuity contracts of both United States risks and foreign risks shall be taken into account. Finally, except as provided in subdivision (i) of this subparagraph, the reserves which are taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section shall be the same reserves which are taken into account in determining under paragraph (a) of this section the taxable income of such corporation.

(iv) *Method of comparing reserves when subject to more than one State.* If the insurance business of a controlled foreign corporation is subject to the law of more than one State, the amount of reserves taken into account under subparagraph (1)(i) of this paragraph shall be the amount of the highest aggregate reserve required by any State, determined as provided in paragraph (a) of §1.801–5 of this chapter.

(d) *Domestic corporation tax attributes.* In determining taxable income of a controlled foreign corporation under this section there shall be allowed, except as provided in section 953(b), this section, and §1.953–5, the exclusions and deductions from gross income which would be allowed if such corporation were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have

been reinsured or issued by such corporation. For this purpose, the provisions of sections 819, 821(e), 822(e), 831(b), and 832(d), relating to foreign insurance companies, shall not apply; however, for the exclusion from the taxable income determined under section 953 of amounts derived from sources within the United States, see section 952(b) and paragraph (b) of §1.952–1. Furthermore, taxable income shall be determined under this section without regard to section 882 (b) and (c), relating to gross income and deductions of a foreign corporation, and without regard to whether the controlled foreign corporation is carrying on an insurance business in the United States. For other rules relating to the determination of gross income and taxable income of a foreign corporation for purposes of subpart F, see §1.952–2.

(e) *Limitation on certain amounts in respect of United States risks.* In determining taxable income under this section the following amounts shall not, in accordance with section 953(b)(4), be taken into account except to the extent they are attributable to the reinsuring or issuing of any insurance or annuity contract in connection with United States risks described in §1.953–2 or §1.953–3:

(1) The amount of premiums determined under section 809(c)(1);

(2) The net decrease in reserves determined under section 809(c)(2);

(3) The net increase in reserves determined under section 809(d)(2); and

(4) The premiums earned on insurance contracts during the taxable year, as determined under section 832(b)(4). For the allocation and apportionment of such amounts to income from the insurance of United States risks, see paragraphs (f) and (g) of this section.

(f) *Items allocated or apportioned*—(1) *Rules of allocation or apportionment.* In determining taxable income under this section, first determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in §§1.953–2 and 1.953–3, and allocate such items to the insurance of United States risks. For example, the deductions allowed by section 809(d)(1), relating to death benefits, section 809(d)(3), relating to dividends to policyholders, and section 809(d)(7), relating to the assumption by another person of liabilities under insurance contracts, shall be allocated to the insurance of United States risks to the extent they relate directly to the premiums received for reinsuring or issuing insurance or annuity contracts in connection with United States risks. Next, determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with foreign risks and allocate such items to the reinsuring of foreign risks. Finally, determine all items of income, expenses, losses, and other deductions which relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with both United States risks and foreign risks, and, except as provided in paragraph (g) of this section, apportion such items between the insurance of United States risks and the insurance of foreign risks in the manner prescribed in subparagraph (2) or (3) of this paragraph, as the case may be. As used in this section, the term ''foreign risks'' means risks which are not United States risks as defined in §1.953–2 or §1.953–3.

(2) *Method of apportionment in determination of life insurance taxable income*—(i) *Investment yield and net long-term capital gain.* Unless they can be allocated to the insurance of United States risks, as provided in subparagraph (1) of this paragraph, in determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section—

(*a*) The investment yield under section 804(c),

(*b*) The amount (if any) under section 809(b)(1)(B) by which the net long-term capital gain exceeds the net short-term capital loss, and

(*c*) Those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United

States risks in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and deductions as the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing any insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts. Thus, for example, if the ratio which the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts in one to three, then, unless an allocation to the insurance of United States risks can be made as provided in subparagraph (1) of this paragraph, one-third of each of such amounts of investment yield, excess gain, and deductions shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks, and two-thirds of each of such amounts shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with foreign risks.

(ii) *Other income and deductions—(a) Amount taken into account.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section, all items of income taken into account under section 809(c)(3), relating to other amounts of gross income, and the other deductions allowed under section 809(d)(12) to the extent that such other deductions do not relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to each of such items of income or of such other deductions as the numerator determined under (*b*) of this subdivision bears to the denominator determined under (*c*) of this subdivision.

(*b*) *Numerator.* The numerator used for purposes of the apportionment under (*a*) of this subdivision shall be an amount which equals the amount determined under (*c*) of this subdivision, but only to the extent that the amount so determined is taken into account under paragraph (e) of this section in determining taxable income for the taxable year.

(*c*) *Denominator.* The denominator used for purposes of the apportionment under (*a*) of this subdivision shall be an amount which equals—

(*1*) The amount of premiums determined under section 809(c)(1) for the taxable year, plus

(*2*) The net decrease in reserves determined under section 809(c)(2) for such year, minus

(*3*) The net increase in reserves determined under section 809(d)(2) for such year.

(iii) *Reserves used in apportionment formula.* The rules for determining which reserves are taken into account in determining the taxable income of a controlled foreign corporation under paragraph (a) of this section shall also apply under subdivision (ii) (*b*) and (*c*) of this subparagraph in determining the net decrease in reserves under section 809(c)(2) or the net increase in reserves under section 809(d)(2). See paragraph (c) of this section.

(3) *Method of apportionment in determination of mutual and other insurance income*—(i) *In general.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(2) of this section, any item which is required to be apportioned under subparagraph (1) of this paragraph shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to the total amount of such item as the amount of premiums earned on insurance contracts during the taxable year which is required to be taken into account by such corporation under paragraph (e)(4) of this section in determining such taxable income bears to the total amount

of all its premiums earned (as determined under section 832(b)(4)) on insurance contracts during the taxable year.

(ii) *Reserves used in apportionment formula.* The principles of subparagraph (2)(iii) of this paragraph shall apply in determining the reserves included in premiums earned on insurance contracts during the taxable year for purposes of subdivision (i) of this subparagraph.

(g) *Separate accounting.* The methods of apportionment prescribed in subparagraphs (2) and (3) of paragraph (f) of this section for determining taxable income under this section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts in connection with United States risks. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district, director, which requires a reasonable segregation of those items of income, expense, losses, and other deductions which relate to determining such taxable income.

(h) *Illustration.* The application of paragraphs (e) and (f) of this section may be illustrated by the following example:

*Example.* Controlled foreign corporation A, incorporated under, and engaged in an insurance business subject to, the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. Corporation M is a life insurance company as defined in section 801(a); A Corporation would, if it were a domestic corporation, be taxable under part I of subchapter L of the Code. In 1963, A Corporation derives income from the insurance of United States risks as a result of reinsuring the life insurance policies issued by M Corporation on lives of residents of the United States. In 1963, A Corporation also issues policies of life insurance on individuals who are not residents of the United States, but its premiums from the reinsuring of United States risks exceed he 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1. Based upon the facts set forth in paragraph (a) of this example, A Corporation for 1963 has taxable income under this section of $40,200, which is attributable to the reinsuring of life insurance contracts in connection with United States risks, determined in the manner provided in paragraphs (b), (c), and (d) of this example.

(a) A summary of the entire operations of A Corporation for 1963, determined under this section as though such corporation were a domestic life insurance company but without applying paragraph (f) of this section, is as follows:

| Item | Attributable to all insurance | Attributable to reinsuring U.S. risks | Attributable to insuring foreign risks |
|---|---|---|---|
| Investment Income: | | | |
| (1) Investment yield under section 804(c) | $90,000 | Unallocable | Unallocable |
| (2) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963 | 2,500,000 | $1,000,000 | $1,500,000 |
| (3) Required interest under section 809(a)(2) | 60,000 | 25,000 | 35,000 |
| (4) Deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income | 10,000 | Unallocable | Unallocable |
| Underwriting Income: | | | |
| (5) Premiums under section 809(c)(1) | 600,000 | 200,000 | 400,000 |
| (6) Net decrease in reserves under section 809(c)(2) | 10,000 | None | 10,000 |
| (7) Net increase in reserves under section 809(d)(2) | 40,000 | 40,000 | None |
| (8) Deductions allowed under section 809(d) (other than deduction allowed under section 809(d)(2) and other than those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income): | | | |
| (i) Allocable | 330,000 | 110,000 | 220,000 |
| (ii) Unallocable | 60,000 | Unallocable | Unallocable |

(b) The unallocable investment yield ($90,000) under paragraph (a)(1) of this example and the unallocable deductions ($10,000) under paragraph (a)(4) relating to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(1)(i) of this section in the amounts

of $36,000, and $4,000, respectively, determined as follows:

| | |
|---|---|
| (1) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963, attributable to reinsuring U.S. risks (paragraph (a)(2)) | $1,000,000 |
| (2) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963, attributable to all insurance (paragraph (a)(2)) | $2,500,000 |
| (3) Ratio of amount under subparagraph (1) to amount under subparagraph (2) ($1,000,000/$2,500,000) | 40% |
| (4) Amount of investment yield attributable to reinsuring of U.S. risks (40% of $90,000) | $36,000 |
| (5) Amount of such deductions attributable to reinsuring of U.S. risks (40% of $10,000) | $4,000 |

(c) The unallocable deductions ($60,000) under paragraph (a)(8)(ii) of this example which do not relate to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(2)(ii) of this section in the amount of $16,800, determined as follows:

(1) The numerator determined under paragraph (f)(2)(ii)(*b*) of this section is $160,000, determined as follows:

| | | |
|---|---|---|
| (i) Premiums under section 809(c)(1) attributable to reinsuring U.S. risks (paragraph (a)(5)) | $200,000 | |
| (ii) Plus: Net decrease in reserves under section 809(c)(2) attributable to reinsuring U.S. risks (paragraph (a)(6)) | | $200,000 |
| (iii) Less: Net increase in reserves under section 809(d)(2) attributable to reinsuring U.S. risks (paragraph (a)(7)) | | $40,000 |
| | | $160,000 |

(2) The denominator determined under paragraph (f)(2)(ii)(c) of this section is $570,000, determined as follows:

| | | |
|---|---|---|
| (i) Premiums under section 809(c)(1) attributable to all insurance (paragraph (a)(5)) | $600,000 | |
| (ii) Plus: Net decrease in reserves under section 809(c)(2) attributable to all insurance (paragraph (a)(6)) | 10,000 | |
| | | $610,000 |
| (iii) Less: Net increase in reserves under section 809(d)(2) attributable to all insurance (paragraph (a)(7)) | | 40,000 |
| | | $570,000 |

(3) Ratio which the numerator determined under subparagraph (1) bears to the denominator determined under subparagraph (2) ($160,000/$570,000)—28%.

(4) Amount of deductions attributable to reinsuring of U.S. risks (28% of $60,000)—$16,800.

(d) The taxable income of A Corporation for 1963 which constitutes its income derived from the insurance of United States risks for purposes of paragraph (a) of §1.953–1 is $40,200, determined as follows:

| | Attributable to all insurance | | Attributable to reinsuring U.S. risks | | Attributable to insuring foreign risks | |
|---|---|---|---|---|---|---|
| Item: | | | | | | |
| (1) Investment yield under section 804(c) (paragraph (a)(1), unallocable but as apportioned under paragraph (b)(4) | $90,000 | | $36,000 | | $54,000 | |
| (2) Less: Required interest under section 809(a)(2) (paragraph (a)(3)) | 60,000 | | 25,000 | | 35,000 | |
| (3) Life insurance company's share of investment yield under section 809(b)(1)(A) | ..... | $30,000 | | $11,000 | | $19,000 |
| Plus sum of: | | | | | | |
| (4) Premiums under section 809(c)(1) (paragraph (a)(5)) | 600,000 | | 200,000 | | 400,000 | |
| (5) Net decrease in reserves under section 809(c)(2) (paragraph (a)(6)) | 10,000 | 610,000 | None | 200,000 | 10,000 | 410,000 |
| Sum determined under section 809(b)(1) | ..... | 640,000 | | 211,000 | | 429,000 |
| Less sum of: | | | | | | |
| (6) Net increase in reserves under section 809(d)(2) (paragraph (a)(7)) | 40,000 | | 40,000 | | None | |
| (7) Deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income (paragraph (a)(4)), unallocable but as apportioned under paragraph (b)(5) | 10,000 | | 4,000 | | 6,000 | |
| (8) Deductions allowed under section 809(d) (other than deduction allowed under section 809(d)(2) and other than those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income) (paragraph (a)(8)):. | | | | | | |
| (i) Allocable | 330,000 | | 110,000 | | 220,000 | |

| | Attributable to all insurance | | Attributable to reinsuring U.S. risks | | Attributable to insuring foreign risks | |
|---|---|---|---|---|---|---|
| | | | | | | |
| (ii) Unallocable, but as apportioned under paragraph (c)(4) | 60,000 | 440,000 | 16,800 | 170,800 | 43,200 | 269,200 |
| Gain from operations | | 200,000 | | 40,200 | | 159,800 |

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

### § 1.953–5 Corporations not qualifying as insurance companies.

(a) *In general.* A controlled foreign corporation is not excluded from the application of paragraph (a) of §1.953–1 because such corporation, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies. Thus, if a controlled foreign corporation reinsures or issues insurance or annuity contracts in connection with United States risks, as defined in §1.953–2 or §1.953–3, and satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1, such corporation may derive income from the insurance of United States risks even though the primary and predominant business activity of such corporation during the taxable year is not the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

(b) *Income from insurance of United States risks by noninsurance company.* For purposes of paragraph (a) of §1.953–1, the taxable income derived from the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks by a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies shall be determined under §1.953–4, subject to, and to the extent not inconsistent with, the special rules prescribed in paragraph (c) or (d) of this section, whichever applies.

(c) *Special rules in determining taxable income*—(1) *In general.* The rules prescribed in this paragraph apply in order to exclude from the determination under §1.953–4 of the taxable income described in paragraph (b) of this section those items of the controlled foreign corporation's gross income and deductions which are not attributable to the reinsuring and issuing of insurance and annuity contracts.

(2) *Life insurance taxable income*—(i) *Amount of investment yield taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which would not be taxable as an insurance company to which subchapter L of the Code applies if it were a domestic corporation but would be taxable as an insurance company to which part I of such subchapter applies if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, the investment yield under section 804(c), the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, and all items of income taken into account under section 809(c)(3) shall be taken into account, subject to the provisions of paragraphs (e) and (f) of §1.953–4, in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and income items, as the case may be, as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(*a*) The mean of each of the items described in section 810(c) at the beginning and end of the taxable year, determined in accordance with the rules prescribed in paragraph (c) of §1.953–4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of §1.953–4,

(*b*) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(*c*) The mean of the earnings and profits accumulated by the controlled foreign corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be (a) face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by a controlled foreign corporation using the cash receipts and disbursements method of accounting and (b) adjusted basis in the case of all other assets.

(3) *Mutual and other insurance taxable income*—(i) *Amount of insurance income taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies but which if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, would be taxable as a mutual insurance company to which part II of subchapter L of the Code applies, or would be taxable as a mutual marine insurance or other insurance company to which part III of subchapter L of the Code applies, the sum of the items of gross income referred to in section 832(b)(1) (except the gross amount earned during the taxable year from underwriting income described in section 832(b)(1)(A)) reduced by the deductions allowable under section 832(c) which are related to such items of gross income shall be taken into account, subject to the provisions of paragraphs (e) and (f) of §1.953–4, in an amount which bears the same proportion to the sum of such items of gross income reduced by such deductions as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(*a*) The mean of the controlled foreign corporation's unearned premiums at the beginning and end of the taxable year, determined under section 832(b)(4)(B) and in accordance with the rules prescribed in paragraph (c) of §1.953–4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of §1.953–4,

(*b*) The mean of such corporation's unpaid losses at the beginning and end of the taxable year, determined under section 832(b)(5)(B),

(*c*) The mean of the items described in section 810(c)(4) at the beginning and end of the taxable year, to the extent allowable to such corporation under section 832(c)(11),

(*d*) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(*e*) The mean of the earnings and profits accumulated by such corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined in the manner prescribed in subparagraph (2)(iii) of this paragraph.

(d) *Separate accounting.* The special rules prescribed in paragraph (c) of this

section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district director, which requires a reasonable segregation of the insurance assets of the controlled foreign corporation.

[T.D. 6781, 29 FR 18211, Dec. 23, 1964]

### § 1.953–6 Relationship of sections 953 and 954.

(a) *Priority of application.* For purposes of determining the subpart F income of a controlled foreign corporation under section 952 for any taxable year, the provisions of section 954, relating to foreign base company income, shall be applied, after first applying section 953, only with respect to income which is not income derived from the insurance of United States risks under section 953. For example, the provisions of section 954 may be applied with respect to the income of a controlled foreign corporation which is not income derived from the insurance of United States risks under section 953 because such corporation does not satisfy the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1, even though such corporation has taxable income, as determined under §1.953–4, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks. In addition, the provisions of section 954 may apply with respect to the income of a controlled foreign corporation to the extent such income is not allocated or apportioned under §1.953–4 to the insurance of United States risks.

(b) *Decrease in income not material.* It is not material that the income of a controlled foreign corporation is decreased as a result of the application of paragraph (a) of this section. Thus, in applying §1.953–4 to the income of a controlled foreign corporation described in paragraph (c)(2) of §1.953–5 which would, but for paragraph (a) of this section, be subject to the provisions of section 954, there shall be allowed, in determining the taxable income derived from the insurance of United States risks under §1.953–4, a deduction under section 809(a)(1) for the share of each and every item of investment yield set aside for policyholders; it is not material that in determining foreign base company income such deduction would not be allowed under section 954(b)(5). Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for the provisions of paragraph (a) of this section, constitute foreign base company income under section 954 shall not be taken into account under section 954(b)(3)(B) in determining whether foreign base company income exceeds 70 percent of gross income for the taxable year.

(c) *Increase in income not material.* It is not material that the income of a controlled foreign corporation is increased as a result of the application of paragraph (a) of this section. Thus, in applying §1.953–4 to income of a controlled foreign corporation which would, but for paragraph (a) of this section, be subject to the provisions of section 954, it is not material that the dividends, interest, and gains from the sale or exchange of stock or securities derived from certain investments which would not be included in foreign personal holding company income under section 954(c)(3)(B) are included under section 953 in income derived from the insurance of United States risks. Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for paragraph (a) of this section, constitute foreign base company income shall not be excluded under section 954(b)(3)(A) for the taxable year.

[T.D. 6781, 29 FR 18212, Dec. 23, 1964]

**§ 1.954–0 Introduction.**

(a) *Effective dates*—(1) *Final regulations*—(i) *In general.* Except as otherwise specifically provided, the provisions of §§ 1.954–1 and 1.954–2 apply to taxable years of a controlled foreign corporation beginning after November 6, 1995. If any of the rules described in §§ 1.954–1 and 1.954–2 are inconsistent with provisions of other regulations under subpart F, these final regulations are intended to apply instead of such other regulations.

(ii) *Election to apply final regulations retroactively*—(A) *Scope of election.* An election may be made to apply the final regulations retroactively with respect to any taxable year of the controlled foreign corporation beginning on or after January 1, 1987. If such an election is made, these final regulations must be applied in their entirety for such taxable year and all subsequent taxable years. All references to section 11 in the final regulations shall be deemed to include section 15, where applicable.

(B) *Manner of making election.* An election under this paragraph (a)(1)(ii) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(*1*) By the controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns for the taxable year of such United States shareholders in which or with which the taxable year of the CFC ends, and including any additional information required by applicable administrative pronouncements, or

(*2*) In such other manner as may be prescribed in applicable administrative pronouncements.

(C) *Time for making election.* An election may be made under this paragraph (a)(1)(ii) with respect to a taxable year of the controlled foreign corporation beginning on or after January 1, 1987 only if the time for filing a return or claim for refund has not expired for the taxable year of any United States shareholder of the controlled foreign corporation in which or with which such taxable year of the controlled foreign corporation ends.

(D) *Revocation of election.* An election made under this paragraph (a)(1)(ii) may not be revoked.

(2) *Temporary regulations.* The provisions of §§ 4.954–1 and 4.954–2 of this chapter apply to taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. However, the provisions of § 4.954–2(b)(6) of this chapter continue to apply. For transactions entered into on or before October 10, 1995, taxpayers may rely on Notice 89–90, 1989–2 C.B. 407, in applying the temporary regulations.

(3) *§§ 1.954A–1 and 1.954A–2.* The provisions of §§ 1.954A–1 and 1.954A–2 (as contained in 26 CFR part 1 edition revised April 1, 1995) apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of §§ 1.954–0, 1.954–1 and 1.954–2.*

*§ 1.954–0 Introduction.*

(a) Effective dates.
(1) Final regulations.
(i) In general.
(ii) Election to apply final regulations retroactively.
(A) Scope of election.
(B) Manner of making election.
(C) Time for making election.
(D) Revocation of election.
(2) Temporary regulations.
(3) §§ 1.954A–1 and 1.954A–2.
(b) Outline of §§ 1.954–0, 1.954–1, and 1.954–2.

*§ 1.954–1 Foreign base company income.*

(a) In general.
(1) Purpose and scope.
(2) Gross foreign base company income.
(3) Adjusted gross foreign base company income.
(4) Net foreign base company income.
(5) Adjusted net foreign base company income.
(6) Insurance income.
(7) Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).
(b) Computation of adjusted gross foreign base company income and adjusted gross insurance income.
(1) De minimis and full inclusion tests.
(i) De minimis test.
(A) In general.
(B) Currency translation.

(C) Coordination with sections 864(d) and 881(c).
(ii) Seventy percent full inclusion test.
(2) Character of gross income included in adjusted gross foreign base company income.
(3) Coordination with section 952(c).
(4) Anti-abuse rule.
(i) In general.
(ii) Presumption.
(iii) Related persons.
(iv) Example.
(c) Computation of net foreign base company income.
(1) General rule.
(i) Deductions against gross foreign base company income.
(ii) Losses reduce subpart F income by operation of earnings and profits limitation.
(iii) Items of income.
(A) Income other than passive foreign personal holding company income.
(B) Passive foreign personal holding company income.
(2) Computation of net foreign base company income derived from same country insurance income.
(d) Computation of adjusted net foreign base company income or adjusted net insurance income.
(1) Application of high tax exception.
(2) Effective rate at which taxes are imposed.
(3) Taxes paid or accrued with respect to an item of income.
(i) Income other than passive foreign personal holding company income.
(ii) Passive foreign personal holding company income.
(4) Special rules.
(i) Consistency rule.
(ii) Coordination with earnings and profits limitation.
(iii) Example.
(5) Procedure.
(6) Coordination of full inclusion and high tax exception rules.
(7) Examples.
(e) Character of income.
(1) Substance of the transaction.
(2) Separable character.
(3) Predominant character.
(4) Coordination of categories of gross foreign base company income or gross insurance income.
(i) In general.
(ii) Income excluded from other categories of gross foreign base company income.
(f) Definition of related person.
(1) Persons related to controlled foreign corporation.
(i) Individuals.
(ii) Other persons.
(2) Control.
(i) Corporations.
(ii) Partnerships.
(iii) Trusts and estates.
(iv) Direct or indirect ownership.

*§ 1.954–2 Foreign personal holding company income.*

(a) Computation of foreign personal holding company income.
(1) Categories of foreign personal holding company income.
(2) Coordination of overlapping categories under foreign personal holding company provisions.
(i) In general.
(ii) Priority of categories.
(3) Changes in the use or purpose for which property is held.
(i) In general.
(ii) Special rules.
(A) Anti-abuse rule.
(B) Hedging transactions.
(iii) Example.
(4) Definitions and special rules.
(i) Interest.
(ii) Bona fide hedging transaction.
(A) Definition.
(B) Identification.
(C) Effect of identification and non-identification.
(*1*) Transactions identified.
(*2*) Inadvertent identification.
(*3*) Transactions not identified.
(*4*) Inadvertent error.
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(iii) Inventory and similar property.
(A) Definition.
(B) Hedging transactions.
(iv) Regular dealer.
(v) Dealer property.
(A) Definition.
(B) Securities dealers.
(C) Hedging transactions.
(vi) Examples.
(vii) Debt instrument.
(b) Dividends, interest, rents, royalties and annuities.
(1) In general.
(2) Exclusion of certain export financing interest.
(i) In general.
(ii) Exceptions.
(iii) Conduct of a banking business.
(iv) Examples.
(3) Treatment of tax-exempt interest. [Reserved]
(4) Exclusion of dividends or interest from related persons.
(i) In general.
(A) Corporate payor.
(B) Payment by a partnership.
(ii) Exceptions.
(A) Dividends.
(B) Interest paid out of adjusted foreign base company income or insurance income.
(*1*) In general.
(*2*) Rule for corporations that are both recipients and payors of interest.
(C) Coordination with sections 864(d) and 881(c).
(iii) Trade or business requirement.

(iv) Substantial assets test.
(v) Valuation of assets.
(vi) Location of tangible property.
(A) In general.
(B) Exception.
(vii) Location of intangible property.
(A) In general.
(B) Exception for property located in part in the payor's country of incorporation.
(viii) Location of inventory and dealer property.
(A) In general.
(B) Inventory and dealer property located in part in the payor's country of incorporation.
(ix) Location of debt instruments.
(x) Treatment of certain stock interests.
(xi) Treatment of banks and insurance companies. [Reserved]
(5) Exclusion of rents and royalties derived from related persons.
(i) In general.
(A) Corporate payor.
(B) Payment by a partnership.
(ii) Exceptions.
(A) Rents or royalties paid out of adjusted foreign base company income or insurance income.
(B) Property used in part in the controlled foreign corporation's country of incorporation.
(6) Exclusion of rents and royalties derived in the active conduct of a trade or business.
(c) Excluded rents.
(1) Active conduct of a trade or business.
(2) Special rules.
(i) Adding substantial value.
(ii) Substantiality of foreign organization.
(iii) Active leasing expenses.
(iv) Adjusted leasing profit.
(3) Examples.
(d) Excluded royalties.
(1) Active conduct of a trade or business.
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(i) Adding substantial value.
(ii) Substantiality of foreign organization.
(iii) Active licensing expenses.
(iv) Adjusted licensing profit.
(3) Examples.
(e) Certain property transactions.
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(i) Inclusions.
(ii) Exceptions.
(iii) Treatment of losses.
(iv) Dual character property.
(2) Property that gives rise to certain income.
(i) In general.
(ii) Gain or loss from the disposition of a debt instrument.
(3) Property that does not give rise to income.
(f) Commodities transactions.
(1) In general.
(i) Inclusion in foreign personal holding company income.
(ii) Exception.
(iii) Treatment of losses.
(2) Definitions.
(i) Commodity.
(ii) Commodities transaction.
(iii) Qualified active sale.
(A) In general.
(B) Active conduct of a commodities business.
(C) Substantially all.
(D) Activities of employees of a related entity.
(iv) Qualified hedging transaction entered into prior to January 31, 2003.
(A) In general.
(B) Exception.
(C) Effective date.
(v) Qualified hedging transaction entered into on or after January 31, 2003.
(A) In general.
(B) Exception.
(C) Examples.
(D) Effective date.
(vi) Financial institutions not a producer, etc.
(g) Foreign currency gain or loss.
(1) Scope and purpose.
(2) In general.
(i) Inclusion.
(ii) Exclusion for business needs.
(A) General rule.
(B) Business needs.
(C) Regular dealers.
(1) General rule.
(2) Certain interest-bearing liabilities treated as dealer property.
(i) In general.
(ii) Failure to identify certain liabilities.
(iii) Effective date.
(D) Example.
(iii) Special rule for foreign currency gain or loss from an interest-bearing liability.
(3) Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category.
(i) In general.
(ii) Time and manner of election.
(iii) Revocation of election.
(iv) Example.
(4) Election to treat all foreign currency gains or losses as foreign personal holding company income.
(i) In general.
(ii) Time and manner of election.
(iii) Revocation of election.
(5) Gains and losses not subject to this paragraph.
(i) Capital gains and losses.
(ii) Income not subject to section 988.
(iii) Qualified business units using the dollar approximate separate transactions method.
(iv) Gain or loss allocated under §1.861–9. [Reserved]
(h) Income equivalent to interest.
(1) In general.

(i) Inclusion in foreign personal holding company income.
(ii) Exceptions.
(A) Liability hedging transactions.
(B) Interest.
(2) Definition of income equivalent to interest.
(i) In general.
(ii) Income from the sale of property.
(3) Notional principal contracts.
(i) In general.
(ii) Regular dealers.
(4) Income equivalent to interest from factoring.
(i) General rule.
(ii) Exceptions.
(iii) Factored receivable.
(iv) Examples.
(5) Receivables arising from performance of services.
(6) Examples.

[T.D. 8618, 60 FR 46508, Sept. 7, 1995; T.D. 8618, 60 FR 62024, Dec. 4, 1995; T.D. 8767, 63 FR 14615, Mar. 26, 1998; T.D. 9039, 68 FR 4917, Jan. 31, 2003]

### § 1.954–1 Foreign base company income.

(a) *In general*—(1) *Purpose and scope.* Section 954 and §§ 1.954–1 and 1.954–2 provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and thus is subject to current taxation under section 1, 11 or 55 of the Internal Revenue Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957.

(2) *Gross foreign base company income.* The gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income (determined after the application of section 952(b))—

(i) Foreign personal holding company income, as defined in section 954(c);

(ii) Foreign base company sales income, as defined in section 954(d);

(iii) Foreign base company services income, as defined in section 954(e);

(iv) Foreign base company shipping income, as defined in section 954(f); and

(v) Foreign base company oil related income, as defined in section 954(g).

(3) *Adjusted gross foreign base company income.* The term *adjusted gross foreign base company income* means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term *net foreign base company income* means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions (including taxes) properly allocable or apportionable to such income under the rules of section 954(b)(5) and paragraph (c) of this section.

(5) *Adjusted net foreign base company income.* The term *adjusted net foreign base company income* means the net foreign base company income of a controlled foreign corporation reduced, first, by any items of net foreign base company income excluded from subpart F income pursuant to section 952(c) and, second, by any items excluded from subpart F income pursuant to the high tax exception of section 954(b). See paragraph (d)(4)(ii) of this section. The term *foreign base company income* as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income, unless otherwise provided.

(6) *Insurance income.* The term *gross insurance income* includes all gross income taken into account in determining insurance income under section 953. The term *adjusted gross insurance income* means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term *net insurance income* means adjusted gross insurance income reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The term *adjusted net insurance income* means net insurance income reduced by any items of net insurance income

that are excluded from subpart F income pursuant to section 952(b) or pursuant to the high tax exception of section 954(b). The term *insurance income* as used in subpart F of the Internal Revenue Code and in the regulations under that subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income, respectively. Amounts subject to recharacterization under section 952(c) are determined after adjusted net foreign base company income and adjusted net insurance income are otherwise determined under subpart F and are not again subject to any exceptions or special rules that would affect the amount of subpart F income. Thus, for example, items of gross foreign base company income or gross insurance income that are excluded from adjusted gross foreign base company income or adjusted gross insurance income because the de minimis test is met are subject to recharacterization under section 952(c). Further, the de minimis and full inclusion tests of paragraph (b) of this section, and the high tax exception of paragraph (d) of this section, for example, do not apply to such amounts.

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis and full inclusion tests*—(i) *De minimis test*—(A) *In general.* Except as provided in paragraph (b)(1)(i)(C) of this section, adjusted gross foreign base company income and adjusted gross insurance income are equal to zero if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(*1*) 5 percent of gross income; or

(*2*) $1,000,000.

(B) *Currency translation.* Controlled foreign corporations having a functional currency other than the United States dollar shall translate the $1,000,000 threshold using the exchange rate provided under section 989(b)(3) for amounts included in income under section 951(a).

(C) *Coordination with sections 864(d) and 881(c).* Adjusted gross foreign base company income or adjusted gross insurance income of a controlled foreign corporation always includes income from trade or service receivables described in section 864(d)(1) or (6), and portfolio interest described in section 881(c), even if the de minimis test of this paragraph (b)(1)(i) is otherwise satisfied.

(ii) *Seventy percent full inclusion test.* Except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the controlled foreign corporation other than gross insurance income and amounts described in section 952(b), and adjusted gross insurance income consists of all gross insurance income other than amounts described in section 952(b), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income. See paragraph (d)(6) of this section, under which certain items of full inclusion foreign base company income may nevertheless be excluded from subpart F income.

(2) *Character of gross income included in adjusted gross foreign base company income.* The gross income included in the adjusted gross foreign base company income of a controlled foreign corporation generally retains its character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. However, gross income included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(ii) of this section is met is termed *full inclusion foreign base company income,* and constitutes a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Income that is included in subpart F income because the full inclusion test of paragraph (b)(1)(ii) of this section is met does not reduce amounts that, under section 952(c), are subject to recharacterization.

(4) *Anti-abuse rule*—(i) *In general.* For purposes of applying the de minimis test of paragraph (b)(1)(i) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if a principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to prevent income from being treated as foreign base company income or insurance income under the de minimis test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the de minimis test of paragraph (b)(1)(i) of this section if the corporations are related persons, as defined in paragraph (b)(4)(iii) of this section, and the corporations are described in paragraph (b)(4)(ii)(A), (B), or (C) of this section. This presumption may be rebutted by proof to the contrary.

(A) The activities carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons (as determined under paragraph (b)(4)(iii) of this section) are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year. A presumption made in connection with the requirements of this paragraph (b)(4)(ii)(A) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of §1.367(a)–6T(g)(2) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and §301.7701–3 of this chapter) that is a related person (as defined in paragraph (b)(4)(iii) of this section) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under §1.367(a)–6T(g)(2) if carried on directly by a United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) 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). In determining for purposes of this paragraph (b) 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) *Example.* The following example illustrates the application of this paragraph (b)(4).

*Example.* (i)(1) *USP* is the sole United States shareholder of three controlled foreign corporations: *CFC1*, *CFC2* and *CFC3.* The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP*, a foreign entity classified as a partnership under section 7701(a)(2) and §301.7701–3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP*, and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP*. Based on the facts in the table below, the foreign base company income derived by each controlled foreign corporation for its current taxable year, including income derived from *FP*, is less than five percent of the gross income of each controlled

foreign corporation and is less than $1,000,000:

| | CFC1 | CFC2 | CFC3 |
|---|---|---|---|
| Gross income | $4,000,000 | $8,000,000 | $12,000,000 |
| Five percent of gross income | 200,000 | 400,000 | 600,000 |
| Foreign base company income | 199,000 | 398,000 | 597,000 |

(2) Thus, without the application of the anti-abuse rule of this paragraph (b)(4), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis test of section 954(b)(3)(A) and paragraph (b)(1)(i) of this section.

(ii) However, under these facts, the requirements of paragraph (b)(4)(i) of this section are met unless the presumption of paragraph (b)(4)(ii) of this section is successfully rebutted. The sum of the foreign base company income of the controlled foreign corporations is $1,194,000. Thus, the amount of gross foreign base company income of each controlled foreign corporation will not be reduced by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(c) *Computation of net foreign base company income*—(1) *General rule.* The net foreign base company income of a controlled foreign corporation (as defined in paragraph (a)(4) of this section) is computed under the rules of this paragraph (c)(1). The principles of §1.904–5(k) shall apply where payments are made between controlled foreign corporations that are related persons (within the meaning of section 954(d)(3)). Consistent with these principles, only payments described in §1.954–2(b)(4)(ii)(B)(*2*) may be offset as provided in §1.904–5(k)(2).

(i) *Deductions against gross foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed first by taking into account deductions in the following manner:

(A) First, the gross amount of each item of income described in paragraph (c)(1)(iii) of this section is determined.

(B) Second, any expenses definitely related to less than all gross income as a class shall be allocated and apportioned under the principles of sections 861, 864 and 904(d) to the gross income described in paragraph (c)(1)(i)(A) of this section.

(C) Third, foreign personal holding company income that is passive within the meaning of section 904 (determined before the application of the high-taxed income rule of §1.904–4(c)) is reduced by related person interest expense allocable to passive income under §1.904–5(c)(2); such interest must be further allocated and apportioned to items described in paragraph (c)(1)(iii)(B) of this section.

(D) Fourth, the amount of each item of income described in paragraph (c)(1)(iii) of this section is reduced by other expenses allocable and apportionable to such income under the principles of sections 861, 864 and 904(d).

(ii) *Losses reduce subpart F income by operation of earnings and profits limitation.* Except as otherwise provided in §1.954–2(g)(4), if after applying the rules of paragraph (c)(1)(i) of this section, the amount remaining in any category of foreign base company income or foreign personal holding company income is less than zero, the loss in that category may not reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of section 952(c)(1).

(iii) *Items of income*—(A) *Income other than passive foreign personal holding company income.* A single item of income (other than foreign personal holding company income that is passive) is the aggregate amount from all transactions that falls within a single separate category (as defined in §1.904–5(a)(1)), and either—

(*1*) Falls within a single category of foreign personal holding company income as—

(*i*) Dividends, interest, rents, royalties and annuities;

(*ii*) Gain from certain property transactions;

(*iii*) Gain from commodities transactions;

(*iv*) Foreign currency gain; or

(*v*) Income equivalent to interest; or

(*2*) Falls within a single category of foreign base company income, other than foreign personal holding company income, as—

(*i*) Foreign base company sales income;

(*ii*) Foreign base company services income;

(*iii*) Foreign base company shipping income;

(*iv*) Foreign base company oil related income; or

(*v*) Full inclusion foreign base company income.

(B) *Passive foreign personal holding company income.* A single item of foreign personal holding company income that is passive is an amount of income that falls within a single group of passive income under the grouping rules of §1.904–4(c)(3), (4) and (5) and a single category of foreign personal holding company income described in paragraphs (c)(1)(iii)(A)(*1*) (*i*) through (*v*).

(2) *Computation of net foreign base company income derived from same country insurance income.* Deductions relating to foreign base company income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks located in the country under the laws of which the controlled foreign corporation is created or organized shall be allocated and apportioned in accordance with the rules set forth in section 953.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term *item of income.* For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see §1.904–4(c). A net item of income qualifies for the high tax exception only if—

(i) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income; and

(ii) It is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(2) *Effective rate at which taxes are imposed.* The effective rate with respect to a net item of income shall be determined separately for each controlled foreign corporation in a chain of corporations through which a distribution is made. The effective rate at which taxes are imposed on a net item of income is—

(i) The United States dollar amount of foreign income taxes paid or accrued (or deemed paid or accrued) with respect to the net item of income, determined under paragraph (d)(3) of this section; divided by

(ii) The United States dollar amount of the net item of foreign base company income or insurance income, described in paragraph (c)(1)(iii) of this section, increased by the amount of foreign income taxes referred to in paragraph (d)(2)(i) of this section.

(3) *Taxes paid or accrued with respect to an item of income*—(i) *Income other than passive foreign personal holding company income.* The amount of foreign income taxes paid or accrued with respect to a net item of income (other than an item of foreign personal holding company income that is passive) for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a United States shareholder under section 951(a)(1)(A) (determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made). For this purpose, in accordance with the regulations under section 960, the amounts that would be

deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a). The amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income.

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to a net item of foreign personal holding company income that is passive for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 and that would be taken into account for purposes applying the provisions of §1.904–4(c) with respect to that net item of income.

(4) *Special rules*—(i) *Consistency rule.* An election to exclude income from the computation of subpart F income for a taxable year must be made consistently with respect to all items of passive foreign personal holding company income eligible to be excluded for the taxable year. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must either be excluded in its entirety, or remain subject to subpart F in its entirety.

(ii) *Coordination with earnings and profits limitation.* If the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation of section 952(c)(1), the amount of income that is a net item of income, within the meaning of paragraph (c)(1)(iii) of this section, is determined after the application of the rules of section 952(c)(1).

(iii) *Example.* The following example illustrates the provisions of paragraph (d)(4)(ii) of this section. All of the taxes referred to in the following example are foreign income taxes. For simplicity, this example assumes that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, this example does not separately illustrate the deduction for taxes and gross-up.

*Example.* During its 1995 taxable year, CFC, a controlled foreign corporation, earns royalty income, net of taxes, of $100 that is foreign personal holding company income. CFC has no expenses associated with this royalty income. CFC pays $50 of foreign income taxes with respect to the royalty income. For 1995, CFC has current earnings and profits of $50. CFC's subpart F income, as determined prior to the application of this paragraph (d), exceeds its current earnings and profits. Thus, under paragraph (d)(4)(ii) of this section, the amount of CFC's only net item of income, the royalty income, will be limited to $50. The remaining $50 will be subject to recharacterization in a subsequent taxable year under section 952(c)(2). Because the amount of foreign income taxes paid with respect to this net item of income is $50, the effective rate of tax on the item, for purposes of this paragraph (d), is 50 percent ($50 of taxes/$50 net item + $50 of taxes). Accordingly, an election under paragraph (d)(5) of this section may be made to exclude the item of income from the computation of subpart F income.

(5) *Procedure.* An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(i) By the controlling United States shareholders, as defined in §1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by applicable administrative pronouncements; or

(ii) In such other manner as may be prescribed in applicable administrative pronouncements.

(6) *Coordination of full inclusion and high tax exception rules.* Notwithstanding paragraph (b)(1)(ii) of this section, full inclusion foreign base company income will be excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a controlled foreign corporation (determined without regard to the full inclusion test of paragraph (b)(1) of this section) is attributable to net amounts excluded from subpart F income pursuant to an election to have the high tax exception

described in section 954(b)(4) and this paragraph (d) apply.

(7) *Examples.* (i) The following examples illustrate the rules of this paragraph (d). All of the taxes referred to in the following examples are foreign income taxes. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up. Except as otherwise stated, these examples assume there are no earnings, deficits, or foreign income taxes in the post-1986 pools of earnings and profits or foreign income taxes.

*Example 1.* (i) *Items of income.* During its 1995 taxable year, controlled foreign corporation *CFC* earns from outside its country of operation portfolio dividend income of $100 and interest income, net of taxes, of $100 (consisting of a gross payment of $150 reduced by a third-country withholding tax of $50). For purposes of illustration, assume that *CFC* incurs no expenses. None of the income is taxed in *CFC*'s country of operation. The dividend income was not subject to third-country withholding taxes. Pursuant to the operation of section 904, the interest income is high withholding tax interest and the dividend income is passive income. Accordingly, pursuant to paragraph (c)(1)(iii) of this section, *CFC* has two net items of income—

(1) $100 of foreign personal holding company (FPHC)/passive income (the dividends); and

(2) $100 of FPHC/high withholding tax income (the interest).

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(1) of this *Example 1.* Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F income under the rules of this paragraph (d). Foreign tax of $50 would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(2) of this *Example 1.* Therefore, the effective rate of foreign tax is 33 percent ($50 of creditable taxes paid, divided by $150, consisting of the net item of foreign base company income ($100) plus creditable taxes paid thereon ($50)). The highest rate of tax specified in section 11 for the 1995 taxable year is 35 percent. Accordingly, the net item of income described in paragraph (i)(2) of this *Example 1* may be excluded from subpart F income if an election under paragraph (d)(5) of this section is made, since it is subject to foreign tax at an effective rate that is greater than 31.5 percent (90 percent of 35 percent). However, for purposes of section 904(d), it remains high withholding tax interest.

*Example 2.* (i) The facts are the same as in *Example 1*, except that *CFC*'s country of operation imposes a tax of $50 with respect to *CFC*'s dividend income (and thus *CFC* earns portfolio dividend income, net of taxes, of only $50). The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, *CFC* has two items of income for purposes of this paragraph (d)—

(1) $50 of FPHC/passive income (net of the $50 foreign tax); and

(2) $100 of FPHC/high withholding tax interest income.

(ii) Each item is taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of this *Example 2:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 2:* foreign tax ($50) divided by sum ($150) of income item ($100) plus creditable tax thereon ($50) equals 33 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either or both of the net items of income described in paragraphs (i)(1) and (2) of this *Example 2* from subpart F income. If no election is made the items would be included in the subpart F income of *CFC.*

*Example 3.* (i) The facts are the same as in *Example 1*, except that the $100 of portfolio dividend income is subject to a third-country withholding tax of $50, and the $150 of interest income is from sources within *CFC's* country of operation, is subject to a $10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (c)(1)(iii)(B) of this section they constitute separate items of income pursuant to the application of the grouping rules of §1.904–4(c). Accordingly, *CFC* has two net items of income for purposes of this paragraph (d)—

(1) $50 (net of $50 tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and

(2) $140 (net of $10 tax) of FPHC/country of operation income.

(ii) The item described in paragraph (i)(1) of this *Example 3* is taxed at an effective rate greater than 31.5 percent, but Item 2 is not. The net item of income described in paragraph (i)(1) of this *Example 3:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 3:* foreign

tax ($10) divided by sum ($150) of net item of income ($140) plus creditable tax thereon ($10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude the net item of income described in paragraph (i)(1) of this *Example 3* but not the net item of income described in paragraph (i)(2) of this *Example 3* from subpart F income.

*Example 4.* The facts are the same as in *Example 3*, except that the $150 of interest income is subject to an income tax of $50 in *CFC*'s country of operation. Accordingly, *CFC*'s items of income are the same as in *Example 3*, but both items are taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of *Example 3:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of *Example 3:* foreign tax ($50) divided by sum ($150) of net item of income ($100) plus creditable tax thereon ($50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(i) of this section, an election made by *CFC*'s controlling United States shareholders must exclude from subpart F income both items of FPHC income under the high tax exception of section 954(b)(4) and this paragraph (d). The election may not be made only with respect to one item.

*Example 5.* The facts are the same as in *Example 1*, except that *CFC* earns $5 of portfolio dividend income and $150 of interest income. In addition, *CFC* earns $45 for performing consulting services within its country of operation for unrelated persons. *CFC*'s gross foreign base company income for 1995 of $155 ($150 of gross interest income and $5 of portfolio dividend income) is greater than 70 percent of its gross income of $200. Therefore, under the full inclusion test of paragraph (b)(1)(ii) of this section, *CFC*'s adjusted gross foreign base company income is $200, and under paragraph (b)(2) of this section, the $45 of consulting income is full inclusion foreign base company income. If *CFC* elects, under paragraph (d)(5) of this section, to exclude the interest income from subpart F income pursuant to the high tax exception, the $45 of full inclusion foreign base company income will be excluded from subpart F income under paragraph (d)(6) of this section because the $150 of gross interest income excluded under the high tax exception is more than 90 percent of *CFC*'s adjusted gross foreign base company income of $155.

(ii) The following examples generally illustrate the application of paragraph (c) of this section and this paragraph (d). *Example 1* illustrates the order of computations. *Example 2* illustrates the computations required by sections 952 and 954 and this §1.954–1 if the full inclusion test of paragraph (b)(1)(ii) of this section is met and the income is not excluded from subpart F income under section 952(b). Computations in these examples involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up.

*Example 1.* (i) *Gross income. CFC*, a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and §1.954–2(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 952(b) or section 954(c). Another $50 is foreign base company sales income under section 954(d). The remaining $850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f) or (g) or 953, and is foreign source general limitation income described in section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of $500. This amount includes $8 of interest paid to a related person that is allocable to foreign personal holding company income under section 904, and $2 of other expense that is directly related to foreign personal holding company income. Another $20 of expense is directly related to foreign base company sales. The remaining $470 of expenses is allocable to general limitation income that is not foreign base company income or insurance income.

(iii) *Earnings and losses. CFC* has earnings and profits for the current taxable year of $500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by $600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of $30 is considered imposed on the interest income

under the rules of section 954(b)(4), this paragraph (d), and §1.904–6. Foreign income tax of $14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904–6. Foreign income tax of $177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4), this paragraph (d), and §1.904–6. For the taxable year of *CFC*, the maximum United States rate of taxation under section 11 is 35 percent.

(v) *Conclusion.* Based on these facts, if CFC elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have $500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows:

| | |
|---|---|
| *Step 1—Determine gross income:* | |
| (1) Gross income | $1000 |
| *Step 2—Determine gross foreign base company income and gross insurance income:* | |
| (2) Interest income included in gross foreign personal holding company income under section 954(c) | 100 |
| (3) Gross foreign base company sales income under section 954(d) | 50 |
| (4) Total gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (line (2) plus line (3)) | 150 |
| *Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:* | |
| (5) Five percent of gross income (.05 × line (1)) | 50 |
| (6) Seventy percent of gross income (.70 × line (1)) | 700 |
| (7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or $1,000,000) (if the amount on this line 7 is zero, proceed to Step 8) | 150 |
| (8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) | 150 |
| *Step 4—Compute net foreign base company income:* | |
| (9) Expenses directly related to adjusted gross foreign base company sales income | 20 |
| (10) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income | 2 |
| (11) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904 | 8 |
| (12) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by lines (10) and (11)) | 90 |
| (13) Net foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (3) reduced by line (9)) | 30 |
| (14) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (12) plus line (13)) | 120 |
| *Step 5—Compute net insurance income:* | |
| (15) Net insurance income under section 953 | 0 |
| *Step 6—Compute adjusted net foreign base company income:* | |
| (16) Foreign income tax imposed on net foreign personal holding company income (as determined under section 954(b)(4) and this paragraph (d)) | 30 |
| (17) Foreign income tax imposed on net foreign base company sales income (as determined under section 954(b)(4) and this paragraph (d)) | 14 |
| (18) Ninety percent of the maximum United States corporate tax rate | 31.5% |
| (19) Effective rate of foreign income tax imposed on net foreign personal holding company income ($90 of interest) under section 954(b)(4) and this paragraph (d) (line (16) divided by line (12)) | 33% |
| (20) Effective rate of foreign income tax imposed on $30 of net foreign base company sales income under section 954(b)(4) and this paragraph (d) (line (17) divided by line (13)) | 47% |
| (21) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (12) if line (19) is greater than line (18)) | 90 |
| (22) Net foreign base company sales income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (13) if line (20) is greater than line (18)) | 30 |
| (23) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (14), reduced by the sum of line (21) and line (22)) | 0 |
| *Step 7—Compute adjusted net insurance income:* | |
| (24) Adjusted net insurance income | 0 |
| *Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):* | |
| (25) Earnings and profits for the current year | 500 |
| (26) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (25) over the sum of lines (23) and (24)); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year | 500 |
| (27) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) | 600 |
| (28) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (23), line (24), and the lesser of line (26) or line (27)) | 500 |
| (29) Amount of prior year's deficit to be recharacterized as subpart F income in later years under section 952(c) (excess of line (27) over line (26)) | 100 |

*Example 2.* (i) *Gross income. CFC*, a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and §1.954–2(b)(1)(ii), is not income from trade or service receivables described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 954(c) and §1.954–2 or section 952(b). The remaining $280 is services income that is not

included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f), or (g) or 953, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of $650. This amount includes $350 of interest paid to related persons that is allocable to foreign personal holding company income under section 904, and $50 of other expense that is directly related to foreign personal holding company income. The remaining $250 of expenses is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and losses. CFC* has earnings and profits for the current taxable year of $350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by $600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of $120 is considered imposed on the $720 of interest income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904–6. Foreign income tax of $2 is considered imposed on the services income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904–6. For the taxable year of *CFC*, the maximum United States rate of taxation under section 11 is 35 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have $350 of subpart F income as defined in section 952(a), determined as follows.

| | |
|---|---|
| *Step 1—Determine gross income:* | |
| (1) Gross income | $1000 |
| *Step 2—Determine gross foreign base company income and gross insurance income:* | |
| (2) Gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (interest income) | 720 |
| *Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:* | |
| (3) Seventy percent of gross income (.70 × line (1)) | 700 |
| (4) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) | 1000 |
| (5) Full inclusion foreign base company income under paragraph (b)(1)(ii) (line (4) minus line (2)) | 280 |
| *Step 4—Compute net foreign base company income:* | |
| (6) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income | 50 |
| (7) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904 | 350 |
| (8) Deductions allocable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) of this section | 250 |
| (9) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by line (6) and line (7)) | 320 |
| (10) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (5) reduced by line (8)) | 30 |
| (11) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (9) plus line (10)) | 350 |
| *Step 5—Compute net insurance income:* | |
| (12) Net insurance income under section 953 | 0 |
| *Step 6—Compute adjusted net foreign base company income:* | |
| (13) Foreign income tax imposed on net foreign personal holding company income (interest) | 120 |
| (14) Foreign income tax imposed on net full inclusion foreign base company income | 2 |
| (15) Ninety percent of the maximum United States corporate tax rate | 31.5% |
| (16) Effective rate of foreign income tax imposed on $320 of net foreign personal holding company income under section 954(b)(4) and this paragraph (d) (line (13) divided by line (9)) | 38% |
| (17) Effective rate of foreign income tax imposed on $30 of net full inclusion foreign base company income under section 954(b)(4) and this paragraph (d) (line (14) divided by line (10)) | 7% |
| (18) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (9) if line (16) is greater than line (15)) | 320 |
| (19) Net full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (10) if line (17) is greater than line (15)) | 0 |
| (20) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (11) reduced by the sum of line (18) and line (19)) | 30 |
| *Step 7—Compute adjusted net insurance income:* | |
| (21) Adjusted net insurance income | 0 |
| *Step 8—Reduction of adjusted net foreign base company income or adjusted net insurance income by reason of paragraph (d)(6) of this section:* | |
| (22) Adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1) of this section) (line (4) reduced by line (5)) | 720 |
| (23) Ninety percent of adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1)(ii) of this section) (90% of the amount on line (22)) | 648 |
| (24) Net foreign base company income and net insurance income excluded from subpart F income under section 954(b)(4), increased by the amount of expenses that reduced this income under section 954(b)(5) and paragraph (c) of this section (line (18) increased by the sum of line (6) and line (7)) | 720 |

| | |
|---|---|
| (25) Adjusted net full inclusion foreign base company income excluded from subpart F income under paragraph (d)(6) of this section (zero, or line (10) reduced by line (19) if line (24) is greater than line (23)) | 30 |
| (26) Adjusted net foreign base company income after application of paragraph (d)(6) of this section (line (20) reduced by line (25)) | 0 |
| *Step 9—Additions to or reduction of subpart F income by reason of section 952(c):* | |
| (27) Earnings and profits for the current year | 350 |
| (28) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (27) over the sum of line (21) and line (26)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year | 350 |
| (29) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) | 600 |
| (30) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (21) and line (26) plus the lesser of line (28) or line (29)) | 350 |
| (31) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (29) over line (28)) | 250 |

(e) *Character of income*—(1) *Substance of the transaction.* For purposes of section 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income.

(2) *Separable character.* To the extent the definitional provisions of section 953 or 954 describe the income or gain derived from a transaction, or any portion or portions thereof, that income or gain, or portion or portions thereof, is so characterized for purposes of subpart F. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing personal property and selling it to related persons outside its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income for purposes of these rules.

(3) *Predominant character.* The portion of income or gain derived from a transaction that is included in the computation of foreign personal holding company income is always separately determinable and thus must always be segregated from other income and separately classified under paragraph (e)(2) of this section. However, the portion of income or gain derived from a transaction that would meet a particular definitional provision under section 954 or 953 (other than the definition of foreign personal holding company income) in unusual circumstances may not be separately determinable. If such portion is not separately determinable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise not separately determinable, then the classification of income from the transaction shall be made in accordance with the predominant character of the arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income*—(i) *In general.* The computations of gross foreign base company income and gross insurance income are limited by the following rules:

(A) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered insurance income or income in any other category of foreign base company income.

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(A) of this section.

(C) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of

foreign base company income except as provided in paragraph (e)(4)(i)(A) or (B) of this section.

(D) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, other than as provided in paragraph (e)(4)(i)(A), (B) or (C) of this section.

(ii) *Income excluded from other categories of gross foreign base company income.* Income shall not be excluded from a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in another category of gross foreign base company income or gross insurance income, if the income is excluded from that other category by a more specific provision of section 953 or 954. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under §1.954–2(f) as income from a qualified active sale may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See §1.954–2(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

(f) *Definition of related person*—(1) *Persons related to controlled foreign corporation.* Unless otherwise provided, for purposes of section 954 and §§1.954–1 through 1.954–8 inclusive, the following persons are considered under section 954(d)(3) to be related persons with respect to a controlled foreign corporation:

(i) *Individuals.* An individual, whether or not a citizen or resident of the United States, who controls the controlled foreign corporation.

(ii) *Other persons.* A foreign or domestic corporation, partnership, trust or estate that controls or is controlled by the controlled foreign corporation, or is controlled by the same person or persons that control the controlled foreign corporation.

(2) *Control*—(i) *Corporations.* With respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.

(ii) *Partnerships.* With respect to a partnership, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the capital or profits interest in the partnership.

(iii) *Trusts and estates.* With respect to a trust or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interest in the trust or estate.

(iv) *Direct or indirect ownership.* For purposes of this paragraph (f), to determine direct or indirect ownership, the principles of section 958 shall be applied without regard to whether a corporation, partnership, trust or estate is foreign or domestic or whether or not an individual is a citizen or resident of the United States.

(g) *Distributive share of partnership income*—(1) *Application of related person and country of organization tests.* Unless otherwise provided, to determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly, under §1.952–1(g), if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the controlled foreign corporation is created or organized, this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership.

(2) *Application of related person test for sales and purchase transactions between a partnership and its controlled foreign corporation partner.* For purposes of determining whether a controlled foreign corporation's distributive share of any item of gross income of a partnership is foreign base company sales income under section 954(d)(1) when the item of income is derived from the sale by the partnership of personal property purchased by the partnership from (or sold by the partnership on behalf of) the controlled foreign corporation; or the sale by the partnership of personal

property to (or the purchase of personal property by the partnership on behalf of) the controlled foreign corporation (CFC-partnership transaction), the CFC-partnership transaction will be treated as a transaction with an entity that is a related person, within the meaning of section 954(d)(3), under paragraph (g)(1) of this section, if—

(i) The controlled foreign corporation purchased such personal property from (or sold it to the partnership on behalf of), or sells such personal property to (or purchases it from the partnership on behalf of), a related person with respect to the controlled foreign corporation (other than the partnership), within the meaning of section 954(d)(3); or

(ii) The branch rule of section 954(d)(2) applies to treat as foreign base company sales income the income of the controlled foreign corporation from selling to the partnership (or a third party) personal property that the controlled foreign corporation has manufactured, in the case where the partnership purchases personal property from (or sells personal property on behalf of) the controlled foreign corporation.

(3) *Examples.* The application of this paragraph (g) is illustrated by the following examples:

*Example 1.* CFC, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country A. All of the stock of CFC is owned by USP, a U.S. corporation. Partnership earns commission income from purchasing Product O on behalf of USP, from unrelated manufacturers in Country B, for sale in the United States. To determine whether CFC's distributive share of Partnership's commission income is foreign base company sales income under section 954(d), CFC is treated as if it purchased Product O on behalf of USP. Under section 954(d)(3), USP is a related person with respect to CFC. Thus, with respect to CFC, the sales income is deemed to be derived from the purchase of personal property on behalf of a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC's country of organization, CFC's distributive share of the sales income is foreign base company sales income.

*Example 2.* (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. To determine whether CFC1's distributive share of Partnership's sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC1's country of organization, CFC1's distributive share of the sales income is foreign base company sales income.

(ii) Because Product A is both manufactured and sold for use within CFC2's country of organization, CFC2's distributive share of Partnership's sales income is not foreign base company sales income.

*Example 3.* CFC, a controlled foreign corporation organized in Country A, is an 80 percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. P Corp sold the goods to unrelated customers in Country D. The goods were manufactured in Country C by persons unrelated to J Corp . CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of section 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will also be foreign base company sales income.

*Example 4.* The facts are the same as *Example 3,* except that MJK Partnership purchased the goods from P Corp and sold those goods to CFC. CFC sold the goods to J Corp. J Corp sold the goods to unrelated customers in Country C. CFC's distributive share of the income of MJK Partnership from the sale of the goods by the partnership to itself will be treated as income from the sale of goods to a related person, for purposes of section 954(d)(1). Because the goods were both manufactured and sold for use outside of Country

A, CFC's distributive share of income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to J Corp is also foreign base company sales income.

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

[T.D. 8618, 60 FR 46509, Sept. 7, 1995; 60 FR 62024, 62025, Dec. 4, 1995, as amended by T.D. 8704, 62 FR 20, Jan. 2, 1997; T.D. 8767, 63 FR 14615, Mar. 26, 1998; T.D. 8827, 64 FR 37677, July 13, 1999; T.D. 9008, 67 FR 48023, July 23, 2002]

### § 1.954–2 Foreign personal holding company income.

(a) *Computation of foreign personal holding company income*—(1) *Categories of foreign personal holding company income.* For purposes of subpart F and the regulations under that subpart, foreign personal holding company income consists of the following categories of income—

(i) Dividends, interest, rents, royalties, and annuities as described in paragraph (b) of this section;

(ii) Gain from certain property transactions as described in paragraph (e) of this section;

(iii) Gain from commodities transactions as described in paragraph (f) of this section;

(iv) Foreign currency gain as described in paragraph (g) of this section; and

(v) Income equivalent to interest as described in paragraph (h) of this section.

(2) *Coordination of overlapping categories under foreign personal holding company provisions*—(i) *In general.* If any portion of income, gain or loss from a transaction is described in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section), that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

(ii) *Priority of categories.* The categories of foreign personal holding company income, listed from highest priority (paragraph (a)(2)(ii)(A) of this section) to lowest priority (paragraph (a)(2)(ii)(E) of this section), are—

(A) Dividends, interest, rents, royalties, and annuities, as described in paragraph (b) of this section;

(B) Income equivalent to interest, as described in paragraph (h) of this section without regard to the exceptions in paragraph (h)(1)(ii)(A) of this section;

(C) Foreign currency gain or loss, as described in paragraph (g) of this section without regard to the exclusion in paragraph (g)(2)(ii) of this section;

(D) Gain or loss from commodities transactions, as described in paragraph (f) of this section without regard to the exclusion in paragraph (f)(1)(ii) of this section; and

(E) Gain or loss from certain property transactions, as described in paragraph (e) of this section without regard to the exceptions in paragraph (e)(1)(ii) of this section.

(3) *Changes in the use or purpose for which property is held*—(i) *In general.* Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which property is held is that use or purpose for which it was held for more than one- half of the period during which the controlled foreign corporation held the property prior to the disposition.

(ii) *Special rules*—(A) *Anti-abuse rule.* If a principal purpose of a change in use or purpose of property was to avoid including gain or loss in the computation of foreign personal holding company income, all the gain or loss from the disposition of the property is treated as foreign personal holding company income. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Hedging transactions.* The provisions of paragraph (a)(3)(i) of this section shall not apply to bona fide hedging transactions, as defined in paragraph (a)(4)(ii) of this section. A transaction will be treated as a bona fide hedging transaction only so long as it

satisfies the requirements of paragraph (a)(4)(ii) of this section.

(iii) *Example.* The following example illustrates the application of this paragraph (a)(3).

*Example.* At the beginning of taxable year 1, *CFC*, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from the building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. The building was not used in an active trade or business of *CFC* for more than one-half of the period during which it was held by *CFC*. Therefore, the building is considered to be property that gives rise to rents, as described in paragraph (e)(2) of this section, and gain from the sale is included in the computation of *CFC*'s foreign personal holding company income under paragraph (e) of this section.

(4) *Definitions and special rules.* The following definitions and special rules apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term *interest* includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code or Income Tax Regulations or any other provision of law. For example, interest includes stated interest, acquisition discount, original issue discount, de minimis original issue discount, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(ii) *Bona fide hedging transaction*—(A) *Definition.* The term *bona fide hedging transaction* means a transaction that meets the requirements of §1.1221–2 (a) through (d) and that is identified in accordance with the requirements of paragraph (a)(4)(ii)(B) of this section, except that in applying §1.1221–2(b)(1), the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. A transaction that hedges the liabilities, inventory or other assets of a related person (as defined in section 954(d)(3)), that is entered into to assume or reduce risks of a related person, or that is entered into by a person other than a person acting in its capacity as a regular dealer (as defined in paragraph (a)(4)(iv) of this section) to reduce risks assumed from a related person, will not be treated as a bona fide hedging transaction. For an illustration of how this rule applies with respect to foreign currency transactions, see paragraph (g)(2)(ii)(D) of this section.

(B) *Identification.* The identification requirements of this section shall be satisfied if the taxpayer meets the identification and recordkeeping requirements of §1.1221–2(f). However, for bona fide hedging transactions entered into prior to March 7, 1996 the identification and recordkeeping requirements of §1.1221–2 shall not apply. Rather, for bona fide hedging transactions entered into on or after July 22, 1988 and prior to March 7, 1996 the identification and recordkeeping requirements shall be satisfied if such transactions are identified by the close of the fifth day after the day on which they are entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the identification and recordkeeping requirements shall be satisfied if such transactions are identified reasonably contemporaneously with the date they are entered into, but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

(C) *Effect of identification and non-identification—(1) Transactions identified.* If a taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the identification is binding with respect to any loss arising from such transaction whether or not all of the requirements of paragraph (a)(4)(ii)(A) of this section are satisfied. Accordingly, such loss will be allocated against income that is not subpart F income (or, in the case of an election under paragraph (g)(3) of this section, against the category of subpart F income to which it relates) and apportioned among the categories of income described in section 904(d)(1). If the transaction is not in fact a bona fide hedging transaction

described in paragraph (a)(4)(ii)(A) of this section, however, then any gain realized with respect to such transaction shall not be considered as gain from a bona fide hedging transaction. Accordingly, such gain shall be treated as gain from the appropriate category of foreign personal holding company income. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself operate to exclude gain from the appropriate category of foreign personal holding company income.

(*2*) *Inadvertent identification.* Notwithstanding paragraph (a)(4)(ii)(C)(*1*) of this section, if the taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the characterization of the loss is determined as if the transaction had not been identified as a bona fide hedging transaction if—

(*i*) The transaction is not a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(*ii*) The identification of the transaction as a bona fide hedging transaction was due to inadvertent error; and

(*iii*) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(*3*) *Transactions not identified.* Except as provided in paragraphs (a)(4)(ii)(C)(*4*) and (*5*) of this section, the absence of an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section is binding and establishes that a transaction is not a bona fide hedging transaction. Thus, subject to the exceptions, the characterization of gain or loss is determined without reference to whether the transaction is a bona fide hedging transaction.

(*4*) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section, the taxpayer may treat gain or loss from the transaction as gain or loss from a bona fide hedging transaction if—

(*i*) The transaction is a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(*ii*) The failure to identify the transaction was due to inadvertent error; and

(*iii*) All of the taxpayer's bona fide hedging transactions in all open years are being treated on either original or, if necessary, amended returns as bona fide hedging transactions in accordance with the rules of this section.

(*5*) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (a)(4)(ii)(B) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a bona fide hedging transaction, then loss from the transaction shall be treated as realized with respect to a bona fide hedging transaction. Thus, a taxpayer may not elect to exclude loss from its proper characterization as a bona fide hedging transaction. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (a)(4)(ii)(A) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(iii) *Inventory and similar property*—(A) *Definition.* The term *inventory and similar property* (or *inventory or similar property*) means property that is stock in trade of the controlled foreign corporation or other property of a kind that would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year (if the controlled foreign corporation were a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business.

(B) *Hedging transactions.* A bona fide hedging transaction with respect to inventory or similar property (other than a transaction described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)) shall be treated as a transaction in inventory or similar property.

(iv) *Regular dealer.* The term *regular dealer* means a controlled foreign corporation that—

(A) Regularly and actively offers to, and in fact does, purchase property

from and sell property to customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business.

(v) *Dealer property*—(A) *Definition.* Property held by a controlled foreign corporation is *dealer property* if—

(*1*) The controlled foreign corporation is a regular dealer in property of such kind (determined under paragraph (a)(4)(iv) of this section); and

(*2*) The property is held by the controlled foreign corporation in its capacity as a dealer in property of such kind without regard to whether the property arises from a transaction with a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. The property is not held by the controlled foreign corporation in its capacity as a dealer if the property is held for investment or speculation on its own behalf or on behalf of a related person (as defined in section 954(d)(3)).

(B) *Securities dealers.* If a controlled foreign corporation is a licensed securities dealer, only the securities that it has identified as held for investment in accordance with the provisions of section 475(b) or section 1236 will be considered to be property held for investment or speculation under this section. A licensed securities dealer is a controlled foreign corporation that is both a securities dealer, as defined in section 475, and a regular dealer, as defined in paragraph (a)(4)(iv) of this section, and that is either—

(*1*) Registered as a securities dealer under section 15(a) of the Securities Exchange Act of 1934 or as a Government securities dealer under section 15C(a) of such Act; or

(*2*) Licensed or authorized in the country in which it is chartered, incorporated, or organized to purchase and sell securities from or to customers who are residents of that country. The conduct of such securities activities must be subject to bona fide regulation, including appropriate reporting, monitoring, and prudential (including capital adequacy) requirements, by a securities regulatory authority in that country that regularly enforces compliance with such requirements and prudential standards.

(C) *Hedging transactions.* A bona fide hedging transaction with respect to dealer property shall be treated as a transaction in dealer property.

(vi) *Examples.* The following examples illustrate the application of paragraphs (a)(4)(ii), (iv) and (v) of this section.

*Example 1.* (i) *CFC1* and *CFC2* are related controlled foreign corporations (within the meaning of section 954(d)(3)) located in Countries F and G, respectively. *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons with respect to *CFC1* or *CFC2* (within the meaning of section 954(d)(3)) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments. *CFC1* uses securities that are traded in securities markets in Country G to hedge positions that it enters into with customers located in Country F. *CFC1* is not a member of a securities exchange in Country G, so it purchases such securities from *CFC2* and unrelated persons that are registered as securities dealers in Country G and that are members of Country G securities exchanges. Such hedging transactions qualify as bona fide hedging transactions under paragraph (a)(4)(ii) of this section.

(ii) Transactions that *CFC1* and *CFC2* enter into with each other do not affect the determination of whether they are regular dealers. Because *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons within the meaning of section 954(d)(3) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments, however, they qualify as regular dealers in such property within the meaning of paragraph (a)(4)(iv) of this section. Moreover, because *CFC1* purchases securities from *CFC2* as bona fide hedging transactions with respect to dealer property, the securities are dealer property under paragraph (a)(4)(v)(C) of this section. Similarly, because *CFC2* sells securities to *CFC1* in the ordinary course of its business as a dealer, the securities are dealer property under paragraph (a)(4)(v)(A) of this section.

*Example 2.* (i) *CFC* is a controlled foreign corporation located in Country B. *CFC* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. *CFC* regularly and actively holds itself out as being willing to, and in fact does, enter into either side of options, forward contracts, or other financial instruments with other members of the same controlled group. *CFC* hedges risks arising from such transactions by entering into transactions with persons who are not related persons (within the meaning of section 954(d)(3)) with respect to *CFC*. However, *CFC* does not regularly and actively hold itself out as being willing to, and does not, enter into either side of transactions with unrelated persons.

(ii) *CFC* is not a regular dealer in property under paragraph (a)(4)(iv) of this section and its options, forwards, and other financial instruments are not dealer property within the meaning of paragraph (a)(4)(v) of this section.

(vii) *Debt instrument.* The term *debt instrument* includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(5) *Special rules applicable to distributive share of partnership income*—(i) [Reserved]

(ii) *Certain other exceptions applicable to foreign personal holding company income.* To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income—

(A) The exceptions contained in section 954(c) that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business, including section 954(c)(2) and paragraphs (b)(2) and (6), (e)(1)(ii) and (3)(ii), (iii) and (iv), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii) of this section, shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person;

(B) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(h) unless the controlled foreign corporation is an eligible controlled foreign corporation within the meaning of section 954(h)(2) (taking into account the income of the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the controlled foreign corporation, including the controlled foreign corporation's distributive share of partnership income) and the partnership, of which the controlled foreign corporation is a partner, generates qualified banking or financing income within the meaning of section 954(h)(3) (taking into account only the income of the partnership);

(C) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(i) unless the controlled foreign corporation is a qualifying insurance company, as defined in section 953(e)(3), and the income of the partnership would have been qualified insurance income, as defined in section 954(i)(2), if received by the controlled foreign corporation directly. See §1.952–1(g)(1).

(iii) *Examples.* The application of paragraph (a)(5)(ii) is demonstrated by the following examples:

*Example 1.* B Corp, a Country C corporation, is a controlled foreign corporation within the meaning of section 957(a). B Corp is an 80 percent partner of RKS Partnership, a Country D partnership whose principal office is located in Country D. RKS Partnership is a qualified business unit of B Corp, within the meaning of section 989(a). B Corp, including income earned through RKS Partnership, derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions in various countries with customers which are not related persons. Thus, B Corp is predominantly engaged in the active conduct of a banking, financing, or similar business within the meaning of section 954(h)(2)(A)(i). B Corp conducts substantial activity with respect to such business within the meaning of section 954(h)(2)(A)(ii). RKS Partnership derives more than 30 percent of its income from the

active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions with customers which are not related persons and which are located solely within the home country of RKS Partnership, Country D. B Corp's distributive share of RKS Partnership's income from its lending or finance business will satisfy the special rule for income derived in the active conduct of banking, financing, or similar business of section 954(h). B Corp is an eligible controlled foreign corporation within the meaning of section 954(h)(2) and RKS Partnership generates qualified banking or financing income within the meaning of section 954(h)(3). B Corp does not have any foreign personal holding company income with respect to its distributive share of RKS Partnership income attributable to its lending or finance business income earned in Country D.

*Example 2.* D Corp, a Country F corporation, is a controlled foreign corporation within the meaning of section 957(a). D Corp is a qualifying insurance company, within the meaning of section 953(e)(3), that is engaged in the business of issuing life insurance contracts. D Corp has reserves of $100x, all of which are allocable to exempt contracts, and $10x of surplus, which is equal to 10 percent of the reserves allocable to exempt contracts. D Corp contributed the $100x of reserves and $10x of surplus to DJ Partnership in exchange for a 40-percent partnership interest. DJ Partnership is an entity organized under the laws of Country G and is treated as a partnership under the laws of Country G and Country F. DJ Partnership earns $30x of investment income during the taxable year that is received from persons who are not related persons with respect to D Corp, within the meaning of section 954(d)(3). D Corp's distributive share of this investment income is $12x. This income is treated as earned by D Corp in Country F under the tax laws of Country F and meets the definition of exempt insurance income in section 953(e)(1). This $12x of investment income would be qualified insurance income, under section 954(i)(2), if D Corp had received the income directly, because the $110x invested by D Corp in DJ Partnership is equal to D Corp's reserves allocable to exempt contracts under section 954(i)(2)(A) and allowable surplus under section 954(i)(2)(B)(ii). Thus, D Corp's distributive share of DJ Partnership's income will be excluded from foreign personal holding company income under section 954(i).

(iv) [Reserved]

(v) *Effective date.* This paragraph (a)(5) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) *Dividends, interest, rents, royalties, and annuities*—(1) *In general.* Foreign personal holding company income includes—

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(4) of this section and distributions of previously taxed income under section 959(b);

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(4) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in paragraph (b)(5) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(6) of this section; and

(iv) Annuities.

(2) *Exclusion of certain export financing interest*—(i) *In general.* Foreign personal holding company income does not include interest that is export financing interest. The term *export financing interest* means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G). Solely for purposes of determining whether interest is export financing interest, property is treated as manufactured, produced, grown, or extracted in the United States if it is so treated under §1.927(a)–1T(c).

(ii) *Exceptions.* Export financing interest does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6) after the application of section 864(d)(7).

(iii) *Conduct of a banking business.* For purposes of this section, export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(2).

*Example 1.* (i) *DS,* a domestic corporation, manufactures property in the United States.

In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC*, a controlled foreign corporation with respect to which *DS* is a related person (within the meaning of section 954(d)(3)), provides loans described in section 864(d)(6) to unrelated persons for the purchase of property from *DS*. This property is purchased exclusively for use or consumption outside the United States and outside *CFC*'s country of incorporation.

(ii) If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS*, *CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of this paragraph (b)(2) and, thus, not included in foreign personal holding company income. However, interest from the loans made with respect to purchases from *DS* of property that is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the exception under section 864(d)(7) does not apply. Thus the interest from loans made with respect to this inventory is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

*Example 2.* (i) DS, a domestic corporation, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of §1.954–3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 is not manufactured in the United States under §1.927(a)–1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

(3) *Treatment of tax exempt interest.* For taxable years of a controlled foreign corporation beginning after March 3, 1997, foreign personal holding company income includes all interest income, including interest that is described in section 103 (see §1.952–2(c)(1)).

(4) *Exclusion of dividends or interest from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include dividends or interest if the payor—

(*1*) Is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3);

(*2*) Is created or organized under the laws of the same foreign country (the *country of incorporation*) as is the controlled foreign corporation; and

(*3*) Uses a substantial part of its assets in a trade or business in its country of incorporation, as determined under this paragraph (b)(4).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(4), if a partnership with one or more corporate partners makes a payment of interest, a corporate partner will be treated as the payor of the interest—

(*1*) If the interest payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under section 704(b); or

(*2*) If the interest payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Dividends.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(4) only to the extent that they are paid out of earnings and profits that are earned or accumulated during a period in which—

(*1*) The stock on which dividends are paid with respect to which the exclusion is claimed was owned by the recipient controlled foreign corporation

directly, or indirectly through a chain of one or more subsidiaries each of which meets the requirements of paragraph (b)(4)(i)(A) of this section; and

(*2*) Each of the requirements of paragraph (b)(4)(i)(A) of this section is satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to the controlled foreign corporation and the other requirements of paragraph (b)(4)(i)(A) of this section were substantially satisfied.

(*3*) This paragraph (b)(4)(ii)(A) is illustrated by the following example:

*Example.* *A*, a domestic corporation, owns all of the stock of *B*, a corporation created and organized under the laws of Country Y, and *C*, a corporation created and organized under the laws of Country X. The taxable year of each of the corporations is the calendar year. In Year 1, *B* earns $100 of income from the sale of products in Country Y that it manufactured in Country Y. *C* had no earnings and profits in Year 1. On January 1 of Year 2, *A* contributes all of the stock of *B* and *C* to Newco, a Country Y corporation, in exchange for all of the stock of Newco. Neither *B* nor *C* earns any income in Year 2, but at the end of Year 2 *B* distributes the $100 accumulated earnings and profits to Newco. Newco's income from the distribution, $100, is foreign personal holding company income because the earnings and profits distributed by *B* were not earned or accumulated during a period in which the stock of *B* was owned by Newco and in which each of the requirements of paragraph (b)(4)(i)(A) of this section was satisfied.

(B) *Interest paid out of adjusted foreign base company income or insurance income*—(*1*) *In general.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that the deduction for the interest is allocated under §1.954–1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in §1.954–1(a)(3)), adjusted gross insurance income (as defined in §1.954–1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(*2*) *Rule for corporations that are both recipients and payors of interest.* If a controlled foreign corporation is both a recipient and payor of interest, the interest that is received will be characterized before the interest that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by the controlled foreign corporation to a related person (as defined in section 954(d)(3)) shall be offset against and eliminate any interest received or accrued, directly or indirectly, by the controlled foreign corporation from that related person. In a case in which the controlled foreign corporation pays or accrues interest to a related person, as defined in section 954(d)(3), and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amounts of all other interest payments are reduced by the amount of the smallest interest payment.

(C) *Coordination with sections 864(d) and 881(c).* Income of a controlled foreign corporation that is treated as interest under section 864(d)(1) or (6), or that is portfolio interest, as defined by section 881(c), is not excluded from foreign personal holding company income under section 954(c)(3)(A)(i) and this paragraph (b)(4).

(iii) *Trade or business requirement.* Except as otherwise provided under this paragraph (b)(4), the principles of section 367(a) apply for purposes of determining whether the payor has a trade or business in its country of incorporation and whether its assets are used in that trade or business. Property purchased or produced for use in a trade or business is not considered used in a trade or business before it is placed in service or after it is retired from service as determined in accordance with the principles of sections 167 and 168.

(iv) *Substantial assets test.* A substantial part of the assets of the payor will be considered to be used in a trade or business located in the payor's country of incorporation for a taxable year only if the average value of the payor's assets for such year that are used in the trade or business and are located in such country equals more than 50 percent of the average value of all the assets of the payor (including assets not used in a trade or business). The average value of assets for the taxable year is determined by averaging the values of assets at the close of each quarter of the taxable year. The value of assets is determined under paragraph (b)(4)(v) of

this section, and the location of assets used in a trade or business of the payor is determined under paragraphs (b)(4)(vi) through (xi) of this section.

(v) *Valuation of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their fair market value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property*—(A) *In general.* Tangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, and dealer property as defined in paragraph (a)(4)(v) of this section) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* An item of tangible personal property that is used in the trade or business of a payor in the payor's country of incorporation is considered located within the payor's country of incorporation while it is temporarily located elsewhere for inspection or repair if the property is not placed in service in a country other than the payor's country of incorporation and is not to be so placed in service following the inspection or repair.

(vii) *Location of intangible property*—(A) *In general.* Intangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, dealer property as defined in paragraph (a)(4)(v) of this section, and debt instruments) is considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the use or exploitation of the property in that country during that entire quarter. For this purpose, the country in which the activities connected to the use or exploitation of the property are conducted is the country in which the expenses associated with these activities are incurred. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(4) if they would be deductible under section 162 or includible in inventory costs or the cost of goods sold if the payor were a domestic corporation. If the payor conducts such activities through an agent or independent contractor, then the expenses incurred by the payor with respect to the agent or independent contractor shall be deemed to be incurred by the payor in the country in which the expenses of the agent or independent contractor were incurred by the agent or independent contractor.

(B) *Exception for property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the use or exploitation of an item of intangible property, including goodwill (other than inventory and similar property, dealer property and debt instruments) during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the intangible considered located in the payor's country of incorporation during that quarter is a percentage of the value of the item as of the close of the quarter. That percentage equals the ratio that the expenses incurred by the payor (described in paragraph (b)(4)(vii)(A) of this section) during the entire quarter by reason of activities that are connected with the use or exploitation of the item of intangible property and are conducted in the payor's country of incorporation bear to all expenses incurred by the payor during the entire quarter by reason of all such activities worldwide.

(viii) *Location of inventory and dealer property*—(A) *In general.* Inventory and similar property, as defined in paragraph (a)(4)(iii) of this section, and dealer property, as defined in paragraph (a)(4)(v) of this section, are considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the production and sale, or purchase and resale, of such property in its country of incorporation during that entire quarter. If the payor conducts such activities through an agent or independent contractor, then the location of such activities is the place in which they are conducted by the agent or independent contractor.

(B) *Inventory and dealer property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the production and sale, or purchase and resale, of inventory or similar property or dealer property during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the inventory or similar property or dealer property considered located in the payor's country of incorporation during each quarter is a percentage of the value of the inventory or similar property or dealer property as of the close of the quarter. That percentage equals the ratio that the costs and expenses incurred by the payor during the entire quarter by reason of activities connected with the production and sale, or purchase and resale, of inventory or similar property or dealer property that are conducted in the payor's country of incorporation bear to all costs or expenses incurred by the payor during the entire quarter by reason of all such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property or dealer property is included in this computation if it—

(*1*) Would be included in inventory costs or otherwise capitalized with respect to inventory or similar property or dealer property under section 61, 263A, 471, or 472 if the payor were a domestic corporation; or

(*2*) Would be deductible under section 162 if the payor were a domestic corporation and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of §1.861–8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(4), debt instruments, other than debt instruments that are inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or dealer property (as defined in paragraph (a)(4)(v) of this section) are considered to be used in a trade or business only if they arise from the sale of inventory or similar property or dealer property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, and only until such time as interest is required to be charged under section 482. Debt instruments that arise from the sale of inventory or similar property or dealer property during a quarter are treated as having the same location, proportionately, as the inventory or similar property or dealer property held during that quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* Stock in a controlled foreign corporation (lower-tier corporation) that is incorporated in the same country as the payor and that is more than 50-percent owned, directly or indirectly, by the payor within the meaning of section 958(a) shall be considered located in the payor's country of incorporation and, solely for purposes of section 954(c)(3), used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(4).

(xi) *Treatment of banks and insurance companies.* [Reserved]

(5) *Exclusion of rents and royalties derived from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include rents or royalties if—

(*1*) The payor is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3); and

(*2*) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation receiving the payments is created or organized (the country of incorporation).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(5), if a partnership with one or more corporate partners makes a payment of rents or

royalties, a corporate partner will be treated as the payor of the rents or royalties—

(*1*) If the rent or royalty payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent the item of deduction is allocable to the corporate partner under section 704(b); or

(*2*) If the rent or royalty payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(5) to the extent that deductions for the payments are allocated under section 954(b)(5) and §1.954–1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in §1.954–1(a)(3)), adjusted gross insurance income (as defined in §1.954–1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(B) *Property used in part in the controlled foreign corporation's country of incorporation.* If the payor uses the property both in the controlled foreign corporation's country of incorporation and elsewhere, the part of the rent or royalty attributable (determined under the principles of section 482) to the use of, or the privilege of using, the property outside such country of incorporation is included in the computation of foreign personal holding company income under this paragraph (b).

(6) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties that are derived in the active conduct of a trade or business and received from a person that is not a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. For purposes of this section, rents or royalties are derived in the active conduct of a trade or business only if the provisions of paragraph (c) or (d) of this section are satisfied.

(c) *Excluded rents*—(1) *Active conduct of a trade or business.* Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—

(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or

(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such

an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses.* The term *active leasing expenses* means the deductions incurred by an organization of the lessor in a foreign country that are properly allocable to rental income and that would be allowable under section 162 to the lessor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the lessor;

(B) Deductions for rents paid or accrued;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the lessor (if the lessor were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the leased property other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(iv) *Adjusted leasing profit.* The term *adjusted leasing profit* means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the lessor with respect to such rental income;

(B) The amounts that would be allowable to such lessor (if the lessor were a domestic corporation) as deductions under sections 167 or 168 with respect to such rental income; and

(C) The amounts paid by the lessor to agents or independent contractors with respect to such rental income other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(3) *Examples.* The application of this paragraph (c) is illustrated by the following examples.

*Example 1.* Controlled foreign corporation *A* is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of Corporation *A* from these leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 2.* Controlled foreign corporation *D* purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation *D* owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation *D* also leases in country X on a long-term basis, generally for a term of one year, motor vehicles that it owns. Under the terms of the long-term leases, Corporation *D* is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation *D* maintains and operates an organization therein that is regularly engaged in the business of marketing and servicing the motor vehicles that are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation *D* receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 3.* Controlled foreign corporation *E* owns a complex of apartment buildings that it has acquired by purchase. Corporation *E* engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to Corporation *E*. The rental income of Corporation *E* from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 4.* Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 5.* Controlled foreign corporation *G* owns equipment that it ordinarily uses to perform contracts in foreign countries to

drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents Corporation *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Active conduct of a trade or business.* Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term *active licensing expenses* means the deductions incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the licensor;

(B) Deductions for royalties paid or incurred;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the licensor (if the controlled foreign corporation were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term *adjusted licensing profit* means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the licensor with respect to such royalty income;

(B) The amounts that would be allowable to such licensor as deductions under section 167 or 197 (if the licensor were a domestic corporation) with respect to such royalty income; and

(C) The amounts paid by the licensor to agents or independent contractors with respect to such royalty income.

(3) *Examples.* The application of this paragraph (d) is illustrated by the following examples.

*Example 1.* Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility, employees of Corporation *A* who are scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, that ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights that it develops as a

result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A), but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind.

*Example 2.* Assume that Corporation *A* in *Example 1*, in addition to receiving royalties for the use of patents that it develops, receives royalties for the use of patents that it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 3.* Controlled foreign corporation *B* receives royalties for the use of patents that it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents that it has purchased raw from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 4.* Controlled foreign corporation *C* receives royalties for the use of a patent that it developed through its own staff of employees at its facility in country X. Corporation *C* has developed no other patents. It does not regularly employ a staff of scientists, engineers or technicians to create new products to be patented. Further, it does not purchase and license patents developed by others to which it has added substantial value. The royalties received by Corporation *C* are not derived from the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 5.* Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice that is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusions.* Gain from certain property transactions described in section 954(c)(1)(B) includes the excess of gains over losses from the sale or exchange of—

(A) Property that gives rise to dividends, interest, rents, royalties or annuities, as described in paragraph (e)(2) of this section;

(B) Property that is an interest in a partnership, trust or REMIC; and

(C) Property that does not give rise to income, as described in paragraph (e)(3) of this section.

(ii) *Exceptions.* Gain or loss from certain property transactions described in section 954(c)(1)(B) and paragraph (e)(1)(i) of this section does not include gain or loss from the sale or exchange of—

(A) Inventory or similar property, as defined in paragraph (a)(4)(iii) of this section;

(B) Dealer property, as defined in paragraph (a)(4)(v) of this section; or

(C) Property that gives rise to rents or royalties described in paragraph (b)(6) of this section that are derived in the active conduct of a trade or business from persons that are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation.

(iii) *Treatment of losses.* Section 1.954–1(c)(1)(ii) provides for the treatment of losses in excess of gains from the sale or exchange of property described in paragraph (e)(1)(i) of this section.

(iv) *Dual character property.* Property may, in part, constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or, in part, constitute property that does not give rise to any income

as described in paragraph (e)(3) of this section. However, property that is described in paragraph (e)(1)(i)(B) of this section cannot be dual character property. Dual character property must be treated as two separate properties for purposes of paragraph (e)(2) or (3) of this section. Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under paragraph (e)(2) or (3) of this section, and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated under this paragraph (e)(1)(iv) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its trade or business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain that is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(iv) addresses the contemporaneous use of property for dual purposes. For rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (b) of this section, including—

(A) Property that gives rise to export financing interest described in paragraph (b)(2) of this section; and

(B) Property that gives rise to income from related persons described in paragraph (b)(4) or (5) of this section.

(ii) *Gain or loss from the disposition of a debt instrument.* Gain or loss from the sale, exchange or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) In the case of gain—

(*1*) It is interest (as defined in paragraph (a)(4)(i) of this section); or

(*2*) It is income equivalent to interest (as described in paragraph (h) of this section); and

(B) In the case of loss—

(*1*) It is directly allocated to, or treated as an adjustment to, interest income (as described in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Internal Revenue Code or Income Tax Regulations; or

(*2*) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Internal Revenue Code or Income Tax Regulations.

(3) *Property that does not give rise to income.* Except as otherwise provided in this paragraph (e)(3), for purposes of this section, the term *property that does not give rise to income* includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options. Property that does not give rise to income shall not include—

(i) Property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (e)(2) of this section;

(ii) Tangible property (other than real property) used or held for use in the controlled foreign corporation's trade or business that is of a character that would be subject to the allowance for depreciation under section 167 or 168 and the regulations under those sections (including tangible property described in §1.167(a)–2);

(iii) Real property that does not give rise to rental or similar income, to the extent used or held for use in the controlled foreign corporation's trade or business;

(iv) Intangible property (as defined in section 936(h)(3)(B)), goodwill or going concern value, to the extent used or

held for use in the controlled foreign corporation's trade or business;

(v) Notional principal contracts (but see paragraphs (f)(2), (g)(2) and (h)(3) of this section for rules that include income from certain notional principal contracts in gains from commodities transactions, foreign currency gains and income equivalent to interest, respectively); or

(vi) Other property that is excepted from the general rule of this paragraph (e)(3) by the Commissioner in published guidance. See §601.601(d)(2) of this chapter.

(f) *Commodities transactions*—(1) *In general*—(i) *Inclusion in foreign personal holding company income.* Foreign personal holding company income includes the excess of gains over losses from commodities transactions.

(ii) *Exception.* Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f).

(iii) *Treatment of losses.* Section 1.954–1(c)(1)(ii) provides for the treatment of losses in excess of gains from commodities transactions.

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term *commodity* includes tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

(ii) *Commodities transaction.* The term *commodities transaction* means the purchase or sale of a commodity for immediate (spot) delivery or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, or an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to—

(A) A futures or forward contract in a commodity;

(B) A leverage contract in a commodity purchased from a leverage transaction merchant;

(C) An exchange of futures for physical transaction;

(D) A transaction, including a notional principal contract, in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities;

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities; and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(iii) *Qualified active sale*—(A) *In general.* The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities is not a qualified active sale. For example, the sale by a controlled foreign corporation of commodities that were held for investment or speculation would not be a qualified active sale.

(B) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities only with respect to commodities for which each of the following conditions is satisfied—

(*1*) It holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or as dealer property (as defined in paragraph (a)(4)(v) of this section); and

(*2*) With respect to such commodities, it incurs substantial expenses in the ordinary course of a commodities business from engaging in one or more of the following activities directly, and

not through an independent contractor—

(*i*) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(*ii*) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(*iii*) Significant activities as described in paragraph (f)(2)(iii)(B)(*3*) of this section.

(*3*) For purposes of paragraph (f)(2)(iii)(B)(*2*)(*iii*) of this section, the significant activities must relate to—

(*i*) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging freight, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(*ii*) Owning and operating facilities for storage or warehousing; or

(*iii*) Owning or chartering vessels or vehicles for the transportation of the commodities.

(C) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities if the sum of its gross receipts from all of its qualified active sales (as defined in this paragraph (f)(2)(iii) without regard to the substantially all requirement) of commodities and its gross receipts from all of its qualified hedging transactions (as defined in paragraph (f)(2)(iv) of this section, applied without regard to the substantially all requirement of this paragraph (f)(2)(iii)(C)) equals or exceeds 85 percent of its total gross receipts for the taxable year (computed as though the corporation were a domestic corporation). In computing gross receipts, the District Director may disregard any sale or hedging transaction that has as a principal purpose manipulation of the 85 percent gross receipts test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(D) *Activities of employees of a related entity.* For purposes of this paragraph (f), activities of employees of an entity related to the controlled foreign corporation, who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by (or reimbursed to the related entity by), the controlled foreign corporation, are treated as activities engaged in directly by the controlled foreign corporation.

(iv) *Qualified hedging transaction entered into prior to January 31, 2003*(A) *In general.* The term *qualified hedging transaction* means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to qualified active sales (other than transactions described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)).

(B) *Exception.* The term *qualified hedging transaction* does not include transactions that are not reasonably necessary to the conduct of business of the controlled foreign corporation as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others.

(C) *Effective date.* This paragraph (f)(2)(iv) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into prior to January 31, 2003.

(v) *Qualified hedging transaction entered into on or after January 31, 2003*—(A) *In general.* The term *qualified hedging transaction* means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others. For purposes of this paragraph (f)(2)(v), a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business.

(B) *Exception.* The term *qualified hedging transaction* does not include a

transaction described in section 988(c)(1) (without regard to section 988(c)(1)(D)(i)).

(C) *Examples.* The following examples illustrate the provisions of this paragraph (f)(2)(v):

*Example 1.* CFC1 is a controlled foreign corporation located in country A. CFC1 manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. CFC1 conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aluminum used in the machinery it manufactures, CFC1 enters into futures purchase contracts for the delivery of aluminum. These futures purchase contracts are bona fide hedging transactions. As CFC1 purchases aluminum and component parts containing significant amounts of aluminum in the spot market for use in its business, it closes out an equivalent amount of aluminum futures purchase contracts by entering into offsetting aluminum futures sales contracts. The aluminum futures purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the computation of foreign personal holding company income.

*Example 2.* CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are bona fide hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

(D) *Effective date.* This paragraph (f)(2)(v) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into on or after January 31, 2003.

(vi) *Financial institutions not a producer, etc.* For purposes of this paragraph (f), a corporation is not a producer, processor, merchant or handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

(g) *Foreign currency gain or loss*—(1) *Scope and purpose.* This paragraph (g) provides rules for the treatment of foreign currency gains and losses. Paragraph (g)(2) of this section provides the general rule. Paragraph (g)(3) of this section provides an election to include foreign currency gains or losses that would otherwise be treated as foreign personal holding company income under this paragraph (g) in the computation of another category of subpart F income. Paragraph (g)(4) of this section provides an alternative election to treat any net foreign currency gain or loss as foreign personal holding company income. Paragraph (g)(5) of this section provides rules for certain gains and losses not subject to this paragraph (g).

(2) *In general*—(i) *Inclusion.* Except as otherwise provided in this paragraph (g), foreign personal holding company income includes the excess of foreign currency gains over foreign currency losses attributable to any section 988 transactions (foreign currency gain or loss). Section 1.954–1(c)(1)(ii) provides rules for the treatment of foreign currency losses in excess of foreign currency gains. However, if an election is made under paragraph (g)(4) of this section, the excess of foreign currency losses over foreign currency gains to which the election would apply may be apportioned to, and offset, other categories of foreign personal holding company income.

(ii) *Exclusion for business needs*—(A) *General rule.* Foreign currency gain or loss directly related to the business needs of the controlled foreign corporation is excluded from foreign personal holding company income.

(B) *Business needs.* Foreign currency gain or loss is directly related to the business needs of a controlled foreign corporation if—

(*1*) The foreign currency gain or loss—

(*i*) Arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business, other than the trade or business of trading foreign currency;

(*ii*) Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss;

(*iii*) Does not arise from a transaction described in section 988(c)(1)(B)(iii); and

(*iv*) Is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; or

(*2*) The foreign currency gain or loss arises from a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property that satisfies the requirements of paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transaction or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transaction or property. For purposes of this paragraph (g)(2)(ii)(B)(*2*), a hedging transaction will satisfy the aggregate hedging rules of §1.1221–2(c)(3) only if all (or all but a de minimis amount) of the aggregate risk being hedged arises in connection with transactions or property that satisfy the requirements of paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transactions or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transactions or property.

(C) *Regular dealers—(1) General rule.* Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(*2*) *Certain interest-bearing liabilities treated as dealer property*—(*i*) *In general.* For purposes of this paragraph (g)(2)(ii)(C), an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency shall be treated as dealer property of the type described in paragraph (g)(2)(ii)(C)(*1*) of this section if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

(*ii*) *Failure to identify certain liabilities.* If a controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property under paragraph (g)(2)(ii)(C)(*2*)(*i*) of this section but fails to so identify other interest-bearing liabilities that manage its currency risk with respect to assets held that constitute dealer property, the Commissioner may treat such other liabilities as properly identified as dealer property under paragraph (g)(2)(ii)(C)(*2*)(*i*) of this section if the Commissioner determines that the failure to identify such other liabilities had as one of its principal purposes the avoidance of Federal income tax.

(*iii*) *Effective date.* This paragraph (g)(2)(ii)(C)(*2*) applies only to gain or loss from an interest-bearing liability entered into by a controlled foreign corporation on or after January 31, 2003.

(D) *Example.* The following example illustrates the provisions of this paragraph (g)(2).

*Example.* (i) *CFC1* and *CFC2* are controlled foreign corporations located in Country B, and are members of the same controlled group. *CFC1* is engaged in the active conduct of a trade or business that does not produce any subpart F income. *CFC2* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks

outside of the group. Pursuant to this arrangement, and to hedge the currency risk on a non-interest bearing receivable incurred by *CFC1* in the normal course of its business, on Day 1 *CFC1* enters into a forward contract to sell Japanese Yen to CFC2 in 30 days. Also on Day 1, *CFC2* enters into a forward contract to sell Yen to unrelated Bank X on Day 30. *CFC2* is not a regular dealer in Yen spot and forward contracts, and the Yen is not the functional currency for either *CFC1* or *CFC2*.

(ii) Because the forward contract entered into by *CFC1* to sell Yen hedges a transaction entered into in the normal course of *CFC1*'s business that does not give rise to subpart F income, it qualifies as a bona fide hedging transaction as defined in paragraph (a)(4)(ii) of this section. Therefore, *CFC1*'s foreign exchange gain or loss from that forward contract will not be treated as foreign personal holding company income or loss under this paragraph (g).

(iii) Because the forward contract to purchase Yen was entered into by *CFC2* in order to assume currency risks incurred by *CFC1* it does not qualify as a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section. Thus, foreign exchange gain or loss recognized by *CFC2* from that forward contract will be foreign personal holding company income. Because *CFC2* entered into the forward contract to sell Yen in order to hedge currency risks of *CFC1,* that forward contract also does not qualify as a bona fide hedging transaction. Thus, *CFC2*'s foreign currency gain or loss arising from that forward contract will be foreign personal holding company income.

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability.* Except as provided in paragraph (g)(2)(ii)(C)(*2*) or (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T.

(3) *Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category*—(i) *In general.* For taxable years of a controlled foreign corporation beginning on or after November 6, 1995, the controlling United States shareholders of the controlled foreign corporation may elect, under this paragraph (g)(3), to exclude foreign currency gain or loss otherwise includible in the computation of foreign personal holding company income under this paragraph (g) from the computation of foreign personal holding company income under this paragraph (g) and include such foreign currency gain or loss in the category (or categories) of subpart F income (described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*)) to which such gain or loss relates. If an election is made under this paragraph (g)(3) with respect to a category (or categories) of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*), the election shall apply to all foreign currency gain or loss that arises from—

(A) A transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business that gives rise to income in that category (or categories) and that is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; and

(B) A bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property described in paragraph (g)(3)(i)(A) of this section. For purposes of this paragraph (g)(3)(i)(B), a hedging transaction will satisfy the aggregate hedging rules of §1.1221–2(c)(3) only if all (or all but a de minimus amount) of the aggregate risk being hedged arises in connection with transactions or property that generate the same category of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*).

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in §1.964–1(c)(5), make the election on behalf of the controlled foreign corporation by filing a statement with their original income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is made, clearly indicating that such election has been made. If

the controlling United States shareholders elect to apply these regulations retroactively, under §1.954–0(a)(1)(ii), the election under this paragraph (g)(3) may be made by the amended return filed pursuant to the election under §1.954–0(a)(1)(ii). The controlling United States shareholders filing the election statement described in this paragraph (g)(3)(ii) must provide copies of the election statement to all other United States shareholders of the electing controlled foreign corporation. Failure to provide copies of such statement will not cause an election under this paragraph (g)(3) to be voidable by the controlled foreign corporation or the controlling United States shareholders. However, the District Director has discretion to void the election if it is determined that three was no reasonable cause for the failure to provide copies of such statement. The statement shall include the following information—

(A) The name, address, taxpayer identification number, and taxable year of such United States shareholder;

(B) The name, address, and taxable year of the controlled foreign corporation for which the election is effective; and

(C) Any additional information required by the Commission by administrative pronouncement.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(iv) *Example.* The following example illustrates the provisions of this paragraph (g)(3).

*Example.* (i) *CFC,* a controlled foreign corporation, is a sales company that earns foreign base company sales income under section 954(d). *CFC* makes an election under this paragraph (g)(3) to treat foreign currency gains or losses that arise from a specific category (or categories) of subpart F income (as described in section 952(a), or, in the case of foreign base company income, as described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*)) as that type of income. *CFC* aggregates the currency risk on all of its transactions that generate foreign base company sales income and hedges this net currency exposure.

(ii) Assuming no more than a de minimus amount of risk in the pool of risks being hedged arises from transactions or property that generate income other than foreign base company sales income, pursuant to its election under (g)(3), *CFC*'s net foreign currency gain from the pool and the hedging transactions will be treated as foreign base company sales income under section 954(d), rather than as foreign personal holding company income under section 954(c)(1)(D). If the pool of risks and the hedging transactions generate a net foreign base company sales loss, however, *CFC* must apply the rules of §1.954–1(c)(1)(ii).

(4) *Election to treat all foreign currency gains or losses as foreign personal holding company income*—(i) *In general.* If the controlling United States shareholders make an election under this paragraph (g)(4), the controlled foreign corporation shall include in its computation of foreign personal holding company income the excess of foreign currency gains over losses or the excess of foreign currency losses over gains attributable to any section 988 transaction (except those described in paragraph (g)(5) of this section) and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Separate elections for section 1256 contracts and section 988 transactions are not permitted. An election under this paragraph (g)(4) supersedes an election under paragraph (g)(3) of this section.

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in §1.964–1(c)(5), make the election on behalf of the controlled foreign corporation in the same time and manner as provided in paragraph (g)(3)(ii) of this section.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(5) *Gains and losses not subject to this paragraph*—(i) *Capital gains and losses.* Gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss for purposes of this paragraph (g). Such gain or loss is treated as gain or loss from the sale or exchange of property that is included in the computation of

foreign personal holding company income under paragraph (e)(1) of this section. Paragraph (a)(2) of this section provides other rules concerning income described in more than one category of foreign personal holding company income.

(ii) *Income not subject to section 988.* Gain or loss that is not treated as foreign currency gain or loss by reason of section 988 (a)(2) or (d) is not foreign currency gain or loss for purposes of this paragraph (g). However, such gain or loss may be included in the computation of other categories of foreign personal holding company income in accordance with its characterization under section 988 (a)(2) or (d) (for example, foreign currency gain that is treated as interest income under section 988(a)(2) will be included in the computation of foreign personal holding company income under paragraph (b)(ii) of this section).

(iii) *Qualified business units using the dollar approximate separate transactions method.* This paragraph (g) does not apply to any DASTM gain or loss computed under §1.985–3(d). Such gain or loss is allocated under the rules of §1.985–3 (e)(2)(iv) or (e)(3). However, the provisions of this paragraph (g) do apply to section 988 transactions denominated in a currency other than the United States dollar or the currency that would be the qualified business unit's functional currency were it not hyperinflationary.

(iv) *Gain or loss allocated under §1.861–9.* [Reserved]

(h) *Income equivalent to interest*—(1) *In general*—(i) *Inclusion in foreign personal holding company income.* Except as provided in this paragraph (h), foreign personal holding company income includes income equivalent to interest as defined in paragraph (h)(2) of this section.

(ii) *Exceptions*—(A) *Liability hedging transactions.* Income, gain, deduction or loss that is allocated and apportioned in the same manner as interest expense under the provisions of §1.861–9T is not income equivalent to interest for purposes of this paragraph (h).

(B) *Interest.* Amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest for purposes of this paragraph (h).

(2) *Definition of income equivalent to interest*—(i) *In general.* The term *income equivalent to interest* includes income that is derived from—

(A) A transaction or series of related transactions in which the payments, net payments, cash flows or return predominantly reflect the time value of money;

(B) Transactions in which the payments (or a predominant portion thereof) are, in substance, for the use or forbearance of money;

(C) Notional principal contracts, to the extent provided in paragraph (h)(3) of this section;

(D) Factoring, to the extent provided in paragraph (h)(4) of this section;

(E) Conversion transactions, but only to the extent that gain realized with respect to such a transaction is treated as ordinary income under section 1258;

(F) The performance of services, to the extent provided in paragraph (h)(5) of this section;

(G) The commitment by a lender to provide financing, if any portion of such financing is actually provided;

(H) Transfers of debt securities subject to section 1058; and

(I) Other transactions, as provided by the Commissioner in published guidance. See §601.601(d)(2) of this chapter.

(ii) *Income from the sale of property.* Income from the sale of property will not be treated as income equivalent to interest by reason of paragraph (h)(2)(i)(A) or (B) of this section. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes an advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90-day payment terms and at prearranged prices and terms such that the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the

risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(3) *Notional principal contracts*—(i) *In general.* Income equivalent to interest includes income from notional principal contracts denominated in the functional currency of the taxpayer (or a qualified business unit of the taxpayer, as defined in section 989(a)), the value of which is determined solely by reference to interest rates or interest rate indices, to the extent that the income from such transactions accrues on or after August 14, 1989.

(ii) *Regular dealers.* Income equivalent to interest does not include income earned by a regular dealer (as defined in paragraph (a)(4)(iv) of this section) from notional principal contracts that are dealer property (as defined in paragraph (a)(4)(v) of this section).

(4) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(4)(ii) of this section, the term *factoring income* includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable). The rules of this paragraph (h)(4) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable.

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) (relating to income derived from trade or service receivables of related persons), even if such income is treated as not described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short-term rate (as defined under section 1274) (or the analogous rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(4), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(4), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Examples.* The following examples illustrate the application of this paragraph (h)(4).

*Example 1. DP,* a domestic corporation, owns all of the outstanding stock of *FS,* a controlled foreign corporation. *FS* acquires accounts receivable arising from the sale of property by unrelated corporation *X.* The receivables have a face amount of $100, and after 30 days bear stated interest equal to at least 120 percent of the applicable Federal short-term rate (determined as of the date the receivables are acquired by *FS*). *FS* purchases the receivables from *X* for $95 on Day 1 and collects $100 plus stated interest from the obligor under the receivables on Day 40.

Income (other than stated interest) derived by *FS* from the factored receivables is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

*Example 2.* The facts are the same as in *Example 1*, except that, rather than collecting $100 plus stated interest from the obligor under the factored receivables on Day 40, *FS* sells the receivables to controlled foreign corporation *Y* on Day 15 for $97. Both the income derived by *FS* on the factored receivables and the income derived by *Y* (other than stated interest) on the receivables are factoring income within the meaning of paragraph (h)(4)(i) of this section, and therefore, constitute income equivalent to interest.

*Example 3.* The facts are the same as in *Example 1*, except that *FS* purchases the receivables from *X* for $98 on Day 30. Income derived by *FS* from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

*Example 4.* The facts are the same as in *Example 3*, except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by *FS* from this maturity factoring of the receivables is excluded from factoring income under paragraph (h)(4)(ii)(C) of this section and, therefore, does not give rise to income equivalent to interest.

*Example 5.* The facts are the same as in *Example 4*, except that *FS* sells the factored receivables to *Y* for $99 on Day 45, at which time stated interest is accruing on the unpaid balance of $100. Because interest was accruing at the time *Y* acquired the receivables at a rate equal to at least 120 percent of the applicable Federal short-term rate, income derived by *Y* from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

*Example 6. DP*, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of *FS*, a controlled foreign corporation. On Day 1, individual *A* uses a credit card issued by *DP* to purchase shoes priced at $100 from *X*, a foreign corporation unrelated to *DP*, *FS*, or *A*. On Day 7, *X* transfers the receivable (which does not bear stated interest) arising from *A*'s purchase to *FS* in exchange for $95. *FS* collects $100 from *A* on Day 45. Income derived by *FS* on the factored receivable is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the controlled foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (sections 1271 through 1275), if—

(i) Such provisions applied to contracts for the performance of services;

(ii) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months; and

(iii) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

(6) *Examples.* The following examples illustrate the application of this paragraph (h).

*Example 1. CFC*, a controlled foreign corporation, promises that Corporation *A* may borrow up to $500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, Corporation *A* pays *CFC* a commitment fee of $2. Pursuant to this agreement, *CFC* lends $80 to Corporation *A*. As a result, the entire $2 fee is included in the computation of *CFC*'s foreign personal holding company income under paragraph (h)(2)(i)(G) of this section.

*Example 2.* (i) At the beginning of its current taxable year, *CFC*, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by Corporation *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (LIBOR) plus one percentage point. Contemporaneously, *CFC* borrows $100 from Corporation *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues $11 of interest from Corporation *A* on the bond. Because interest is excluded from the definition of income equivalent to interest under paragraph (h)(1)(ii)(B) of this section, the $11 is not income equivalent to interest.

(iii) During its current taxable year, *CFC* incurs $10 of interest expense with respect to the borrowing from Corporation *B*. That expense is allocated and apportioned to, and reduces, subpart F income to the extent provided in section 954(b)(5) and §§ 1.861–9T through 1.861–12T and 1.954–1(c).

*Example 3.* (i) On January 1, 1994, *CFC*, a controlled foreign corporation with the United States dollar as its functional currency, purchases at face value a 10-year debt instrument issued by Corporation *A* having a $100 principal amount and bearing a floating

rate of interest set at LIBOR plus one percentage point payable on December 31st of each year. *CFC* subsequently determines that it would prefer receiving a fixed rate of return. Accordingly, on January 1, 1995, *CFC* enters into a 9-year interest rate swap agreement with Corporation *B* whereby Corporation *B* promises to pay *CFC* on December 31st of each year an amount equal to 10 percent on a notional principal amount of $100. In exchange, *CFC* promises to pay Corporation *B* an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) On December 31, 1995, *CFC* receives $9 of interest income from Corporation *A* with respect to the debt instrument. On the same day, *CFC* receives a total of $10 from Corporation *B* and pays $9 to Corporation *B* with respect to the interest rate swap.

(iii) The $9 of interest income is foreign personal holding income under section 954(c)(1). Pursuant to §1.446–3(d), *CFC* recognizes $1 of swap income for its 1995 taxable year that is also foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(C) of this section.

*Example 4.* (i) *CFC*, a controlled foreign corporation, purchases commodity X on the spot market for $100 and, contemporaneously, enter into a 3-month forward contract to sell commodity X for $104, a price set by the forward market.

(ii) Assuming that substantially all of *CFC*'s expected return is attributable to the time value of the net investment, as described in section 1258(c)(1), the transaction is a conversion transaction under section 1258(c). Accordingly, any gain treated as ordinary income under section 1258(a) will be foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(E) of this section.

[T.D. 8618, 60 FR 46517, Sept. 7, 1995; 60 FR 58731, Nov. 28, 1995; 60 FR 62025, 62026, Dec. 4, 1995, as amended by T.D. 8704, 62 FR 21, Jan. 2, 1997; T.D. 8985, 67 FR 12866, Mar. 20, 2002; T.D. 9008, 67 FR 48024, July 23, 2002; T.D. 9039, 68 FR 4917, Jan. 31, 2003; T.D. 9141, 69 FR 43317, July 20, 2004; T.D. 9240, 71 FR 2463, Jan. 17, 2006; T.D. 9326, 72 FR 38474, July 13, 2007]

### § 1.954–3 Foreign base company sales income.

(a) *Income included*—(1) *In general*—(i) *General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in subparagraphs (2), (3), and (4) of this paragraph, consist of gross income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with (*a*) the purchase of personal property from a related person and its sale to any person, (*b*) the sale of personal property to any person on behalf of a related person, (*c*) the purchase of personal property from any person and its sale to a related person, or (*d*) the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to an unrelated person, as defined in paragraph (e)(2) of §1.954–1, after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal holding company income of the controlled foreign corporation under §1.954–2 or foreign base company shipping income under §1.954–6; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its trade or business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term ''any person'' as used in this subparagraph includes a related person, as defined in paragraph (e)(1) of §1.954–1.

(ii) *Special rule—(a) In general.* The term ''personal property'' as used in section 954(d) and this section shall not include agricultural commodities which are not grown in the United States (within the meaning of section 7701(a)(9)) in commercially marketable quantities. All of the agricultural commodities listed in table I shall be considered grown in the United States in commercially marketable quantities. Bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea shall not

be considered grown in the United States in commercially marketable quantities. All other agricultural commodities shall not be considered grown in the United States in commercially marketable quantities when, in consideration of all of the facts and circumstances of the individual case, such commodities are shown to be produced in the United States in insufficient quantity and quality to be marketed commercially. The term ''agricultural commodities'' includes, but is not limited to, livestock, poultry, fish produced in fish farms, fruit, furbearing animals as well as the products of truck farms, ranches, nurseries, ranges, and orchards. A fish farm is an area where fish are grown or raised (artificially protected and cared for), as opposed to merely caught or harvested. However, the term ''agricultural commodities'' shall not include timber (either standing or felled), or any commodity at least 50 percent of the fair market value of which is attributable to manufacturing or processing, determined in a manner consistent with the regulations under section 993(c) (relating to the definition of export property). For purposes of applying such regulations, the term ''processing'' shall be deemed not to include handling, packing, packaging, grading, storing, transporting, slaughtering, and harvesting. Subdivision (ii) shall apply in the computation of foreign base company sales income for taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders (within the meaning of section 951(b)) within which or with which such taxable years of such foreign corporations end.

(*b*) *Table.*

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES

| Livestock and Products | |
|---|---|
| Beeswax | Horses |
| Cattle and calves | Milk |
| Chickens | Mink |
| Chicken eggs | Mohair |
| Ducks | Rabbits |
| Geese | Sheep and lambs |
| Goats | Turkeys |
| Hogs | Wool |
| Honey | |

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES—Continued

| Crops | |
|---|---|
| Alfalfa | Lettuce |
| Almonds | Lime |
| Apples | Macadamia nuts |
| Apricots | Maple syrup and sugar |
| Artichokes | Mint |
| Asparagus | Mushrooms |
| Avocadoes | Nectarines |
| Barley | Oats |
| Beans | Olives |
| Beets | Onions |
| Blackberries | Oranges |
| Blueberries | Papayas |
| Brussel sprouts | Pecans |
| Broccoli | Peaches |
| Bulbs | Peanuts |
| Cabbage | Pears |
| Cantaloupes | Peas |
| Carrots | Peppers |
| Cauliflower | Plums and prunes |
| Celery | Potatoes |
| Cherries | Potted plants |
| Corn | Raspberries |
| Cotton | Rice |
| Cranberries | Rhubarb |
| Cucumbers | Rye |
| Cut flowers | Sorghum grain |
| Dates | Soybeans |
| Eggplant | Spinach |
| Escarole | Strawberries |
| Figs | Sugar beets |
| Filberts | Sugarcane |
| Flaxseed | Sweet potatoes |
| Garlic | Tangelos |
| Grapes | Tangerines |
| Grapefruit | Tobacco |
| Grass seed | Tomatoes |
| Hay | Walnuts |
| Honeydew melons | Watermelons |
| Hops | Wheat |
| Lemons | |

(iii) The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from M Corporation, a related person, articles manufactured in the United States and sells the articles in the form in which purchased to P, not a related person, for delivery and use in foreign country Y. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

*Example 2.* Corporation A in example 1 also purchases from P, not a related person, articles manufactured in country Y and sells the articles in the form in which purchased to foreign corporation B, a related person, for use in foreign country Z. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign

country X, is a wholly owned subsidiary of domestic corporation N. By contract, N Corporation agrees to pay C Corporation, a related person, a commission equal to 6 percent of the gross selling price of all personal property shipped by N Corporation as the result of orders solicited by C Corporation in foreign countries Y and Z. In fulfillment of such orders, N Corporation ships products manufactured by it in the United States. Corporation C does not assume title to the property sold. Gross commissions received by C Corporation from N Corporation in connection with the sale of such property for use in countries Y and Z constitute foreign base company sales income.

*Example 4.* Controlled foreign corporation D, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation R. In 1964, D Corporation acquires a United States manufactured lathe from R Corporation. In 1972, after having made substantial use of the lathe in its manufacturing business, D Corporation sells the lathe to an unrelated person for use in foreign country Z. Gross income from the sale of the lathe is not foreign base company sales income since it is sold to an unrelated person after substantial use has been made of it by D Corporation in its business.

*Example 5.* Controlled foreign corporation E, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation P. Corporation E purchases from P Corporation articles manufactured by P Corporation outside of country Y and sells the articles to F Corporation, an unrelated person, for use in foreign country Z. Corporation E finances the purchase of the articles by F Corporation by agreeing to accept payment over an extended period of time and receives not only the purchase price but also interest and service fees. All gross income of E Corporation derived in connection with the purchase and sale of the personal property, including interest and service fees derived from financing the sale to F Corporation, constitutes foreign base company sales income.

(2) *Property manufactured, produced, constructed, grown, or extracted within the country in which the controlled foreign corporation is created or organized.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized. See section 954(d)(1)(A). The principles set forth in subparagraph (4) of this paragraph with respect to the manufacture, production, or construction of personal property shall apply under this subparagraph in determining what constitutes manufacture, production, or construction of property. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases coffee beans grown in country X from foreign corporation P, a related person, and sells the beans to M Corporation, a related person, for use in the United States. Income from the purchase and sale of the coffee beans by A Corporation is not foreign base company sales income since the beans were grown in country X.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation C, also incorporated under the laws of country X. Corporation B purchases and imports into country X rough diamonds mined in foreign country Y; in country X it cuts, polishes, and shapes the diamonds in a process which constitutes manufacturing within the meaning of subparagraph (4) of this paragraph. Corporation B sells the finished diamonds to C Corporation, a related person, which in turn sells them for use in foreign country Z. Since for purposes of this subparagraph the finished diamonds are manufactured in country X, gross income derived by C Corporation from their sale is not foreign base company sales income.

(3) *Property sold for use, consumption, or disposition within the country in which the controlled foreign corporation is created or organized*—(i) *In general.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph, (*a*) if the property is sold for use, consumption, or disposition in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or sells on behalf of a related person) is created or organized or (*b*), where the property is

purchased by the controlled foreign corporation on behalf of a related person, if such property is purchased for use, consumption, or disposition in the country under the laws of which such controlled foreign corporation is created or organized. See section 954(d)(1)(B).

(ii) *Rules for determining country of use, consumption, or disposition.* As a general rule, personal property which is sold to an unrelated person will 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 goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person the controlled foreign corporation 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 controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized. A controlled foreign corporation which sells personal property to a related person is presumed to sell such property for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized unless such corporation establishes the use made of the property by the related person; once it has established that the related person has disposed of the property, the rules in the two preceding sentences relating to sales by a controlled foreign corporation to an unrelated person will 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 controlled foreign corporation which sells personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that such property will be used, consumed, or disposed of within such country.

(iii) *Fungible goods.* For purposes of this subparagraph, a controlled foreign corporation which sells to a purchaser personal property which because of its fungible nature cannot reasonable be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless such corporation establishes a different disposition as being proper, treat such 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 regular course of business by such first purchaser. No apportionment need be made, however, on the basis of sporadic sales by the first purchaser. This subdivision shall apply only in a case where the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of goods from the fungible mass.

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

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, and controlled foreign corporation B, incorporated under the laws of foreign country Y, are related persons. Corporation A purchases from B Corporation electric transformers produced by B Corporation in country Y and sells the transformers to D Corporation, an unrelated person, for installation in a factory building being constructed in country X. Since the personal property purchased and sold by A Corporation is to be used within the country in which A Corporation is incorporated, income of A Corporation derived from the purchase and sale of the electric transformers is not foreign base company sales income.

*Example 2.* Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation C purchases from N Corporation sewing machines

manufactured in the United States by N Corporation and sells the sewing machines to retail department stores, unrelated persons, located in foreign country X. The entire activities of the department stores to which C Corporation sells the machines consist of selling goods from inventory to retail customers at retail outlets in country X. Under these circumstances, at the time of sale C Corporation may assume the sewing machines will be used, consumed, or disposed of in country X, and no attempt need be made by C Corporation to determine where the sewing machines will ultimately be used by the customers of the retail department stores. Gross income of C Corporation derived from the sales to the department stores located in country X is not foreign base company sales income.

*Example 3.* Controlled foreign corporation D, incorporated under the laws of foreign country Y, and controlled foreign corporation E, incorporated under the laws of foreign country X, are related persons. Corporation D purchases from E Corporation sulphur extracted by E Corporation from deposits located in country X. Corporation D sells the sulphur to F Corporation, an unrelated person, for delivery to F Corporation's storage facilities located in country Y. At the time of the sale of the sulphur from D Corporation to F Corporation, D Corporation knows that F Corporation is actively engaged in the business of selling a large amount of sulphur in country Y but also that F Corporation sells, in the normal course of its business, 25 percent of its sulphur for ultimate consumption in foreign country Z. However, D Corporation has no knowledge at the time of sale whether any portion of the particular shipment it sells to F Corporation will be resold by F Corporation for ultimate use, consumption, or disposition outside country Y. Moreover, delivery of the sulphur to F Corporation's storage facilities constitutes more than a temporary interruption in the shipment of the sulphur. Under such circumstances, D Corporation may, but is not required to, trace the ultimate disposition by F Corporation of the personal property sold to F Corporation; however, if D Corporation does not trace the ultimate disposition and if it does not establish a different disposition as being proper, 25 percent of the sulphur sold by D Corporation to F Corporation will be treated as being sold for consumption in country Z and 25 percent of the gross income from the sale of sulphur by D Corporation to F Corporation will be treated as foreign base company sales income.

*Example 4.* Controlled foreign corporation G, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation P. Corporation G purchases from P Corporation toys manufactured in the United States by P Corporation and sells the toys to R, an unrelated person, for delivery to a duty-free port in country X. Instructions for the assembly and operation of the toys are printed in a language which is not commonly used in country X. From the facts and circumstances surrounding the sales to R, G Corporation knows, or should know, that the toys will probably not be used, consumed, or disposed of within country X. Therefore, unless G Corporation determines the use to be made of the toys by R, such property will be presumed to have been sold by R for use, consumption, or disposition outside of country X, and the entire gross income of G Corporation derived from the sales will be considered foreign base company sales income.

(4) *Property manufactured or produced by the controlled foreign corporation*—(i) *In general.* Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. A foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see subparagraph (5) of this paragraph.

(ii) *Substantial transformation of property.* If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. The application of this subdivision may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, operates a paper factory in foreign country Y. Corporation A purchases from a related person wood pulp grown in

country Y. Corporation A, by a series of processes, converts the wood pulp to paper which it sells for use in foreign country Z. The transformation of wood pulp to paper constitutes the manufacture or production of property for purposes of this subparagraph.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, purchases steel rods from a related person which produces the steel in foreign country Y. Corporation B operates a machining plant in country X in which it utilizes the purchased steel rods to make screws and bolts. The transformation of steel rods to screws and bolts constitutes the manufacture or production of property for purposes of this subparagraph.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases tuna fish from unrelated persons who own fishing boats which catch such fish on the high seas. Corporation C receives such fish in country X in the condition in which taken from the fishing boats and in such country processes, cans, and sells the fish to related person D, incorporated under the laws of foreign country Y, for consumption in foreign country Z. The transformation of such fish into canned fish constitutes the manufacture or production of property for purposes of this subparagraph.

(iii) *Manufacture of a product when purchased components constitute part of the property sold.* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). The application of this subdivision may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, sells industrial engines for use, consumption, and disposition outside country X. Corporation A, in connection with the assembly of such engines, performs machining and assembly operations. In addition, A Corporation purchases, from related and unrelated persons, components manufactured in foreign country Y. On a per unit basis, A Corporation's selling price and costs of such engines are as follows:

| | | |
|---|---|---|
| Selling price | | $400 |
| Cost of goods sold: | | |
| Material— | | |
| Acquired from related persons | $100 | |
| Acquired from others | 40 | |
| Total material | | $140 |
| Conversion costs (direct labor and factory burden) | | 70 |
| Total cost of goods sold | | 210 |
| Gross profit | | 190 |
| Administrative and selling expenses | | 50 |
| Taxable income | | 140 |

The conversion costs incurred by A Corporation are more than 20 percent of total costs of goods sold ($70/$210 or 33 percent). Although the product sold, an engine, is not sufficiently distinguishable from the components to constitute a substantial transformation of the purchased parts within the meaning of subdivision (ii) of this subparagraph, A Corporation will be considered under this subdivision to have manufactured the product it sells.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, operates an automobile assembly plant. In connection with such activity, B Corporation purchases from related persons assembled engines, transmissions, and certain other components, all of which are manufactured outside of country X; purchases additional components from unrelated persons; conducts stamping, machining, and subassembly operations; and has a substantial investment in tools, jigs, welding equipment, and other machinery and equipment used in the assembly of an automobile. On a per unit basis, B Corporation's selling price and costs of such automobiles are as follows:

| | | |
|---|---|---|
| Selling price | | $2,500 |
| Cost of goods sold: | | |
| Material— | | |
| Acquired from related persons | $1,200 | |
| Acquired from others | 275 | |

| | | |
|---|---|---|
| Total material | $1,475 | |
| Conversion costs (direct labor and factory burden) | 25 | |
| Total cost of goods sold | | 1,800 |
| Gross profit | | 700 |
| Administrative and selling expenses | | 300 |
| Taxable income | | 400 |

The product sold, an automobile, is not sufficiently distinguishable from the components purchased (the engine, transmission, etc.) to constitute a substantial transformation of purchased parts within the meaning of subdivision (ii) of this subparagraph. Although conversion costs of B Corporation are less than 20 percent of total cost of goods sold ($325/$1800 or 18 percent), the operations conducted by B Corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture of a product. Corporation B will be considered under this subdivision to have manufactured the product it sells.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases from related persons radio parts manufactured in foreign country Y. Corporation C designs radio kits, packages component parts required for assembly of such kits, and sells the parts in a knocked-down condition to unrelated persons for use outside country X. These packaging operations of C Corporation do not constitute the manufacture, production, or construction of personal property for purposes of section 954(d)(1).

(5) *Rules for apportionment of income derived from the sale of purchased components used in property not manufactured, produced, or constructed.* The foreign base company sales income derived by a controlled foreign corporation for the taxable year from sales of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed by such corporation within the meaning of subparagraph (4) of this paragraph shall, unless the records of the controlled foreign corporation show that a different apportionment of income is proper or unless all the income from such sales is treated as foreign base company sales income, be determined by first making for such year the following separate classifications and subclassifications with respect to the property which is sold and then by apportioning the income for such year from such sales in accordance with the rules of this subparagraph:

(i) A classification of the cost of components used in the property which is sold into two classes consisting of the cost of components manufactured, produced, constructed, grown, or extracted—

(*a*) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(*b*) Outside such country;

(ii) A subclassification of the class described in subdivision (i) (*b*) of this subparagraph into—

(*a*) The cost of such components purchased from unrelated persons, and

(*b*) The cost of such components purchased from related persons;

(iii) A classification of the income derived from such sales into two classes consisting of income derived from sales for use, consumption, or disposition—

(*a*) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(*b*) Outside such country; and

(iv) A subclassification of the class described in subdivision (iii) (*b*) of this subparagraph into income from—

(*a*) Sales to unrelated persons, and

(*b*) Sales to related persons.

The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to unrelated persons shall be the amount which bears to the amount described in subdivision (iv) (*a*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*b*) of this subparagraph bears to the total cost of components used in the product which is sold. The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) (*b*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*b*) of this subparagraph bears to the total cost of components used in the product which is sold.

The foreign base company sales income for the taxable year from purchases of the property from unrelated persons

and sales to related persons is the amount which bears to the amount described in subdivision (iv) (*b*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*a*) of this subparagraph bears to the total cost of components used in the product which is sold. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation C, which is incorporated under the laws of foreign country X, uses the calendar year as the taxable year. For 1964, C Corporation purchases radio parts of which some are manufactured in foreign country Y; and others, in country X. Some of the parts manufactured in country Y are purchased from related persons. Corporation C uses the purchased parts in radio kits which it designs and sells for assembly by its customers, unrelated persons, some of whom use the kits outside country X. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following factual classifications for such year:

| | | |
|---|---|---|
| Cost of components purchased from all persons: | | |
| Manufactured within country X | | $20 |
| Manufactured outside country X | | 40 |
| Total cost | | 60 |
| Cost of components manufactured outside country X: | | |
| Purchased from unrelated persons | | 10 |
| Purchased from related persons | | 30 |
| Total cost | | 40 |
| Gross income from sales: | | |
| Gross receipts from sales | | 120 |
| Cost of goods sold: | | |
| Components | $60 | |
| Direct labor and factory burden | 10 | 70 |
| Gross income | | 50 |
| Gross income from sales: | | |
| For use within country X | | 26 |
| For use outside country X | | 24 |
| Gross income | | 50 |
| Foreign base company sales income from purchases from related persons and sales to unrelated persons ($24×$30/$60) | | 12 |

*Example 2.* The facts are the same as in example 1 except that none of the purchases are from related persons and some of the sales for use outside country X are to related persons. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following additional factual classification for such year:

| | |
|---|---|
| Gross income from sales for use outside country X— | |
| To unrelated persons | $8 |
| To related persons | 16 |
| Total gross income | 24 |
| Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16×$40/$60) | 10.67 |

*Example 3.* The facts are the same as in example 1 except that some of the sales for use outside country X are to related persons as in example 2. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner:

| | |
|---|---|
| Foreign base company sales income from purchases from related persons and sales to unrelated persons ($8×$30/$60) | $4.00 |
| Foreign base company sales income from purchases from related persons and sales to related persons ($16×$30/$60) | 8.00 |
| Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16×$10/$60) | 2.67 |
| Total foreign base company sales income | 14.67 |

(6) *Special rule applicable to distributive share of partnership income*—(i) *In general.* To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952–1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(ii) *Example.* The application of paragraph (a)(6)(i) of this section is illustrated by the following example:

*Example.* CFC, a controlled foreign corporation organized under the laws of Country A, is an 80 percent partner in Partnership X, a

partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, within the meaning of paragraph (a)(4) of this section, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.

(iii) *Effective date.* This paragraph (a)(6) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) *Branches of controlled foreign corporation treated as separate corporations*—(1) *General rules for determining when to apply separate treatment*—(i) *Sales or purchase branch—(a) In general.* If a controlled foreign corporation carries on purchasing or selling activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(*b*) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to such branch or similar establishment only that income derived by the branch or establishment which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if the income allocated to the branch or similar establishment under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.

(*c*) *Use of more than one branch.* If a controlled foreign corporation carries on purchasing or selling activities by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, or by or through one or more such branches or similar establishments in a case where subdivision (ii) of this subparagraph also applies, then (*b*) of this subdivision shall be applied separately to the income derived by each such branch or similar establishment (by treating such purchasing or selling branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(ii) *Manufacturing branch—(a) In general.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or

similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(*b*) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to the remainder of such controlled foreign corporation only that income derived by the remainder of such corporation, which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if income allocated to the remainder of the controlled foreign corporation under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the branch or similar establishment is located, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country.

(*c*) *Use of one or more sales or purchase branches in addition to a manufacturing branch.* If, with respect to personal property manufactured, produced, constructed, grown, or extracted by or through a branch or similar establishment located outside the country under the laws of which the controlled foreign corporation is created or organized, purchasing or selling activities are carried on by or through more than one branch or similar establishment, or by or through one or more branches or similar establishments located outside such country, of such corporation, then (*b*) of this subdivision shall be applied separately to the income derived by each such purchasing or selling branch or similar establishment (by treating such purchasing or selling branch or similar establishment as though it alone were the remainder of the controlled foreign corporation) for purposes of determining whether the use of such manufacturing, producing, constructing, growing, or extracting branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(2) *Special rules*—(i) *Determination of treatment as a wholly owned subsidiary corporation.* For purposes of determining under this paragraph whether the use of a branch or similar establishment which is treated as a separate corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of a controlled foreign corporation—

(*a*) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(*b*) *Activities treated as performed on behalf of remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(*1*) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(*2*) With respect to personal property (other than property described in (*1*) of this subdivision (*b*)) purchased or sold, or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(*c*) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(*d*) *Determination of hypothetical tax.* To the extent applicable, the principles of paragraph (b)(4)(ii) of §1.954–1 shall be used in determining, under subdivision (i) of subparagraph (1) of this paragraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the controlled foreign corporation is created or organized, or in determining, under subdivision (ii) of such subparagraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the manufacturing, producing, constructing, growing, or extracting branch or similar establishment is located.

(*e*) *Tax laws to be taken into account.* Tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.

(ii) *Determination of foreign base company sales income.* Once it has been determined under subparagraph (1) of this paragraph that a branch or similar establishment and the remainder of the controlled foreign corporation are to be treated as separate corporations, the determination of whether such branch or similar establishment, or the remainder of the controlled foreign corporation, as the case may be, has foreign base company sales income shall be made by applying the following rules:

(*a*) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(*b*) *Activities treated as performed on behalf of remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(*1*) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(*2*) With respect to personal property (other than property described in (*1*) of this subdivision (*b*)) purchased or sold, or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(*c*) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(*d*) *Items not to be twice included in income.* Income which is classified as foreign base company sales income as a result of the application of subdivision

(i) of subparagraph (1) of this paragraph shall not be again classified as foreign base company sales income as a result of the application of subdivision (ii) of such subparagraph.

(*e*) *Comparison with ordinary treatment.* Income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, shall not be considered foreign base company sales income if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

(*f*) *Priority of application.* If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction would be classified as foreign base company sales income of such controlled foreign corporation under section 954(d)(1) and paragraph (a) of this section, the income shall, notwithstanding this paragraph, be treated as foreign base company sales income under paragraph (a) of this section and the branch or similar establishment shall not be treated as a separate corporation with respect to such income.

(3) *Inclusion of amounts in gross income of United States shareholders.* A branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall be treated as separate corporations under this paragraph solely for purposes of determining the foreign base company sales income of each such corporation and for purposes of including an amount in subpart F income of the controlled foreign corporation under section 953(a). See section 954(b)(3) and paragraph (d)(4) of §1.954–1 for rules relating to the treatment of a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation as separate corporations for purposes of independently determining if the foreign base company income of each such corporation is less than 10 percent, or more than 70 percent, of its gross income. For all other purposes, however, a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall not be treated as separate corporations. For example, if the controlled foreign corporation has a deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includable in the subpart F income of such corporation will apply. Moreover, income, war profits, or excess profits taxes paid by a branch or similar establishment to a foreign country will be treated as having been paid by the controlled foreign corporation for purposes of section 960 (relating to special rules for foreign tax credit) and the regulations thereunder. Also, income of a branch or similar establishment, treated as a separate corporation under this paragraph, will not be treated as dividend income of the controlled foreign corporation of which it is a branch or similar establishment.

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

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in the manufacturing business in such country. Corporation A negotiates sales of its products for use outside of country X through a sales office, branch B, maintained in foreign country Y. These activities constitute the only activities of A Corporation. Country X levies an income tax at an effective rate of 50 percent on the income of A Corporation derived by the manufacturing plant in country X but does not tax the sales income of A Corporation derived by branch B in country Y. Country Y levies an income tax at an effective rate of 10 percent on the sales income derived by branch B but does not tax the income of A Corporation derived by the manufacturing plant in country X. If the sales income derived by branch B were, under the laws of country X, derived from sources within country X by A Corporation, such income would be taxed by such country at an effective rate of 50 percent. In determining foreign base company sales income of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 10 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income. The remainder of A Corporation, treated as a separate corporation, derives no foreign base

company sales income since it produces the product which is sold.

*Example 2.* Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation located in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income.

*Example 3.* Controlled foreign corporation E, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation D, also incorporated under the laws of country X. Corporation E maintains branch B in foreign country Y. Both corporations use the calendar year as the taxable year. In 1964, E Corporation's sole activity, carried on through branch B, consists of the purchase of articles manufactured in country X by D Corporation, a related person, and the sale of the articles through branch B for use outside country X. The income of E Corporation derived by branch B from such transactions is taxed to E Corporation by country X only at the time E Corporation distributes such income to D Corporation and is then taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by E Corporation from sources within country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on income derived from sources within such country, but the income of branch B for 1964 is effectively taxed by country Y at a 5 percent rate since, under the laws of such country, only 10 percent of branch B's income is derived from sources within such country. Corporation E makes no distributions to D Corporation in 1964. In determining foreign base company sales income of E Corporation for 1964, branch B is treated as a separate wholly owned subsidiary corporation of E Corporation, the 5 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of E Corporation, a related person, and constitutes foreign base company sales income.

*Example 4.* Controlled foreign corporation F, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation F, through its branch B in foreign country Y, purchases from controlled foreign corporation G, a wholly owned subsidiary of M Corporation incorporated under the laws of foreign country Z, personal property which G Corporation manufactures in country Z. Corporation F sells such property for use in foreign country W. Since the income of F Corporation from such purchases and sales is classified as foreign base company sales income under section 954(d)(1) and paragraph (a) of this section, branch B will not be treated as a separate corporation with respect to such income even if the tax differential between countries X and Y would otherwise justify such treatment.

*Example 5.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through its home office, located in country X, and selling such articles through branch B, located in foreign country Y, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

| | X Country | Y Country | Z Country |
|---|---|---|---|
| Income of: | | | |
| Home office | $200,000 | | |
| Branch B | | $100,000 | |

| | X Country | Y Country | Z Country |
|---|---|---|---|
| Branch C | ..... | ..... | $100,000 |
| Income tax | $100,000 | $20,000 | $20,000 |
| Effective rate of tax | 50% | 20% | 20% |

By applying subparagraph (1)(i) of this paragraph and by treating branch B as though it were the only branch of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch B under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country X. Moreover, by applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. The income derived by branch B and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country Y and country Z, respectively, is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income for 1963. The home office of A Corporation, treated as a separate corporation, derives no foreign base company sales income for 1963 since it produces the articles which are sold.

*Example 6.* Controlled foreign corporation A, incorporated under the laws of foreign country X is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through branch C, located in foreign country Z, and through its home office, located in country X, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

| | X Country | Y Country | Z Country |
|---|---|---|---|
| Income of: | | | |
| Home office | $100,000 | ..... | ..... |
| Branch B | ..... | $200,000 | ..... |
| Branch C | ..... | ..... | $100,000 |
| Income tax | $20,000 | $100,000 | $20,000 |
| Effective rate of tax | 20% | 50% | 20% |

In determining foreign base company sales income of A Corporation for 1963 neither branch B nor branch C is treated, by applying subparagraph (1)(i) of this paragraph, as a separate wholly owned subsidiary corporation of A Corporation since branch B derives no income from the purchase or sale of personal property and since, in the case of branch C treated as though it were the only branch of A Corporation, the 20 percent rate of tax on the income of branch C is not less than 90 percent of, and not as much as 5 percentage points less than, the 20 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. However, by applying subparagraph (1)(ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1)(ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C are treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on

behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

*Example 7.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through the home office, located in country X, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

| | X Country | Y Country | Z Country |
|---|---|---|---|
| Income of: | | | |
| Home office .... | $100,000 | ..... | ..... |
| Branch B ..... | ..... | $200,000 | ..... |
| Branch C ..... | ..... | ..... | $100,000 |
| Income tax ..... | $40,000 | $100,000 | $20,000 |
| Effective rate of tax ..... | 40% | 50% | 20% |

By applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. In addition, by applying subparagraph (1)(ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 40 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1)(ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C would again be treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y; however, for purposes of determining foreign base company sales income of A Corporation for 1963, only the classification under subparagraph (1)(i) of this paragraph shall, by reason of the application of subparagraph (2)(ii)(*d*) of this paragraph, be applied with respect to the income derived by branch C. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

(c) *Shipping income for taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under §1.954–6) of a controlled foreign corporation shall not also be considered foreign base company sales income of that controlled foreign corporation.

[T.D. 6734, 29 FR 6392, May 15, 1964, as amended by T.D. 7545, 43 FR 32754, May 8, 1978; T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22523, May 19, 1983; T.D. 9008, 67 FR 48025, July 23, 2002]

### § 1.954–4 Foreign base company services income.

(a) *Items included.* Except as provided in paragraph (d) of this section, foreign base company services income means income of a controlled foreign corporation, whether in the form of compensation, commissions, fees, or otherwise, derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) Are performed for, or on behalf of a related person, as defined in paragraph (e)(1) of §1.954–1, and

(2) Are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

(b) *Services performed for, or on behalf of, a related person*—(1) *Specific cases.* For purposes of paragraph (a)(1) of this section, ''services which are performed for, or on behalf of, a related person'' include (but are not limited to) services performed by a controlled foreign corporation in a case where—

(i) The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;

(ii) The controlled foreign corporation performs services (whether or not with respect to property sold by a related person) which a related person is, or has been, obligated to perform;

(iii) The controlled foreign corporation performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale; or

(iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons.

(2) *Special rules*—(i) *Guaranty of performance.* Subparagraph (1)(ii) of this paragraph shall not apply with respect to services performed by a controlled foreign corporation pursuant to a contract the performance of which is guaranteed by a related person, if (*a*) the related person's sole obligation with respect to the contract is to guarantee performance of such services, (*b*) the controlled foreign corporation is fully obligated to perform the services under the contract, and (*c*) the related person (or any other person related to the controlled foreign corporation) does not in fact (*1*) pay for performance of, or perform, any of such services the performance of which is so guaranteed or (*2*) pay for performance of, or perform, any significant services related to such services. If the related person (or any other person related to the controlled foreign corporation) does in fact pay for performance of, or perform, any of such services or any significant services related to such services, subparagraph (1)(ii) of this paragraph shall apply with respect to the services performed by the controlled foreign corporation pursuant to the contract the performance of which is guaranteed by the related person, even though such payment or performance is not considered to be substantial assistance for purposes of subparagraph (1)(iv) of this paragraph. For purposes of this subdivision, a related person shall be considered to guarantee performance of the services by the controlled foreign corporation whether it guarantees performance of such services by a separate contract of guaranty or enters into a service contract solely for purposes of guaranteeing performance of such services and immediately thereafter assigns the entire contract to the controlled foreign corporation for execution.

(ii) *Application of substantial assistance test.* For purposes of subparagraph (1)(iv) of this paragraph—

(*a*) Assistance furnished by a related person or persons to the controlled foreign corporation shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.

(*b*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be considered substantial unless either (*1*) the assistance so furnished provides the controlled foreign corporation with skills which are a principal element in producing the income from the performance of such services by such corporation or (*2*) the cost to the controlled foreign corporation of the assistance so furnished equals 50 percent or more of the total cost to the controlled foreign corporation of performing the services performed by such corporation. The term ''cost'', as used in this subdivision (*b*), shall be determined after taking into account adjustments, if any, made under section 482.

(*c*) Financial assistance (other than contributions to capital), equipment,

material, or supplies furnished by a related person to a controlled foreign corporation shall be considered assistance only in that amount by which the consideration actually paid by the controlled foreign corporation for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of such amounts so considered to be assistance in the case of financial assistance, equipment, material, and supplies furnished by all related persons shall be compared with the profits derived by the controlled foreign corporation from the performance of the services to determine whether the financial assistance, equipment, material, and supplies furnished by a related person or persons are by themselves substantial assistance contributing to the performance of such services. For purposes of this subdivision (*c*), determinations shall be made after taking into account adjustments, if any, made under section 482 and the term ''consideration actually paid'' shall include any amount which is deemed paid by the controlled foreign corporation pursuant to such an adjustment.

(*d*) Even though assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how is not considered to be substantial under (*b*) of this subdivision and assistance furnished by a related person or persons in the form of financial assistance (other than contributions to capital), equipment, material, or supplies is not considered to be substantial under (*c*) of this subdivision, such assistance may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons which in itself is not considered to be substantial.

(*e*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be taken into account under (*b*) or (*d*) of this subdivision unless the assistance so furnished assists the controlled foreign corporation directly in the performance of the services performed by such corporation.

(iii) *Special rule applicable to distributive share of partnership income.* A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation, or a person that is a related person with respect to the controlled foreign corporation, provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person. This paragraph (b)(2)(iii) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

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

*Example 1.* Controlled foreign corporation A is paid by related corporation M for the installation and maintenance of industrial machines which M Corporation manufactures and sells to B Corporation. Such installation and maintenance services by A Corporation are performed for, or on behalf of, M Corporation for purposes of section 954(e).

*Example 2.* Controlled foreign corporation B enters into a contract with an unrelated person to drill an oil well in a foreign country. Domestic corporation M owns all the outstanding stock of B Corporation. Corporation B employs a relatively small clerical and administrative staff and owns the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well by B Corporation are regular employees of M Corporation who are temporarily employed by B Corporation. In addition, B Corporation hires on the open market unskilled and semiskilled laborers to work on the drilling project. The services performed by B Corporation under the well-drilling contract are performed for, or on behalf of, a related person for purposes of section 954(e) because the services of the technical and supervisory personnel which are provided by M Corporation are of substantial assistance in the performance of such contract in that they assist B Corporation directly in the execution of the contract and provide B Corporation with skills which are a principal element in producing the income from the performance of such contract.

*Example 3.* Controlled foreign corporation F enters into a contract with an unrelated person to construct a dam in a foreign country. Domestic corporation M owns all the outstanding stock of F Corporation. Corporation F leases or buys from M Corporation, on an arm's length basis, the equipment and material necessary for the construction of the dam. The technical and supervisory personnel who design and oversee the construction of the dam are regular full-time employees of F Corporation who are not on loan from any related person. The principal clerical work, and the financial accounting, required in connection with the construction of the dam by F Corporation are performed, on a remunerated basis, by full-time employees of M Corporation. All other assistance F Corporation requires in completing the construction of the dam is paid for by that corporation and furnished by unrelated persons. The services performed by F Corporation under the contract for the construction of the dam are not performed for, or on behalf of, a related person for purposes of section 954(e) because the clerical and accounting services furnished by M Corporation do not assist F Corporation directly in the performance of the contract.

*Example 4.* Controlled foreign corporation D, a wholly owned subsidiary of domestic corporation M, procures and enters a contract with an unrelated person to construct a superhighway in a foreign country, but such person enters the contract only on the condition that M Corporation agrees to perform, or to pay for the performance by some person other than D Corporation of, the services called for by the contract if D Corporation should fail to complete their performance. Corporation D is capable of performing such contract. No related person as to D Corporation pays for, or performs, any services called for by the contract, or pays for, or performs, any significant services related to such services. The construction of the superhighway by D Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of M Corporation.

*Example 5.* Domestic corporation M is obligated under a contract with an unrelated person to construct a superhighway in a foreign country. At a later date M Corporation assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C, and the unrelated person releases M Corporation from any obligation under the contract. The construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

*Example 6.* Domestic corporation M enters a contract with an unrelated person to construct a superhighway in a foreign country. Corporation M immediately assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C. The unrelated person does not release M Corporation of its obligation under the contract, the sole purpose of these arrangements being to have M Corporation guarantee performance of the contract by C Corporation. Corporation C is capable of performing the construction contract. Neither M Corporation nor any other person related to C Corporation pays for, or performs, any services called for by the construction contract or at any time pays for, or performs, any significant services related to the services performed under such contract. The construction of the superhighway by C Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

*Example 7.* The facts are the same as in example 6 except that M Corporation, preparatory to entering the construction contract, prepares plans and specifications which enable the submission of bids for the contract. Since M Corporation has performed significant services related to the services the performance of which it has guaranteed, the construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

*Example 8.* Domestic corporation M manufactures an industrial machine which requires specialized installation. Corporation M sells the machines for a basic price if the contract of sale contains no provision for installation. If, however, the customer agrees to employ controlled foreign corporation E, a wholly owned subsidiary of M Corporation, to install the machine and to pay E Corporation a specified installation charge, M Corporation sells the machine at a price which is less than the basic price. The installation services performed by E Corporation for customers of M Corporation purchasing the machine at the reduced price are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

*Example 9.* Domestic corporation M manufactures and sells industrial machines with a warranty as to their performance conditional upon their installation and maintenance by a factory-authorized service agency. Controlled foreign corporation F, a wholly owned subsidiary of M Corporation, is the only authorized service agency. Any installation or maintenance services performed by F Corporation on such machines are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

*Example 10.* Domestic corporation M manufactures electric office machines which it sells at a basic price without any provision for, or understanding as to, adjustment or maintenance of the machines. The machines require constant adjustment and maintenance services which M Corporation, certain wholly owned subsidiaries of M Corporation,

and certain unrelated persons throughout the world are qualified to perform. From among the numerous persons qualified and available to perform adjustment and maintenance services with respect to such office machines, foreign corporation B, a customer of M Corporation, employs controlled foreign corporation G, a wholly owned subsidiary of M Corporation, to adjust and maintain the office machines which B Corporation purchases from M Corporation. The adjustment and maintenance services performed by G Corporation for B Corporation are not considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

(c) *Place where services are performed.* The place where services will be considered to have been performed for purposes of paragraph (a)(2) of this section will depend on the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing services for the controlled foreign corporation which derives income in connection with the performance of technical, managerial, architectural, engineering, scientific, skilled, industrial, commercial, or like services are physically located when they perform their duties in the execution of the service activity resulting in such income. Therefore, in many cases, total gross income of a controlled foreign corporation derived in connection with each service contract or arrangement performed for or on behalf of a related person must be apportioned, between income which is not foreign base company services income and that which is foreign base company services income, on a basis of employee-time spent within the foreign country under the laws of which the controlled foreign corporation is created or organized and employee-time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.

(d) *Items excluded.* Foreign base company services income does not include—

(1) Income derived in connection with the performance of services by a controlled foreign corporation if—

(i) The services directly relate to the sale or exchange of personal property by the controlled foreign corporation,

(ii) The property sold or exchanged was manufactured, produced, grown, or extracted by such controlled foreign corporation, and

(iii) The services were performed before the sale or exchange of such property by the controlled foreign corporation;

(2) Income derived in connection with the performance of services by a controlled foreign corporation if the services directly relate to an offer or effort to sell or exchange personal property which was, or would have been, manufactured, produced, grown, or extracted by such controlled foreign corporation whether or not a sale or exchange of such property was in fact consummated; or

(3) For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under § 1.954–6).

[T.D. 6734, 29 FR 6399, May 15, 1964, as amended by T.D. 6981, 33 FR 16497, Nov. 13, 1968; T.D. 7893, 48 FR 22523, May 19, 1983; T.D. 9008, 67 FR 48025, July 23, 2002]

### § 1.954–5 Increase in qualified investments in less developed countries; taxable years of controlled foreign corporations beginning before January 1, 1976.

For rules applicable to taxable years of controlled foreign corporations beginning before January 1, 1976, see section 954(b)(1) (as in effect before the enactment of the Tax Reduction Act of 1975) and 26 CFR 1.954–5 (Revised as of April 1, 1975).

[T.D. 7893, 48 FR 22508, May 19, 1983]

### § 1.954–6 Foreign base company shipping income.

(a) *Scope*—(1) *In general.* This section prescribes rules for determining foreign base company shipping income

under the provisions of section 954(f), as amended by the Tax Reduction Act of 1975.

(2) *Effective date.* (i) The rules prescribed in this section apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951 (b)) within which or with which such taxable years of such foreign corporations end.

(ii) Except as described in paragraph (b)(1)(viii) of this section, foreign base company shipping income does not include amounts earned by a foreign corporation in a taxable year of such corporation beginning before January 1, 1976. See example 1 of paragraph (g)(2) of this section for an illustration of the effect of this subparagraph on partnership income. See example 3 of paragraph (f)(4)(ii) of this section for an illustration of the effect of this subparagraph on certain dividend income. See paragraph (f)(5)(iii) of this section for the effect of this subparagraph on certain interest and gains.

(b) *Definitions*—(1) *Foreign base company shipping income.* The term ''foreign base company shipping income'' means—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce (see paragraph (c) of this section),

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce (see paragraph (d) of this section),

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as provided in paragraph (e) of this section,

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used or held for use (by the seller or by a person related to the seller) in foreign commerce,

(v) In the case of a controlled foreign corporation, dividends, interest, and gains described in paragraph (f) of this section,

(vi) Income described in paragraph (g) of this section (relating to partnerships, trusts, etc.),

(vii) Exchange gain, to the extent allocable to foreign base company shipping income (see §1.952–2(c)(2)(v)(*b*), and

(viii) In the case of a controlled foreign corporation and at its option, dividends, interest, and gains attributable to income derived from aircraft and vessels (as defined in 26 CFR 1.954–1(b)(2) (Revised as of April 1, 1975)) by a less developed country shipping company (described in §1.955–5(b)) in taxable years beginning after December 31, 1962, and before January 1, 1976. The portion of a dividend, interest, or gain attributable to such income shall be determined by the same method as that for determining the portion of a dividend, interest, or gain attributable to foreign base company shipping income under paragraphs (f)(4), (5), and (6) of this section, but without regard to paragraphs (f)(6)(ii) and (iv)(B).

(2) *Foreign base company shipping operations.* For purposes of sections 951 through 964, the term ''foreign base company shipping operations'' means the trade or business from which gross income described in subparagraph (1)(i) and (ii) of this paragraph is derived.

(3) *Foreign commerce.* For purposes of sections 951 through 964—

(i) An aircraft or vessel is used in foreign commerce to the extent it is used in transportation of property or passengers—

(A) Between a port (or airport) in the United States or possession of the United States and a port (or airport) in a foreign country, or

(B) Between a port (or airport) in a foreign country and another in the same country or between a port (or airport) in a foreign country and one in another foreign country.

Thus, for example, a trawler, a factory ship, and an oil drilling ship are not considered to be used in foreign commerce. On the other hand, a cruise ship which visits one or more foreign ports is considered to be so used. Notwithstanding subdivision (i)(B) of this paragraph (b)(3), foreign base company income does not include income derived from, or in connection with, the use of an aircraft or vessel in transportation of property or passengers between a port (or airport) in a foreign country and another port (or airport) in the

same country if both the foreign corporation is created or organized and the aircraft or vessel is registered in that country.

(ii) The term *vessel* includes all water craft and other artificial contrivances of whatever description and at whatever stage of construction, whether on the stocks or launched, which are used or are capable of being used or are intended to be used as a means of transportation on water. This definition does not apply for purposes of section 956(b)(2)(G) and §1.956–2(b)(1)(ix).

(iii) The term *port* means any place (whether on or off shore) where aircraft or vessels are accustomed to load or unload goods or to take on or let off passengers.

(iv) Any vessel (such as a lighter or beacon lightship) which serves other vessels used in foreign commerce (within the meaning of subdivision (i) of this subparagraph) shall, to the extent so used, also be considered to be used in foreign commerce.

(v) For the meaning of the term ''foreign country'', see section 638(2).

(4) *Use in foreign commerce.* For purposes of sections 951 through 964, the use of an aircraft or vessel in foreign commerce includes the hiring or leasing (or subleasing) of an aircraft or vessel to another for use in foreign commerce. Thus, for example, an aircraft or vessel is ''used in foreign commerce'' within the meaning of section 955(b)(1)(A) if such aircraft or vessel is chartered (whether pursuant to a bareboat charter, time charter, or otherwise) to another for use in foreign commerce.

(5) *Related person.* With respect to a controlled foreign corporation, the term ''related person'' means a related person as defined in §1.954–1(e)(1), and the term ''unrelated person'' means an unrelated person as defined in §1.954–1(e)(2).

(c) *Aircraft or vessel income*—(1) *In general.* The term ''income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce'' as used in paragraph (b)(1)(i) of this section means—

(i) Income derived from transporting passengers or property by aircraft or vessel in foreign commerce and

(ii) Income derived from hiring or leasing an aircraft or vessel to another for use in foreign commerce.

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

*Example 1.* Foreign corporation C owns a foreign flag vessel which it charters under a long-term charter to foreign corporation D. The vessel is used by D as a tramp which has no fixed or regular schedule. The vessel carries bulk and packaged cargoes, as well as occasional passengers, under charter parties, contracts of affreightment, or other contracts of carriage. The carriage of cargoes and passengers is between a port in the United States and a port in a foreign country or between a port in one foreign country and another port in the same or a different foreign country. The charter hire paid to C by D constitutes income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire is allocable to income derived from the use of the vessel between ports in the same foreign country in which both C is incorporated and the vessel is registered. The charter hire and freight and passenger revenue (including demurrage and dead freight) derived by D also constitute income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire and freight and passenger revenue are allocable to the use of the vessel between ports in the same foreign country in which both D is incorporated and the vessel is registered.

*Example 2.* (a) Foreign corporation E owns a foreign flag tanker which it charters under a long-term bareboat charter to foreign corporation F for use in foreign commerce. F produces oil in a foreign country and ships the oil to other foreign countries and to the United States. The vessel, when not engaged in carrying F's oil, is used to carry bulk cargoes for unrelated persons in foreign commerce as opportunity offers. The charger hire received by E constitutes income derived from the use of the vessel in foreign commerce. The income derived by F from carrying bulk cargoes for unrelated persons also constitutes income derived from the use of the vessel in foreign commerce.

(b) F is forced to lay up the vessel as a result of adverse market developments. Pursuant to the terms of the charter, F continues to pay charter hire to E during the period of lay-up. The charter hire received by E during the period of lay-up constitutes income derived from the use of the vessel in foreign commerce.

*Example 3.* (a) A shipment of cheese is loaded into a container owned by controlled foreign corporation S at the consignor's place

of business in Hamar, Norway. The cheese is transported to Milan, Italy, by the following routings:

(1) Overland by road from Hamar, Norway, to Gothenburg, Sweden, by unrelated motor carriers via Oslo, Norway,

(2) By sea from Gothenburg to Rotterdam, Netherlands, by feeder vessel under foreign flag, time chartered to S by unrelated owner,

(3) By sea from Rotterdam to Algeciras, Spain, by feeder vessel under foreign flag, time chartered to S by unrelated owner.

(4) By sea from Algeciras to Genoa, Italy, by line-haul vessel under U.S. flag, chartered by S from related company, and

(5) Overland from Genoa to Milan, Italy, by unrelated motor carrier.

(b) The consignor pays S total charges of $1,710, and S pays $676 to unrelated third parties, which amounts may be broken down as follows:

| Description of charges | Amount billed to customer and collected by S | Revenue collected by S on behalf of an unrelated party | Costs paid to unrelated 3d party and absorbed by S |
|---|---|---|---|
| Ocean freight | $1,420 | ..... | ..... |
| Trucking charge of empty equipment to shipper's facility | 50 | $50 | ..... |
| Trucking charges Hamar to Oslo | 60 | 60 | ..... |
| Trucking charges Oslo to Gothenburg | ..... | ..... | $315 |
| Trucking charges Genoa to Milan | 180 | 180 | ..... |
| Brokerage Commission in Europe | ..... | ..... | 71 |
| Total | 1,710 | 290 | 386 |

(c) Of the $1,710 amount billed to the consignor and collected by S, $290 is collected by S on behalf of unrelated third parties. This $290 amount is not includable in S's gross income, and is therefore not includable in S's foreign base company shipping income. The remaining $1,420 amount (i.e., $1,710 − $290) is includable in S's foreign base company shipping income. The $386 amount paid by S to unrelated third parties and absorbed by S is deductible from foreign base company shipping income under §1.954–1(c).

(d) *Services directly related*—(1) *In general.* The term ''income derived from, or in connection with, the performance of services directly related to the use of an aircraft or vessel in foreign commerce'', as used in paragraph (b)(1)(ii) of this section, means—

(i) Income derived from, or in connection with, the performance of services described in subparagraph (2) or (3) of this paragraph, and

(ii) Income treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(2) *Intragroup services.* The services described in this subparagraph are services performed for a person who is the owner, lessor, lessee or operator of an aircraft or vessel used in foreign commerce, by such person or by a person related to such person, and which fall into one or more of the following categories:

(i) Terminal services, such as dockage, wharfage, storage, lights, water, refrigeration, and similar services;

(ii) Stevedoring and other cargo handling services;

(iii) Container related services (including the rental of containers and related equipment) performed either in connection with the local drayage or inland haulage of cargo or in the course of transportation in foreign commerce;

(iv) Services performed by tugs, lighters, barges, scows, launches, floating cranes, and other similar equipment;

(v) Maintenance and repairs;

(vi) Training of pilots and crews;

(vii) Licensing of patents, know-how, and similar intangible property developed and used in the course of foreign base company shipping operations;

(viii) Services performed by a booking, operating, or managing agent; and

(ix) Any service performed in the course of the actual transportation of passengers or property.

(3) *Services for passenger, consignor, or consignee.* The services described in this subparagraph are services provided by the operator (or person related to the operator) of an aircraft or vessel in foreign commerce for the passenger, consignor, or consignee, such as—

(i) Services described in one or more of the categories set out in subparagraphs (2)(i) through (iv) and (ix) of this paragraph,

(ii) The rental of staterooms, berths, or living accommodations and the furnishing of meals,

(iii) Barber shop and other services to passengers aboard vessels,

(iv) Excess baggage, and

(v) Demurrage, dispatch, and dead freight.

(4) *The 70-percent test.* At the option of the foreign corporation all the gross income for a taxable year derived by a foreign corporation from any facility used in connection with the performance of services described in one or more of the categories set out in subparagraph (2)(i) through (ix) of this paragraph is foreign base company shipping income if more than 70 percent of such gross income for either—

(i) Such taxable year, or

(ii) Such taxable year and the two preceding taxable years,

is foreign base company shipping income (determined without regard to this subparagraph). Thus, for example, if 80 percent of the gross income derived by a controlled foreign corporation at a stevedoring facility is treated as foreign base company shipping income under subparagraph (2) of this paragraph, then the remaining 20 percent is treated as foreign base company shipping income under this subparagraph.

(5) *Rules for applying subparagraph (4).* (i) Solely for purposes of applying subparagraphs (4) of this paragraph, foreign base company shipping income and gross income shall be deemed to include an arm's length charge (see paragraph (h)(5) of this section) for services performed by the foreign corporation for itself.

(ii) In determining whether services performed by a foreign corporation are performed at a single facility or at two or more different facilities, all of the facts and circumstances involved will be taken into account. Ordinarily, all services performed by a foreign corporation within a single port area will be considered performed at a single facility.

(iii) The application of this subparagraph and subparagraph (4) of this paragraph may be illustrated by the following example in which it is assumed that the foreign corporation has chosen to apply the 70-percent test of subparagraph (4):

*Example.* (a) Controlled foreign corporation X uses the calendar year as the taxable year. For 1976, X is divided into two operating divisions, A and B. Division A operates a number of vessels in foreign commerce. Division B operates a terminal facility at which it performs services described in subparagraph (2)(i) of this paragraph for vessels some of which are operated by division A, some of which are operated by persons related to X, and some of which are operated by persons unrelated to X. For 1976, X includes under subparagraph (5) as foreign base company shipping income and gross income, for purposes of subparagraph (4), an arm's length charge for services performed for itself. For 1976, the gross income derived by division B is reconstructed for purposes of subparagraph (4) of this paragraph as follows, based on the facts shown in the following table:

| | |
|---|---|
| (1) Gross income derived from persons unrelated to *X* | $20 |
| (2) Gross income derived from persons related to *X* | 10 |
| (3) Actual gross income (line (1) plus line (2)) | 30 |
| (4) Hypothetical gross income derived from division A (determined by the application of subdivision (i) of this subparagraph) | 70 |
| (5) Total reconstructed gross income (line (3) plus line (4)) | 100 |

(b) Since 80 percent of the reconstructed gross income derived by division B would be treated as foreign base company shipping income under subparagraph (2) of this paragraph, the entire $30 amount of the gross income actually derived by division B is treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(6) *Arm's length charge.* For purposes of this section, the arm's length charge for services performed by a foreign corporation for itself shall be determined by applying the principles of section 482 and the regulations thereunder as if the party for whom the services are performed and the party by whom the services are performed were not the same person, but were controlled taxpayers within the meaning of §1.482–1(a)(4).

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

*Example 1.* Controlled foreign corporation A acts as a managing agent for foreign corporation B, a related person which contracts to construct and charter a foreign flag vessel for use in foreign commerce. As managing agent for B, A performs a broad range of services relating to the use of the vessel, including arranging for, and supervising of, construction and chartering of the vessel, and handling of operating services after construction is completed. The income derived by A from its management and operating services constitutes income derived in connection with the performance of services directly related to the use of the vessel in foreign commerce.

*Example 2.* Controlled foreign corporation C uses the calendar year as the taxable year. During 1976, C is engaged in the trade or business of acting as a steamship agent solely for unrelated persons. C's activities as steamship agent range from ''husbanding'' (i.e., arranging for fuel, supplies and port services, and attending to crew and customs matters) to the solicitation and booking of cargo at a number of foreign ports. None of C's other gross income for 1976 is foreign base company shipping income. Under these circumstances, C's gross income derived from its steamship agency does not constitute foreign base company shipping income.

(e) *Incidental income*—(1) *In general.* Foreign base company shipping income includes all incidental income derived by a foreign corporation in the course of its active conduct of foreign base company shipping operations.

(2) *Examples.* Examples of incidental income derived in the course of the active conduct of foreign base company shipping operations include—

(i) Gain from the sale, exchange or other disposition of assets which are related shipping assets within the meaning of §1.955A–2(b),

(ii) Income derived from temporary investments described in §1.955A–2(b)(2)(i) and (iii),

(iii) Interest on accounts receivable and evidences of indebtedness described in §1.955A–2(b)(2)(ii),

(iv) Income derived from granting concessions to others aboard aircraft or vessels used in foreign commerce,

(v) Income derived from stock and currency futures described in §1.955A–2(b)(2)(vii) and (viii),

(vi) Income derived by the lessor of an aircraft or vessel used in foreign commerce from additional rentals for the use of related equipment (such as a complement of containers), and

(vii) Interest derived by the seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel described in §1.955A–2(a)(1)(i).

(f) *Certain dividends, interest, and gain*—(1) *In general.* (i) The foreign base company shipping income of a controlled foreign corporation (referred to in subdivision (ii)(A) of this paragraph (f)(1) as ''first corporation'') includes—

(A) Dividends and interest received from foreign corporations listed in subdivision (ii) of this paragraph (f)(1), and

(B) Gain recognized from the sale, exchange, or other disposition of stock or obligations of foreign corporations listed in subdivision (ii) of this paragraph (f)(1),

but only to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income of the foreign corporations listed in subdivision (ii) of this paragraph (f)(1).

(ii) The foreign corporations referred to in subdivision (i) of this paragraph (f)(1) are—

(A) Foreign corporations with respect to which the first corporation (see subdivision (i) of this paragraph (f)(1)) would be deemed under section 902(b) to pay taxes,

(B) Controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)), and

(C) Less developed country shipping companies described in §1.955–5(b).

(2) *Corporation deemed to pay taxes.* (i) For purposes of this paragraph, a controlled foreign corporation would be deemed under section 902(b) to pay taxes in respect of any other foreign corporation if such controlled foreign corporation would be deemed, for purposes of applying section 902(a) to any United States shareholder of such controlled foreign corporation, to pay taxes in respect of dividends which were received from such other foreign corporation (whether or not such other foreign corporation actually pays any taxes or dividends). Solely for purposes of this subdivision, each United States shareholder (within the meaning of section 951(b)) shall be deemed to be a domestic corporation.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

*Example 1.* Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y is not a controlled foreign corporation. For purposes of subdivision (1) of this subparagraph, X is deemed to pay taxes in respect of Y.

*Example 2.* The facts are the same as in example 1, except that United States shareholder A, an individual, owns 80 percent of the stock of corporation X, and United States shareholders B and C, parent and child, own the other 20 percent in equal

shares. For purposes of applying this paragraph to all three United States shareholders (A, B, and C), X is deemed to pay taxes in respect of Y.

(3) *Obligation defined.* For purposes of this section, the term ''obligation'' means any bond, note, debenture, certificate, or other evidence of indebtedness, and a debt recorded in the books of account of both the creditor and the debtor. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Dividends.* (i) For purposes of this paragraph and §1.954–1(b)(2), the portion of a dividend which is attributable to foreign base company shipping 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 base company shipping income bears to the total earnings and profits out of which such dividend is paid. For purposes of this subdivision, the source of the earnings and profits out of which a distribution is made shall be determined under section 316(a), except that the source of the earnings and profits out of which a distribution is made by a controlled foreign corporation with respect to stock owned (within the meaning of section 958(a)) by a United States shareholder of such controlled foreign corporation shall be determined under §1.959–3.

(ii) The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y, which is not (and has not been) either a controlled foreign corporation or a less developed country shipping company, makes a distribution of $100 to X. Under section 316(a), such distribution is made out of Y's earnings and profits for 1978. Sixty percent of Y's earnings and profits for 1978 are attributable to foreign base company shipping income. As a result, $60 of the $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

*Example 2.* The facts are the same as in example 1, except that under section 316(a) $20 of the $100 dividend is paid out of Y's earnings and profits for 1979, and the other $80 is paid out of Y's earnings and profits for 1978. Thirty percent of Y's earnings and profits for 1979 are attributable to foreign base company shipping income. Since 60 percent of Y's earnings and profits for 1978 are also attributable to foreign base company shipping income, $54, i.e. (.60×$80)+(.30×$20), of the $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

*Example 3.* The facts are the same as in example 1 except that under section 316(a) the $100 dividend is made out of Y's earnings and profits for 1972. Since under paragraph (a)(2)(ii) of this section foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping company) in a taxable year beginning before January 1, 1978, no amount of such $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

*Example 4.* Domestic corporation N owns 100 percent of the one class of stock of controlled foreign corporation S, which in turn owns 100 percent of the one class of stock of controlled foreign corporation T. T makes a distribution of $100 to S, of which $80 is allocable under §1.959–3 to earnings and profits for 1977 which are described in §1.959–3(b)(2), and $20 is allocable to earnings and profits for 1978 which are described in §1.959–3(b)(3). The $80 amount is excluded from S's gross income under section 959(b) and therefore is not included in S's foreign base company shipping income. One hundred percent of T's earnings and profits for 1978 described in §1.959–3(b)(3) were attributable to reinvested foreign base company shipping income. As a result, the entire $20 amount is included in S's foreign base company shipping income under this paragraph. See §1.954–1(b)(2) for the rule that such $20 amount may be excluded from the foreign base company income of S.

(5) *Interest and gain.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph, the portion of any interest paid by a foreign corporation, or gain recognized from the sale, exchange, or other disposition of stock or obligations of a foreign corporation, which is attributable to the foreign base company shipping income of such foreign corporation is that amount which bears the same ratio to such interest or gain as the foreign base company shipping income of such corporation for the period described in subparagraph (6) of this paragraph bears to its gross income for such period.

(ii) Interest which is paid by a controlled foreign corporation is attributable to such corporation's foreign base company shipping income to the same extent that such interest is allocable (under the principles of §1.954–1(c)) to its foreign base company shipping income.

(iii) If interest is paid by a foreign corporation, or if stock obligations of a foreign corporation are sold, exchanged, or otherwise disposed of, during a taxable year of such foreign corporation beginning before January 1, 1976, then no portion of such interest or gain is attributable to foreign base company shipping income.

(iv) Solely for purposes of subdivision (i) of this subparagraph, if a controlled foreign corporation (the ''first corporation'') owns more than 10 percent of the stock of another controlled foreign corporation (the ''second corporation''), then

(A) The gross income of the first corporation for any taxable year shall be—

(*1*) Increased by its pro rata share of the gross income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(*2*) Decreased by the amount of any dividends received from the second corporation; and

(B) The foreign base company shipping income of the first corporation for any taxable year shall be—

(*1*) Increased by its pro rata share of the foreign base company shipping income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(*2*) Decreased by the amount of any dividends received from the second corporation which constitute foreign base company income.

(v) Solely for purposes of applying subdivision (i) of this subparagraph, the district director shall make such other adjustments to the gross income and the foreign base company shipping income of any foreign corporation as are necessary to properly determine the extent to which any interest or gain is attributable to foreign base company shipping income, including proper adjustments to reflect any transaction during the test period described in subparagraph (6) of this paragraph to which section 332, 351, 354, 355, 356, or 361 applies.

(6) *Test period.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph the period described in this subparagraph with respect to any foreign corporation is the 3-year period ending with the close of such corporation's taxable year preceding the year during which interest was paid or stock or obligations were sold, exchanged, or otherwise disposed of, or such part of such period as such corporation was in existence.

(ii) The period described in this paragraph shall not include any part of a taxable year beginning before January 1, 1976.

(iii) If interest is paid by a foreign corporation, or if stock or obligations of a foreign corporation are sold, exchanged, or otherwise disposed of during its first taxable year, then the period described in this paragraph shall be such first taxable year.

(iv) For purposes of subdivision (iii) of this subparagraph, the first taxable year of a foreign corporation is the later of—

(A) The first taxable year of its existence, or

(B) Its first taxable year beginning after December 31, 1975.

(g) *Income from partnerships, trusts, etc.*—(1) *In general.* The foreign base company shipping income of any foreign corporation includes—

(i) Its distributive share of the gross income of any partnership, and

(ii) Any amounts includible in its gross income under section 652(a), 662(a), 671, or 691(a),

to the extent that such items would have been includible in its foreign base company shipping income had they been realized by it directly.

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

*Example 1.* Controlled foreign corporations X and Y are equal partners in partnership P. The taxable years end on December 31 for X, June 30 for Y, and March 31 for P. In the fiscal year ending March 31, 1976, P's sole business activity is the use of a vessel in foreign commerce. P derives gross income of $200

from the use of the vessel, and incurs expenses, taxes, and other deductions of $160. Assume X's distributive share of such

$200 of P's gross income is $100, all of which is includible in X's gross income. If X had realized its distributive share of $100 directly, then the amount which would have been includible in X's foreign base company shipping income under this paragraph is the portion allocable to the months of January, February, and March of 1976. Such amount, $25 (i.e., ½ × $200 × 3 months/12 months), is included in X's foreign base company shipping income for its taxable year ending December 31, 1976. Similarly, X is entitled under this paragraph to a deduction from foreign base company shipping income of $20 (i.e., ½ × $160 × 3 months/12 months). Since foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping corporation) in a taxable year beginning before January 1, 1976, Y has no foreign base company shipping income (under this paragraph or otherwise) for its taxable year beginning on July 1, 1975.

*Example 2.* The facts are the same as in example 1, except that P incurs expenses, taxes, and deductions of $240 in its taxable year ending on March 31, 1976. Accordingly, $25 is includible in X's foreign base company shipping income, and the amount deductible therefrom under this paragraph is $30 (i.e., ½ × $240 × 3 months/12 months).

(3) *Other income.* Except as expressly provided in subparagraph (1) of this paragraph, foreign base company shipping income does not include any amount includible in the gross income of a controlled foreign corporation under part I of subchapter J (section 641 and following, relating to estates, trusts, and beneficiaries), and gains from the sale or other disposition of any interest in an estate or trust.

(h) *Additional rules*—(1) *Gross income.* For purposes of this section and §1.955A–2, the gross income of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 952 and §1.952–2. Thus, for example, section 883 (relating to exclusions from gross income of foreign corporations) is inapplicable under §1.952–2 (a)(1) and (c)(1). In addition, the gross income of a controlled foreign corporation shall be determined, with respect to a United States shareholder of such controlled foreign corporation, by excluding distributions received by such corporation which are excluded from gross income under section 959(b) with respect to such shareholder.

(2) *Earnings and profits.* For purposes of this section, the earnings and profits of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 964 and the regulations thereunder.

(3) *No double counting.* No item of gross income shall be counted as foreign base company shipping income under more than one provision of this section. For example, If $200 of gross income derived from the use of a lighter is treated as foreign base company shipping income under both paragraphs (b)(1)(i) and (ii) of this section, then such $200 is counted only once as foreign base company shipping income. A taxpayer may choose under which provision to include an item of income.

(4) *Losses.* (i) Generally, if a controlled foreign corporation has losses which are properly allocable to foreign base company shipping income, the extent to which such losses are deductible from such income shall be determined by treating such foreign corporation as a domestic corporation and applying the principles of section 63. See §§1.954–1(c) and 1.952–2(b). Thus for example, losses from sales or exchanges of capital assets are allowable only to the extent of gains from such sales or exchanges.

(ii) If gain from the sale, exchange, or other disposition of any stock or obligation would be treated (to any extent) as foreign base company shipping income, then loss from such sale, exchange, or other disposition is properly allocable to foreign base company shipping income (to the same extent).

(iii) In determining the extent to which any loss on the disposition of a qualified investment in foreign base company shipping operations is deductible from foreign base company shipping income, it is immaterial that such loss is taken into account under §1.955A–1(b)(1)(ii) as a reduction in the amount of the decrease in (withdrawal from) qualified investments in foreign base company shipping operations.

(5) *Hypothetical charges.* Under paragraph (d)(5)(i) of this section and §1.955A–2(a)(4)(ii)(A), gross income may

be deemed to include hypothetical arm's length charges for services performed by a controlled foreign corporation for itself. Under paragraph (d)(2) of this section, certain of these hypothetical charges may be treated as foreign based company shipping income. Such hypothetical charges are deemed to be income solely for purposes of applying the ''extent of use'' tests prescribed by paragraph (d)(4) of this section and §1.955A–2(a)(4). Charges for services performed by a controlled foreign corporation for itself shall in no event be included in income for any other purposes.

[T.D. 7894, 48 FR 22523, May 19, 1983]

### § 1.954–7 Increase in qualified investments in foreign base company shipping operations.

(a) *Determination of investments at close of taxable year*—(1) *In general.* Under section 954(g), the increase in qualified investments in foreign base company shipping operations, for purposes of section 954(b)(2) and paragraph (b)(1) of §1.954–1, of any controlled foreign corporation for any taxable year is, except as provided in paragraph (b) of this section, the amount by which—

(i) The controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the preceding taxable year.

(2) *Preceding taxable year.* For purposes of this section, a taxable year which begins before January 1, 1976, may be a preceding taxable year.

(3) *Cross-reference.* See section 955 (b) and §1.955A–2 for the definition of the term ''qualified investments in foreign base company shipping operations''.

(b) *Election to determine investments at close of following taxable year*—(1) *General rule.* In lieu of determining an increase in qualified investments in foreign base company shipping operations for a taxable year in the manner provided in paragraph (a) of this section, a United States shareholder of a controlled foreign corporation may make an election under section 955(b)(3) to determine the increase for the corporation's taxable year by ascertaining the amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such following taxable year.

(2) *Election with respect to first taxable year.* Notwithstanding subparagraph (1) of this paragraph, if an election is made without consent by a United States shareholder under §1.955A–4 (b)(1) with respect to a controlled foreign corporation, the increase in such controlled foreign corporation's qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be the amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such first taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such first taxable year.

(3) *Manner of making election.* For the manner of making an election under section 955(b)(3), and for rules pertaining to the revocation of such an election, see §1.955A–4.

(4) *Coordination with prior law.* If a United States shareholder makes an election without consent under §1.955A–4(b)(1) with respect to a controlled foreign corporation, then such corporation's increase in qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be determined by disregarding any change which occurs during such taxable year in the amount of such corporation's investments in stock or obligations of a less developed country shipping company described in §1.955–5 (b) if both of the following conditions exist:

(i) Such taxable year is the first taxable year of such corporation which begins after December 31, 1975, and

(ii) Such United States shareholder has elected to determine the change in such corporation's qualified investments in less developed countries for its last taxable year beginning before January 1, 1976, under §1.954–5(b) or §1.955–3.

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

*Example 1.* (a) Controlled foreign corporation X is a wholly owned subsidiary of domestic corporation M. X uses the calendar year as the taxable year. The amounts of X's qualified investments in foreign base company shipping operations at the close of 1975 through 1979 are as follows:

| | |
|---|---|
| Qualified investments at December 31, 1975 | $16,000 |
| Qualified investments at December 31, 1976 | 17,000 |
| Qualified investments at December 31, 1977 | 23,000 |
| Qualified investments at December 31, 1978 | 28,000 |
| Qualified investments at December 31, 1979 | 30,000 |

(b) Assume that M properly files without consent a timely election under §1.955A–4(b)(1) to determine X's increase for 1976 in qualified investments in foreign base company shipping operations pursuant to this paragraph, and that the election remains in force through 1978. Then X's increases for 1976 through 1978 in qualified investments in foreign base company shipping operations are as follows:

| | |
|---|---|
| Increase for 1976 ($23,000 minus $16,000) | $7,000 |
| Increase for 1977 ($28,000 minus $23,000) | 5,000 |
| Increase for 1978 ($30,000 minus $28,000) | 2,000 |

*Example 2.* Assume the same facts as in example 1, except that M never files an election under §1.955A–4(b)(1). X's increases for 1976 through 1978 in qualified investments in foreign base company shipping operations are as follows:

| | |
|---|---|
| Increase for 1976 ($17,000 minus $16,000) | $1,000 |
| Increase for 1977 ($23,000 minus $17,000) | 6,000 |
| Increase for 1978 ($28,000 minus $23,000) | 5,000 |

*Example 3.* The facts are the same as in example 1, except that X's qualified investments in foreign base company shipping operations include an investment in less developed country shipping companies described in §1.955–5(b) of $500 on December 31, 1975, and $750 on December 31, 1976. Assume further that M has made an election under section 955(b)(3) (as in effect before the enactment of the Tax Reduction Act of 1975) with respect to X's taxable year 1975. Then X's increase in qualified investments in foreign base company shipping operations for 1976 is $6,750 (i.e., $7,000 − $250).

(c) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* (a) Controlled foreign corporation X uses the calendar year as the taxable year. On December 31, 1975, X's qualified investments in foreign base company shipping operations (determined as provided in §1.955A–2(g)) consist of the following amounts:

| | |
|---|---|
| Cash | $6,000 |
| Readily marketable securities | 1,000 |
| Stock of related controlled foreign corporations | 4,000 |
| Traffic and other receivables | 14,000 |
| Marine insurance claims receivables | 1,000 |
| Foreign income tax refunds receivable | 1,000 |
| Prepaid shipping expenses and shipping inventories ashore | 1,000 |
| Vessel construction funds | 0 |
| Vessels | 123,000 |
| Vessel plans and construction in progress | 3,000 |
| Containers and chassis | 0 |
| Terminal property and equipment | 2,000 |
| Shipping office (land and building) | 1,000 |
| Vessel spare parts ashore | 1,000 |
| Performance deposits | 2,000 |
| Deferred charges | 2,000 |
| Stock of less developed country shipping company described in §1–955–5(b) | 10,000 |
| | 172,000 |

(b) On December 31, 1976, X's qualified investments in foreign base company shipping operations (determined as provided in §1.955A–2(g)) consists of the following amounts:

| | |
|---|---|
| Cash | $5,000 |
| Readily marketable securities | 2,000 |
| Stock of related controlled foreign corporations | 4,000 |
| Traffic and other receivables | 16,000 |
| Foreign income tax refunds receivable | 3,000 |
| Prepaid shipping expenses and shipping inventories ashore | 2,000 |
| Vessel construction funds | 1,000 |
| Vessels | 117,000 |
| Vessel plans and construction in progress | 12,000 |
| Containers and chassis | 4,000 |
| Terminal property and equipment | 2,000 |
| Shipping office (land and building) | 1,000 |
| Vessel spare parts ashore | 1,000 |
| Performance deposits | 2,000 |
| Deferred charges | 2,000 |
| Stock of less developed country shipping company described in §1.955–5(b) | 0 |
| | 174,000 |

(c) For 1976, X's increase in qualified investments in foreign base company shipping operations is $2,000, which amount is determined as follows:

| | |
|---|---|
| Qualified investments at Dec. 31, 1976 | $174,000 |
| Qualified investments at Dec. 31, 1975 | 172,000 |
| Increase for 1976 | 2,000 |

[T.D. 7894, 48 FR 22528, May 19, 1983]

## §1.954–8 Foreign base company oil related income.

(a) *Foreign base company oil related income*—(1) *In general.* Under section 954(g), the foreign base company oil related income of a controlled foreign corporation (except as provided under

paragraph (b) of this section) consists of the items of foreign oil related income (''FORI'') described in section 907(c)(2) and (3), other than such income derived from a source within a foreign country in connection with—

(i) Oil or gas which was extracted from an oil or gas well located in that foreign country (''extraction exception''), or

(ii) Oil, gas, or a primary product of oil or gas which is sold by the controlled foreign corporation or a related person for use or consumption within that country or is loaded in that country on a vessel or aircraft as fuel for the vessel or aircraft (''use or consumption exception'').

A taxpayer claiming the use or consumption exception must establish its applicability on the basis of facts and circumstances. For special rules for applying the extraction exception, see paragraph (c) of this section.

(2) *Source of income.* The source of foreign base company oil related income is determined generally under the principles of §§1.861–1 to 1.863–5. See §1.863–6. Thus, income from the performance of a service generally is sourced in the country where the service is performed. See §1.861–4. Underwriting income from insuring a foreign oil related activity is sourced at the location of the risk. See section 861(a)(7) and §1.953–2.

(3) *Primary product.* The term ''primary product'' of oil or gas has the meaning given this term by §1.907(c)–1(d)(5) and (6).

(4) *Vessel.* For the definition of the term ''vessel'', see §1.954–6(b)(3)(ii).

(5) *Foreign country.* For purposes of this section, the term ''foreign country'' has the same meaning as in section 638 (relating to continental shelf areas). Thus, for example, oil or gas extracted from a sea area will be deemed to be extracted in the country which has exclusive rights of exploitation of natural resources with respect to that area if the other conditions of section 638 are met.

(6) *Country of use or consumption.* For rules for determining the country of use or consumption, see §1.954–3(a)(3)(ii).

(7) *Insurance income.* For purposes of this section, income derived from or attributable to insurance of section 907(c)(2) activities means taxable income as defined in section 832(a) and as modified by the principles of §1.953–4 (other than as the section is applied to life insurance).

(8) *Fuel product.* For purposes of this section, the term ''fuel product'' means oil, gas or a primary product of oil or gas.

(9) *Effective date.* The provisions of section 954(g) and this section are applicable to taxable years of foreign corporations beginning on or after January 1, 1983, and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

(b) *Exemption for small oil producers*—(1) *In general.* Foreign base company oil related income does not include any income of a foreign corporation which is not a large oil producer.

(2) *Large oil producer.* A corporation is a large oil producer (within the meaning of section 954(g)(2)) if the average daily production (extraction) of foreign crude oil and natural gas by the related group which includes the corporation and related persons (within the meaning of section 954(d)(3)) for the taxable year or immediately preceding taxable year is 1,000 or more barrels. The average daily production of foreign crude oil or natural gas for any taxable year (and the conversion of cubic feet of natural gas into barrels) is determined under rules similar to the rules of section 613A, except that only crude oil or natural gas from a well located outside the United States is taken into account.

(c) *Special rules for applying the extraction exception of paragraph (a)(1)(i) of this section*—(1) *Refining income described in section 907(c)(2)(A).* With regard to a controlled foreign corporation's refining income from the processing of minerals extracted (by the taxpayer or by any other person) from oil or gas wells into their primary products, as described in section 907(c)(2)(A), a pro rata method will be applied for purposes of determining the part of the refining income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section. The pro rata method will be based on the proportion that the barrels of the fuel product extracted in the country of

processing bears to the total barrels of the fuel product processed in that country and will apply regardless of the country of sale of the primary product.

(2) *Marketing income described in section 907(c)(2)(C).* With regard to a controlled foreign corporation's marketing income from the distribution or sale of minerals extracted from oil or gas wells or of primary products, as described in section 907(c)(2)(C), a pro rata method will be applied for purposes of determining the part of the marketing income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section. When applying the pro rata method to the sale of a fuel product other than a primary product, the pro rata method will be based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product sold in that country. When applying the pro rata method to the sale of primary products, the method will be based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product processed. For purposes of applying the pro rata method, data of the controlled foreign corporation's related group (as defined in section 954(g)(2)(C)) will be taken into account. The pro rata method will not apply, however, if the mineral or primary product is purchased by the controlled foreign corporation from a person not within the controlled foreign corporation's related group. In that situation, the marketing income will be presumed to qualify for the extraction exception if the country of the source of the marketing income is a net exporter of crude oil or gas, whichever is relevant. If the country of the source of the marketing income is not a net exporter of crude oil or gas, whichever is relevant, the marketing income will be presumed not to qualify for the extraction exception. The controlled foreign corporation may, however, rebut this latter presumption by demonstrating on the basis of all the facts and circumstances that its marketing income does qualify for the extraction exception. If a primary product that is acquired from a person within the controlled foreign corporation's related group is commingled with like products acquired from persons not within that related group, the pro rata method based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product processed will be applied to that portion of the total products sold that was purchased from persons within the related group, to the extent that that person did not sell product purchased from an unrelated person, and either the presumption or facts and circumstances will determine the characterization of the remainder.

(3) *Transportation income described in section 907(c)(2)(B).* With regard to a controlled foreign corporation's income from the transportation of minerals from oil and gas wells or of primary products, as described in section 907(c)(2)(B), the rules set forth in paragraph (c)(2) of this section will apply for purposes of determining the part of the transportation income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section.

(4) *Illustrations.* The following examples illustrate the application of this paragraph.

*Example 1.* Controlled foreign corporation M has a refinery in foreign country A that refines 250x barrels of oil during its taxable year beginning in 1984. It is determined that 125x barrels of its 250x barrels were extracted in country A. M sold 150x barrels of its 250x barrels in country A for consumption in country A which resulted in $225x of income from refining and $225x of marketing income, as described in section 907(c)(2)(C). M also sold within foreign country B, for consumption in country B, 100x barrels of its 250x barrels which resulted in an additional $150x of income from refining for M and $170x of marketing income for M. The 100x barrels sold by M within country B, a contiguous country, were transported from M's refinery in country A to country B by a pipeline which is owned by M, and M recognized a total of $10x of income from the transportation of the 100x barrels. Of this $10x, $8x was recognized in country A and $2x was recognized in country B. Under the source of income rules of paragraph (a)(2) of this section, income from refining is considered derived from the country in which the refining occurs and not from the country where the sale of the refined product occurs.

(i) *M's refining income.* M has $75x of foreign base company oil related income with respect to its refining of the 250x barrels, determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M ..... $375x
(B) Amount of income from refining with respect to oil sold for consumption ($225x) in country A (use or consumption exception under paragraph (a)(1)(ii) of this section ..... (225x)
(C) Pro rate amount of income from refining attributable to sales in country B considered extracted from country A ($150x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section ..... *(75x)*
(D) Foreign base company oil related income ..... *$75x*

(ii) *M's marketing income.* M does not have foreign base company oil related income with respect to its sale of the 100x barrels in country B and 150x barrels in country A because the $170x and $225x, respectively, of marketing income was derived from the country in which the oil was sold for consumption (an exception under paragraph (a)(1)(ii) of this section).

(iii) *M's transportation income.* M does not have foreign base company oil related income with respect to its $2x of pipeline transportation income recognized in country B because the income was derived from the country in which the 100x barrels were sold for consumption, an exception under paragraph (a)(1)(ii) of this section. With regard to the $8x of pipeline transportation income recognized in country A, however, M has $4x of foreign base company oil related income since of the total barrels refined in country A (250x) only one-half were extracted in that country. Therefore, only one-half of the transportation income qualifies for the extraction exception of paragraph (a)(1)(i) of this section.

(iv) *M's extraction income.* M does not have foreign base company oil related income for its extraction activity because extraction income is excluded in all events. See section 954(g)(1)(A).

*Example 2.* Assume the same facts as in *Example 1* except that M sold all of the 250x barrels of refined oil in country A. In addition, assume that country A is a net exporter of crude oil. As in *Example 1,* M sold 150x barrels for consumption in country A with the same resulting income. M sold in country A the remaining 100x barrels to unrelated controlled foreign corporation N which resulted in an additional $150x of income from refining for M and $170x of marketing income for M. N immediately resold in country A for export those 100x barrels. N did not commingle the 100x barrels with any other refined oil. N earned $10x of marketing income on that sale.

(i) *M's refining income.* M has $75x foreign base company oil related income with respect to its refining of the 250x barrels determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M ..... $375x
(B) Amount of income from refining with respect to oil sold for consumption ($225x) in country A (use or consumption exception under paragraph (a)(1)(ii) of this section) ..... (225x)
(C) Pro rata amount of income from refining attributable to sales in country A (for consumption outside of country A) considered extracted from country A ($150x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section) ..... *(75x)*
(D) Foreign base company oil related income ..... *$75x*

(ii) *M's marketing income.* M does not have foreign base company oil related income with respect to its marketing income from the sale of the 150x barrels in country A because the $225x of marketing income was derived from the country in which the oil was sold for consumption (an exception under paragraph (a)(1)(ii) of this section). M has $85x of foreign base company oil related income with respect to its marketing income from sale to N of the 100x barrels, determined as follows:

(A) Total amount of marketing income from the sale ..... $170x
(B) Pro rata amount of marketing income attributable to oil product considered extracted in country A ($170x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section) ..... *(85x)*
(C) Foreign base company oil related income ..... *$85x*

(iii) *N's marketing income.* N is not related to M. Therefore, since N sold the 100x barrels in country A, a net exporter of crude oil, and since N did not commingle the 100x barrels with other refined products, it is presumed that all of the 100x barrels were extracted in country A. Accordingly, all of N's $10x of marketing income is excepted under paragraph (a)(1)(i) of this section.

*Example 3.* Assume the same facts as in *Example 2* except that N is related to M. Characterization of M's income remains the same as in *Example 2.* N will have, however, $5x of foreign base company oil related income with regard to its marketing income, determined as follows:

(i) Total amount of marketing income from the sale ..... $10x

(ii) Pro rata amount of marketing income considered extracted from country A ($10x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section).....*5x*

(iii) Foreign base company oil related income .....*$5x*

*Example 4.* Assume that controlled foreign corporation M has a refinery in foreign country A that refines 200x barrels of oil during its taxable year beginning in 1984. It is determined that 100x barrels of that oil were extracted in country A and that the other 100x barrels were extracted in country B. Neither country A nor country B is a net exporter of crude oil. In addition, M purchased from an unrelated country A refiner 100x barrels of already refined oil. M does not know where this oil was extracted. These 100x barrels of purchased refined oil were commingled with the 200x barrels of refined oil from M's refinery. M sold 225x barrels of refined oil in country A for consumption in country A which resulted in $250x of income from refining and $225x of marketing income. M sold within foreign country B for consumption outside of country B 75x barrels of refined oil which resulted in $100x of income from refining and $75x of marketing income. The refined product was transported between country A and country B by an unrelated person.

(i) *M's refining income.* With regard to the sales in country A, M has $50x of foreign base company oil related income with respect to its refining of the 100x barrels, determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M.....$350x

(B) Amount of income from refining with respect to oil sold for consumption in country A ($250x) (use or consumption exception under paragraph (a)(1)(ii) of this section).....(250x)

(C) Pro rata amount of income from refining attributable to sales in country B considered extracted from country A ($100x times 100x barrels/200x barrels) (extraction exception under paragraph (a)(1)(i) of this section).....*(50x)*

(D) Foreign base company oil related income.....*$50x*

(ii) *M's marketing income.* Since the barrels from M's refinery and those that M purchased were commingled, a portion, as follows, of the marketing income is deemed to derive from both purchased and refined products. Since M refined 200x barrels and purchased 100x barrels, its marketing income of $225x from the sale of the 225x barrels in country A for consumption in country A will be deemed to consist of $150x (200x/300x × $225x) from the sale of products refined by M and $75x (100x/300x × $225x) from the sale of purchased products. Likewise, its marketing income of $75x from the sale of the 75x barrels in country B for consumption outside of country B will be deemed to consist of $50x (200x/300x × $75x) from the sale of products refined by M and $25x (100x/300x × $75x) from the sale of purchased products.

(A) *Purchased products.* M is considered as having $75x of marketing income from the sale of purchased products in country A for consumption in country A. None of this marketing income is foreign base company oil related income since the marketing income is earned in country A, the country of consumption. See paragraph (a)(1)(ii) of this section. All of the $25x of M's marketing income from the sale of purchased products in country B will be foreign base company oil related income. The exception at paragraph (a)(1)(ii) of this section does not apply since the refined oil is not sold for use or consumption in country B. Likewise, the extraction exception under paragraph (a)(1)(i) of this section does not apply. The purchased product cannot be presumed to be extracted in country B since country B is not a net exporter of crude oil. In addition, M cannot show, on a facts and circumstances basis, that purchased products were refined from crude oil extracted in country B.

(B) *Products refined by M.* With regard to M's marketing income attributable to the sale of products refined by M, M does not have any foreign base company oil related income with regard to its $150x of marketing income in country A since that income was derived from the country in which the oil was sold for consumption (the use or consumption exception under paragraph (a)(1)(ii) of this section). M has $25x of foreign base company oil related income with regard to its $50x of marketing income in country B determined as follows:

(*1*) Total amount of income from marketing attributable to oil refined by M and sold in country B.....$50x

(*2*) Pro rata amount of income from marketing attributable to sales in country B considered extracted from country B ($50x times 100x barrels/200x barrels) (extraction exception under paragraph (a)(1)(i) of this section).....*(25x)*

(*3*) Foreign base company oil related income.....*$25x*

[T.D. 8331, 56 FR 2847, Jan. 25, 1991; 56 FR 11511, Mar. 19, 1991]

### § 1.955–0 Effective dates.

(a) *Section 955 as in effect before the enactment of the Tax Reduction Act of 1975*—(1) *In general.* In general, §§ 1.955–1 through 1.955–6 are applicable with respect to withdrawals of previously excluded subpart F income from qualified

investment in less developed countries for taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. However, such sections are effective with respect to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before the enactment of the Tax Reduction Act of 1975) only for taxable years of foreign corporations beginning before January 1, 1976, and for taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. For rules applicable to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before such enactment), in taxable years of foreign corporations beginning after December 31, 1975, see section 955(b)(5) (as amended by such Act) and §§1.955A–1 through 1.955A–4.

(2) *References.* Except as otherwise provided therein, all references contained in §§1.955–1 through 1.955–6 to section 954 or 955 or to the regulations under section 954 are to those sections and regulations as in effect before the enactment of the Tax Reduction Act of 1975. For regulations under section 954 (as in effect before such enactment), see 26 CFR §1.954–1 through 1.954–5 (Revised as of April 1, 1975). For taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (as described in section 951(b)) within which or with which such taxable years of such foreign corporations end, the definitions of less developed countries and less developed country corporations contained in section 902(d) (as amended by such Act) and §1.902–2 apply for purposes of determining the credit for corporate stockholders in foreign corporations under section 902.

(b) *Section 955 as amended by the Tax Reduction Act of 1975.* Except as otherwise provided therein, §§1.955A–1 through 1.955A–4 are applicable to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end.

[T.D. 7893, 48 FR 22508, May 19, 1983, as amended by T.D. 7894, 48 FR 22529, May 19, 1983]

### §1.955–1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.

(a) *In general.* Pursuant to section 951(a)(1)(A)(ii) and the regulations thereunder, a United States shareholder of a controlled foreign corporation must include in its gross income its pro rata share (as determined in accordance with paragraph (c) of this section) of the amount of such controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries. Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1962, that is withdrawn from investment in less developed countries for any taxable year of the corporation beginning before January 1, 1976. Except for investment in less developed country shipping companies, section 955 also provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1962, which is withdrawn from investment in less developed countries in taxable years of the corporation beginning after December 31, 1975. To determine the amount of a controlled foreign corporation's previously excluded subpart F income withdrawn from investment in less developed country shipping companies described in section 955(c)(2) in taxable years of a controlled foreign corporation beginning after December 31, 1975, see section 955(b)(5) (as in effect after amendment by the Tax Reduction Act of 1975) and §§1.955A–1 through 1.955A–4. For effective dates, see §1.955–0.

(b) *Amount withdrawn by controlled foreign corporation*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries is an amount equal to the decrease for such year in such corporation's qualified investments in less developed countries. Such decrease is, except as provided in § 1.955–3—

(i) An amount equal to the excess of the amount of its qualified investments in less developed countries at the close of the preceding taxable year over the amount of its qualified investments in less developed countries at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in less developed countries exceed its recognized gains on sales or exchanges during such year of qualified investments in less developed countries,

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See § 1.955–2 for determining the amount of qualified investments in less developed countries.

(2) *Limitations applicable in determining decreases*—(i) *General.* The limitation referred to in subparagraph (1) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(*a*) The sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, (including prior taxable years beginning after December 31, 1975) or,

(*b*) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954–1 from the foreign base company income of such corporation for all prior taxable years, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i)(*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A)(i) or (iii), or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(*b*)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in less developed countries. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(3) *Taxable years beginning after December 31, 1975.* (i) In the case of a taxable year of a controlled foreign corporation beginning after December 31, 1975, § 1.955–2(b)(5) must be applied in determining the amount of its qualified investments in less developed countries on both of the determination dates applicable to such taxable year.

(ii) The application of this subparagraph may be illustrated by the following examples:

*Example 1.* (a) Controlled foreign corporation M uses the calendar year as the taxable year. Throughout 1974 through 1976, M owns 100 percent of the only class of stock of foreign corporation N, a less developed country shipping company described in §1.955–5(b), and M owns no other stock or obligations. The amount taken into account under §1.955–2(d) with respect to the stock of N is $10,000 at the close of 1974, 1975, and 1976. The amount of M's previously excluded subpart F income which is withdrawn for 1975 (a year to which §1.955–2(b)(5) does not apply) from investment in less developed countries is zero, determined as follows:

| | |
|---|---|
| (1) Qualified investments in less developed countries at the close of 1974 | $10,000 |
| (2) Less: qualified investments in less developed countries at the close of 1975 | 10,000 |
| (3) Balance | 0 |

(Further computations similar to those set out in lines (iv) through (ix) of example 1 of paragraph (d) of this section are unnecessary because the balance in line (3) of this example is zero.)

(b) As a result of §1.955–2(b)(5)(ii), the amount of M's previously excluded subpart F income which is withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

| | |
|---|---|
| (1) Qualified investments in less developed countries at the close of 1975 | $0 |
| (2) Less: qualified investments in less developed countries at the close of 1976 | 0 |
| (3) Balance | 0 |

*Example 2.* The facts are the same as in example 1, except that foreign corporation N is a less developed country corporation described in §1.955–5(a). The amount of M's previously excluded subpart F income withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

| | |
|---|---|
| (1) Qualified investments in less developed countries at the close of 1975 | $10,000 |
| (2) Less: qualified investments in less developed countries at the close of 1976 | 10,000 |
| (3) Balance | 0 |

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in less developed countries is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this section. See section 955(a)(3).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)(*b*) of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

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

*Example 1.* A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign corporation throughout the entire period here involved. Both A and M Corporation use the calendar year as a taxable year. Corporation M's qualified investments in less developed countries at the close of 1964 amount to $125,000; and, at the close of 1965, to $75,000. During 1965, M Corporation realizes recognized gains of $5,000 and recognized losses of $15,000, on sales of qualified investments in less developed countries. Corporation M's earnings and profits for 1965 and its accumulated earnings and profits for 1963 and 1964 amount to $45,000, as determined under paragraph (b)(2) of this section. The amount excluded under section 954(b)(1) for 1963 from its foreign base company income is $75,000, and the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries is $25,000. The amount of M Corporation's previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $40,000, and A's pro rata share of such amount is $24,000, determined as follows:

| | |
|---|---|
| (i) Qualified investments in less developed countries at the close of 1964 | $125,000 |
| (ii) Less: Qualified investments in less developed countries at the close of 1965 | 75,000 |
| (iii) Balance | 50,000 |
| (iv) Less: Excess of recognized losses over recognized gains on sales during 1965 of qualified investments in less developed countries ($15,000 less $5,000) | 10,000 |
| (v) Tentative decrease in qualified investments in less developed countries for 1965 | 40,000 |
| (vi) Earnings and profits for 1963, 1964, and 1965 | 45,000 |

| | |
|---|---|
| (vii) Excess of amount excluded under section 954(b)(1) from foreign base company income for 1963 ($75,000 over amount of previously excluded subpart F income withdrawn for 1964 from investment in less developed countries ($25,000) | 50,000 |
| (viii) M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (item (v), but not to exceed the lesser of item (vi) or item (vii)) | 40,000 |
| (ix) A's pro rata share of M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (60 percent of $40,000) | $24,000 |

*Example 2.* The facts are the same as in example 1, except that M Corporation's earnings and profits (determined under paragraph (b)(2) of this section) for 1963, 1964, and 1965 (item (vi)) are $30,000 instead of $45,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $30,000. A's pro rata share of such amount is $18,000 (60 percent of $30,000).

*Example 3.* The facts are the same as in example 1, except that the excess of the amount excluded under section 954(b)(1) for 1963 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries (item (vii)) is $20,000 instead of $50,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $20,000. A's pro rata share of such amount is $12,000 (60 percent of $20,000).

[T.D. 6683, 28 FR 11178, Oct. 18, 1963, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965; T.D. 7893, 48 FR 22509, May 19, 1983; T.D. 7894, 48 FR 22529, May 19, 1983]

### § 1.955–2 Amount of a controlled foreign corporation's qualified investments in less developed countries.

(a) *Included property.* For purposes of sections 951 through 964, a controlled foreign corporation's ''qualified investments in less developed countries'' are items of property (other than property excluded under paragraph (b)(1) of this section) owned directly by such corporation on the applicable determination date for purposes of section 954(f) or section 955(a)(2) and consisting of one or more of the following:

(1) Stock of a less developed country corporation if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation;

(2) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country corporation which, at the time of acquisition (as defined in paragraph (b)(4) of this section) of such obligation by the controlled foreign corporation, has a maturity of one year or more, but only if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; and

(3) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is financially committed. The application of this subparagraph may be illustrated by the following example:

*Example.* A, a political subdivision of foreign country X, constructs and operates a toll bridge. Country X is a less developed country throughout the period here involved. A issues bonds under an indenture which provides for amortization of the principal and interest of such bonds only out of the net revenues derived from operation of the bridge. The bonds of A are obligations in which X country is financially committed and, in the hands of a controlled foreign corporation, are qualified investments in less developed countries.

(b) *Special rules*—(1) *Excluded property.* For purposes of paragraph (a) of this section, property which is disposed of within 6 months after the date of its acquisition shall be excluded from a controlled foreign corporation's qualified investments in less developed countries. However, the fact that property acquired by a controlled foreign corporation has not been held on an applicable determination date for more than 6 months after the date of its acquisition shall not prevent such property from being included in the controlled foreign corporation's qualified investments in less developed countries on such date. Proper adjustments shall

be made subsequently, however, to exclude any item of property so included, if the property is in fact disposed of within 6 months after the date of its acquisition. See section 955(b)(4).

(2) *Determination of stock ownership.* In determining for purposes of paragraphs (a)(1) and (2) of this section whether a controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such controlled foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(3) *Obligation defined.* For purposes of paragraphs (a)(2) and (3) of this section, the term ''obligation'' means any bond, note, debenture, certificate, or other evidence of indebtedness. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Date of acquisition.* For purposes of paragraphs (a)(2) and (b)(5)(i) of this section, stock or an obligation shall be considered acquired by a foreign corporation as of the date such corporation acquires an adjusted basis in the stock or obligation. For this purpose, in a case in which a foreign corporation acquires stock or an obligation in a transaction (other than a reorganization of the type described in section 368(a)(1)(E) or (F)) in which no gain or loss would be recognized had the transaction been between two domestic corporations, such corporation will be considered to have acquired an adjusted basis in such stock or obligation as of the date such transaction occurs.

(5) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, qualified investments in less developed countries do not include—

(i) Any property acquired after the latest determination date applicable to a taxable year beginning before December 31, 1975,

(ii) Stock or obligations of a less developed country shipping company described in §1.955–5(b), and

(iii) Stock or obligations which were not treated as qualified investments in less developed countries on the later of the two determination dates applicable to the preceding taxable year.

See §1.955–1(b)(3) for rules relating to the application of this subparagraph. See §1.955A–2(h) for rules relating to the treatment of investments in stock or obligations described in subdivision (ii) of this subparagraph as qualified investments in foreign base company shipping operations.

(6) *Determination dates.* For purposes of subparagraph (5) of this paragraph and §1.955–1(b)(3), the determination dates applicable to a taxable year of a controlled foreign corporation are—

(i) Except as provided in subdivision (ii) of this subparagraph, the close of such taxable year and the close of the preceding taxable year, and

(ii) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in less developed countries at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

(c) *Termination of designation as a less developed country.* For purposes of sections 951 through 964, property which would constitute a qualified investment in a less developed country but for the fact that a foreign country or United States possession has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country shall be treated as a qualified investment in a less developed country. The application of this paragraph may be illustrated by the following example:

*Example.* On December 31, 1969, in accordance with the provisions of §1.955–4, the designation of the foreign country X as an economically less developed country is terminated. Corporation M, a controlled foreign corporation, has $50,000 of qualified investments in country X acquired before December 31, 1969. After 1969 such investments are treated as qualified investments in a less developed country notwithstanding the termination of the status of X Country as an economically less developed country. However, if such qualified investments of M Corporation are reduced to $40,000, each United States shareholder of M Corporation is required, subject to the provisions of §1.955–1,

to include his pro rata share of the $10,000 decrease in his gross income under section 951(a)(1)(A)(ii) and the regulations thereunder.

(d) *Amount attributable to property*—(1) *General rule.* For purposes of this section, the amount taken into account with respect to any property which constitutes a qualified investment in a less developed country shall be its adjusted basis as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in less developed countries will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(3) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes a qualified investment in a less developed country on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(4) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, the amount taken into account under subparagraph (1) of this paragraph with respect to any property which constitutes a qualified investment in less developed countries shall not exceed the amount taken into account with respect to such property at the close of the preceding taxable year.

[T.D. 6683, 28 FR 11179, Oct. 18, 1963, as amended by T.D. 7894, 48 FR 22529, May 19, 1983]

### §1.955–3 Election as to date of determining qualified investments in less developed countries.

(a) *Nature of election.* In lieu of determining the increase for a taxable year of a foreign corporation beginning before January 1, 1976, under the provisions of section 954(f) and paragraph (a) of §1.954–5, or the decrease under the provisions of section 955(a)(2) and paragraph (b) of §1.955–1, in a controlled foreign corporation's qualified investments in less developed countries for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of paragraph (b) of §1.954–5 and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in less developed countries at the close of such taxable year exceed its qualified investments in less developed countries at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under paragraph (b)(1)(ii) of §1.955–1 for such taxable year,

subject to the limitation provided in paragraph (b)(2) of §1.955–1 for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of paragraph (b) of §1.954–5, subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with paragraph (b) of §1.955–1.

(b) *Time and manner of making election*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such controlled foreign corporation, and

(ii) Such controlled foreign corporation realizes foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation. For taxable years of a foreign corporation beginning after December 31, 1975, no election under this section with respect to a controlled foreign corporation may be made without the consent of the Commissioner.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. Consent will not be granted if the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section begins after December 31, 1975. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be

binding on the United States shareholder and shall apply to all qualified investments in less developed countries acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in less developed countries for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in less developed countries at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the rev- ocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in less developed countries for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(1) or 955(a) without regard to the election provided in this section. The application may also be filed in a taxable year beginning after December 31, 1975. The application shall include the following information:

(i) The name, address, and taxpayer identification number of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be so computed;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the controlled foreign corporation's acquisitions and dispositions of qualified investments in less developed countries for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in less developed countries for the taxable year in which he acquires such stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of paragraph (b)(1) of §1.954–5. If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1 for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in less developed countries for such subsequent taxable year shall be determined in accordance with the provisions of paragraph (b)(2) of §1.954–5.

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

*Example 1.* Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1963, M Corporation makes an election under section 955(b)(3) and the election remains in force for the taxable year 1964. At December 31, 1964, A Corporation's qualified investments in less developed countries amount to $100,000; and, at December 31, 1965, to $80,000. For purposes of paragraph (a)(1) of this section, A Corporation's decrease in qualified investments in less developed countries for the taxable year 1964 is $20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1964 ($100,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000).

*Example 2.* The facts are the same as in example 1 except that A Corporation experiences no changes in qualified investments in less developed countries during its taxable years 1966 and 1967. If M Corporation's election were to remain in force, A Corporation's acquisitions and dispositions of qualified investments in less developed countries during A Corporation's taxable year 1968 would be taken into account in determining whether A Corporation has experienced an increase or a decrease in qualified investments in less developed countries for its taxable year 1967. However, M Corporation duly files before the close of A Corporation's taxable year 1967 an application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M Corporation, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A Corporation's change in qualified investments in less developed countries for its taxable year 1967 is zero because the effect of the revocation of the election is to treat acquisitions and dispositions of qualified investments in less developed countries actually occurring in 1968 as having occurred in such year rather than in 1967.

*Example 3.* The facts are the same as in example 2 except that A Corporation's qualified investments in less developed countries at December 31, 1968, amount to $70,000. For purposes of paragraph (b)(1)(i) of §1.955–1, the decrease in A Corporation's qualified investments in less developed countries for the taxable year 1968 is $10,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1967 ($80,000) exceed its qualified investments in less developed countries at December 31, 1968 ($70,000).

*Example 4.* The facts are the same as in example 1 except that on September 30, 1965, M Corporation sells 40 percent of the only class of stock of A Corporation to N Corporation, a domestic corporation. Corporation N uses the calendar year as a taxable year. Corporation A remains a controlled foreign corporation immediately after such sale of its stock. Corporation A's qualified investments in less developed countries at December 31, 1966, amount to $90,000. The changes in A Corporation's qualified investments in less developed countries occurring in its taxable year 1965 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire $20,000 reduction in A Corporation's qualified investments in less developed countries which occurs during the taxable year 1965 is taken into account by M Corporation for purposes of paragraph (a)(1)

of this section in determining its tax liability for the taxable year 1964. Corporation A's increase in qualified investments in less developed countries for the taxable year 1965 with respect to the 60-percent stock interest retained by M Corporation is $6,000 and is determined by ascertaining M Corporation's pro rata share (60 percent) of the amount by which A Corporation's qualified investments in less developed countries at December 31, 1968 ($90,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000). Corporation N does not make an election under section 955(b)(3) in its return for its taxable year 1966. Corporation A's increase in qualified investments in less developed countries for the taxable year 1966 with respect to the 40-percent stock interest acquired by N Corporation is $4,000.

[T.D. 6683, 28 FR 11180, Oct. 18, 1963, as amended by T.D. 7893, 48 FR 22509, May 19, 1983; T.D. 7894, 48 FR 22530, May 19, 1983]

### § 1.955–4 Definition of less developed country.

(a) *Designation by Executive order.* For purposes of sections 951 through 964, the term ''less developed country'' means any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the foreign corporation's taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of such sections. Each territory, department, province, or possession of any foreign country other than a country within the Sino-Soviet bloc may be treated as a separate foreign country for purposes of such designation if the territory, department, province, or possession is overseas from the country of which it is a territory, department, province, or possession. Thus, for example, an overseas possession of a foreign country may be designated by Executive order as an economically less developed country even though the foreign country itself has not been designated as an economically less developed country; or the foreign country may be so designated even though the overseas possessions of such country have not been designated as economically less developed countries. The term ''possession of the United States'', for purposes of section 955(c)(3) and this section, shall be construed to have the same meaning as that contained in paragraph (b)(2) of § 1.957–3.

(b) *Countries not eligible for designation.* Section 955(c)(3) provides that no designation by Executive order may be made under section 955(c)(3) and paragraph (a) of this section with respect to—

| | |
|---|---|
| Australia | Luxembourg |
| Austria | Monaco |
| Belgium | Netherlands |
| CanadaDenmark | New Zealand |
| France | Norway |
| Germany (Federal Republic) | Union of South Africa |
| Hong Kong | San Marino |
| Italy | Sweden |
| Japan | Switzerland |
| Liechtenstein | United Kingdom. |

(c) *Termination of designation.* Section 955(c)(3) provides that, after the President has designated any foreign country or possession of the United States as an economically less developed country for purposes of sections 951 through 964, he may not terminate such designation (either by issuing an Executive order for the purpose of terminating such designation or by issuing an Executive order which has the effect of terminating such designation) unless, at least 30 days prior to such termination, he has notified the Senate and the House of Representatives of his intention to terminate such designation. If such 30-day notice is given, no action by the Congress of the United States is necessary to effectuate the termination. The requirement for giving 30-day notice to the Senate and House of Representatives applies also to the termination of a designation with respect to an overseas territory, department, province, or possession of a foreign country. See paragraph (c) of § 1.955–2 for the effect of a termination of a Presidential designation upon property which would be a qualified investment in a less developed country but for the fact of such termination.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

### § 1.955–5 Definition of less developed country corporation.

(a) *Less developed country corporation*—(1) *In general.* For purposes of sections 951 through 964, the term ''less

developed country corporation'' means a foreign corporation described in paragraph (b) of this section and also any foreign corporation—

(i) Which is engaged in the active conduct of one or more trades or businesses during the entire taxable year;

(ii) Which derives 80 percent or more of its gross income, if any, for such taxable year from sources within less developed countries, as determined under the provisions of §1.955–6; and

(iii) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of such taxable year consisting of one or more of the following items of property:

(*a*) Property (other than property described in (*b*) through (*h*) of this subdivision) which is used, or held for use, in such trades or businesses and is located in one or more less developed countries;

(*b*) Money;

(*c*) Deposits with persons carrying on the banking business;

(*d*) Stock of any other less developed country corporation;

(*e*) Obligations (within the meaning of paragraph (b)(3) of §1.955–2) of another less developed country corporation which at the time of their acquisition (within the meaning of paragraph (b)(4) of §1.955–2) by the foreign corporation have a maturity of one year or more;

(*f*) Obligations (within the meaning of paragraph (b)(3) of §1.955–2) of any less developed country;

(*g*) Investments which are required to be made or held because of restrictions imposed by the government of any less developed country; and

(*h*) Property described in section 956(b)(2).

For purposes of this subparagraph, if a foreign corporation is a partner in a foreign partnership, as defined in section 7701(a)(2) and (5) and the regulations thereunder, such corporation will be considered to be engaged in the active conduct of a trade or business to the extent and in the manner in which the partnership is so engaged and to own directly its proportionate share of each of the assets of the partnership. For purposes of subdivision (i) of this subparagraph, a newly-organized foreign corporation will be considered engaged in the active conduct of a trade or business from the date of its organization if such corporation commences business operations as soon as practicable after such organization. In the absence of affirmative evidence showing that the 80-percent requirement of subdivision (iii) of this subparagraph has not been satisfied on each day of the taxable year, such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. For purposes of subdivision (iii) of this subparagraph, property (other than stock in trade or other property of a kind which would properly be included in inventory of the foreign corporation if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business of the foreign corporation) purchased for use in a trade or business and temporarily located outside less developed countries will be considered located in less developed countries if, but only if, such property is shipped to and received in less developed countries promptly after such purchase.

(2) *Special rules.* For purposes of subparagraph (1)(iii)(*a*) of this paragraph—

(i) *Treatment of receivables.* Bills receivable, accounts receivable, notes receivable and open accounts shall be considered to be used in the trade or business and located in less developed countries if, but only if—

(*a*) Such obligations arise out of the rental of property located in less developed countries, the performance of services within less developed countries, or the sale of property manufactured, produced, grown, or extracted in less developed countries, but only to the extent that the aggregate amount of such obligations at any time during the taxable year does not exceed an amount which is ordinary and necessary to carry on the business of both parties to the transactions if such transactions are between unrelated persons or, if such transactions are between related persons, an amount which would be ordinary and necessary

to carry on the business of both parties to the transactions if such transactions were between unrelated persons;

(*b*) In the case of bills receivable, accounts receivable, notes receivable, and open accounts arising out of transactions other than those referred to in (*a*) of this subdivision—

(*1*) If the obligor is an individual such individual is a resident of one or more less developed countries and of no other country which is not a less developed country;

(*2*) If the obligor is a corporation which as to the foreign corporation is a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1, such obligor meets, with respect to the period ending with the close of its annual accounting period in which occurs the date on which the obligation is incurred, the 80-percent gross income requirement of paragraph (b)(1)(ii) of §1.955–6.

(*3*) If the obligor is a corporation which as to the foreign corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1, it is reasonable, on the basis of ascertainable facts, for the obligee to believe that the obligor meets, with respect to such period, the 80-percent gross income requirement of paragraph (b)(1)(ii) of §1.955–6.

(ii) *Location of interests in real estate.* Interests in real estate such as leaseholds of land or improvements thereon, mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and mineral, oil, or gas interests shall be considered located in less developed countries if, but only if, the underlying real estate is located in less developed countries.

(iii) *Location of certain other intangibles.* Intangible property (other than any such property described in subdivision (i) or (ii) of this subparagraph) used in the trade or business of the foreign corporation shall be considered to be located in less developed countries in the same ratio that the amount of the foreign corporation's tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses and located or deemed located in less developed countries bears to the total amount of its tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses.

(3) *Illustration.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* Foreign corporation A is formed on November 1, 1963, to engage in the business of manufacturing and selling radios in Brazil, a less developed country as of November 1, 1963. Corporation A uses the calendar year as a taxable year. Shortly after it is formed, A Corporation acquires a plant site and begins construction of a plant which is completed on August 1, 1964. Corporation A commences business operations as soon as practicable and continues such operations through December 31, 1964, and thereafter. Corporation A will be considered for purposes of subparagraph (1)(i) of this paragraph to be engaged in the active conduct of a trade or business for its entire taxable years ending on December 31, 1963, and 1964. The plant site and the plant (while under construction and after completion) will be considered to be property held during such taxable years for use in A Corporation's trade or business.

(b) *Shipping companies.* For purposes of sections 951 through 964, the term ''less developed country corporation'' also means any foreign corporation—

(1) Which has 80 percent or more of its gross income, if any, for the taxable year consisting of one or more of—

(i) Gross income derived—

(*a*) From, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country,

(*b*) From, or in connection with, the performance of services directly related to the use in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or

(*c*) From the sale or exchange of aircraft or vessels registered under the laws of a less developed country and used in foreign commerce by such foreign corporation;

(ii) Dividends and interest received or accrued from other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned at the time such dividends and interest

are so received or accrued by such foreign corporation; and

(iii) Gain from the sale or exchange of stock or obligations of other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned by such foreign corporation immediately before such sale or exchange; and

(2) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of the taxable year consisting of—

(i) Assets used, or held for use, for the production of income described in subparagraph (1) of this paragraph, or in connection with the production of such income, whether or not such income is received during the taxable year, and

(ii) Property described in section 956(b)(2).

In the absence of affirmative evidence showing that the 80-percent requirement of this subparagraph has not been satisfied on each day of the taxable year such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. The provisions of this subparagraph may be illustrated by the following example:

*Example.* Foreign corporation A is formed on November 1, 1963, for the purpose of constructing and operating a vessel and, on that date, enters a charter agreement which provides that such vessel will be registered under the laws of Liberia, a less developed country as of November 1, 1963, and operated between South American and European ports. Corporation A uses the calendar year as a taxable year. Construction of the vessel is completed on September 1, 1965, and the vessel is registered under the laws of Liberia and operated between South American and European ports through December 31, 1965, and thereafter. The charter and the vessel (while under construction and after completion), or any interest of A Corporation in such assets, will be considered assets which are held by A Corporation during its taxable years ending on December 31, 1963, 1964, and 1965, for use in the production of income described in subparagraph (1) of this paragraph.

(c) *Determination of stock ownership.* In determining for purposes of paragraph (b)(1)(ii) and (iii) of this section whether a foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(d) *Determination of value.* For purposes of paragraphs (a)(1)(iii) and (b)(2) of this section—

(1) *General.* Except as provided in subparagraph (2) of this paragraph, the value at which property shall be taken into account is its actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be its adjusted basis.

(2) *Treatment of certain receivables.* The value at which receivables described in paragraph (a)(2)(i) of this section and held by a foreign corporation using the cash receipts and disbursements method of accounting shall be taken into account is their actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be their face value.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

### § 1.955–6 Gross income from sources within less developed countries.

(a) *General.* For purposes of paragraph (a)(1)(ii) of §1.955.5, the determination whether a foreign corporation has derived 80 percent or more of its gross income from sources within less developed countries for any taxable year shall be made by the application of the provisions of sections 861 through 864, and §§1.861–1 through 1.863–5, in application of which the name of a less developed country shall be substituted for ''the United States'', except that if income is derived by the foreign corporation from—

(1) Interest (other than interest to which subparagraph (3) of this paragraph applies), the rules set forth in paragraph (b) of this section shall apply;

(2) Dividends, the rules set forth in paragraph (c) of this section shall apply; or

(3) Income (including interest) derived in connection with the sale of tangible personal property, the rules set forth in paragraph (d) of this section shall apply.

The source of income described in subparagraph (1), (2), or (3) of this paragraph shall be determined solely under the rules of this section and without regard to the rules of sections 861 through 864, and the regulations thereunder.

(b) *Interest*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and paragraph (d) of this section, gross income derived by the foreign corporation from interest on any indebtedness—

(i) Of an individual shall be treated as income from sources within a less developed country if, but only if, such individual is a resident of one or more less developed countries and of no other country which is not a less developed country.

(ii) Of a corporation shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such interest is paid, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section; or

(iii) Of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is financially committed shall be treated as income from sources within such country.

(2) *Special rule.* Gross income derived by the foreign corporation from interest on obligations of the United States shall be treated as income from sources within less developed countries without regard to the provisions of subparagraph (1) of this paragraph.

(3) *Payers other than related persons.* For purposes of subparagraph (1)(ii) of this paragraph, a payer corporation which as to the recipient corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1 shall be deemed to have satisfied the 80-percent gross income requirement if, on the basis of ascertainable facts, it is reasonable for the recipient corporation to believe that such requirement is satisfied.

(c) *Dividends*—(1) *In general.* Gross income derived by the foreign corporation from dividends, as defined in section 316 and the regulations thereunder, shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such dividends are distributed, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section.

(2) *Payers other than related persons.* See paragraph (b)(3) of this section for rule governing satisfaction of the 80-percent gross income requirement by payers other than related persons.

(d) *Sale of tangible personal property*—(1) *In general.* Income (whether in the form of profits, commissions, fees, interest, or otherwise) derived by the foreign corporation in connection with the sale of tangible personal property shall be treated as income from sources within less developed countries if, but only if—

(i) Such property is produced (within the meaning of subparagraph (2) of this paragraph) within less developed countries; or

(ii) Such property is sold for use, consumption, or disposition within less developed countries even though produced outside less developed countries

and the selling corporation is engaged within less developed countries, in connection with sales of such property, in continuous operational activities which are substantial in relation to such sales, as evidenced, for example, by the maintenance within less developed countries of a substantial sales or service organization or substantial facilities for the storage, handling, transportation, assembly, packaging, or servicing of such property.

(2) *Production defined.* For purposes of this paragraph, the term ''produced'' means manufactured, grown, extracted, or constructed and includes a substantial transformation of property purchased for resale or the manufacture of a product when purchased components constitute part of the property which is sold. See paragraph (a)(4)(ii) and (iii) of §1.954–3 for a statement and illustration of the principles set forth in the preceding sentence.

[T.D. 6683, 28 FR 11183, Oct. 18, 1963, as amended by T.D. 6688, 28 FR 11632, Oct. 31, 1963]

### §1.955A–1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations.

(a) *In general.* Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year beginning after December 31, 1975, from investment in foreign base company shipping operations. Pursuant to section 951(a)(1)(A)(iii) and the regulations thereunder, a United States shareholder of such controlled foreign corporation must include in his gross income his pro rata share of such amount as determined in accordance with paragraph (c) of this section.

(b) *Amount withdrawn by controlled foreign corporation*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in foreign base company shipping operations is an amount equal to the decrease for such year in such corporation's qualified investments in foreign base company shipping operations. Such decrease is, except as provided in §1.955A–4—

(i) An amount equal to the excess of the amount of its qualified investments in foreign base company shipping operations at the close of the preceding taxable year over the amount of its qualified investments in foreign base company shipping operations at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in foreign base company shipping operations exceed its recognized gains on sales or exchanges during such year of qualified investments in foreign base company shipping operations,

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See §1.955A–2 for determining the amount of qualified investments in foreign base company shipping operations.

(2) *Limitation applicable in determining decreases*—(i) *In general.* The limitation referred to in subparagraph (i) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(A) The sum of (*1*) the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year, (*2*) the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1975, and (*3*) the amount described in subparagraph (3) of this paragraph; or

(B) The sum of the amounts excluded under section 954(b)(2) (see subparagraph (4) of this paragraph) from the foreign base company income of such corporation for all prior taxable years beginning after December 31, 1975, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all such prior taxable years.

(C) For purposes of the immediately preceding subparagrah (B), the amount excluded under section 954(b)(2) for a taxable year of a controlled foreign corporation (the ''first corporation'') includes (*1*) an amount excluded under section 954(b)(2) by another corporation which is a member of a related group (as defined in §1.955A–3(b)(1)) attributable to the first corporation's excess investment (see §1.955A–3(c)(4)) for a taxable year beginning after December 31, 1983, (*2*) an amount excluded by a corporation under §1.954–1(b)(4)(ii)(*b*) by reason of the application of the carryover rule there set forth, and (*3*) an amount equal to the first corporation's pro rata share of a group excess deduction (see §1.955A–3(c)(2)) of a related group for a taxable year beginning after December 31, 1983 (but not in excess of that portion of such pro rata share which would reduce the first corporation's foreign base company shipping income to zero). Such amounts will not be treated as excluded under section 954(b)(2) by any other corporation.

(ii) *Certain exclusions from earnings and profits.* For purposes of determining the earnings and profits of a controlled foreign corporation under subdivision (i)(A)(*1*) and (*2*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(A)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A)(i), or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(B)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in foreign base company shipping operations. See section 959 and the regulations thereunder for rules relating to the exclusion from gross income of previously taxed earnings and profits.

(3) *Carryover of amounts relating to investments in less developed country shipping companies*—(i) *In general.* The amount described in this subparagraph for any taxable year of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The excess of the amount described in subdivision (ii) of this subparagraph, over the amount described in subdivision (iii) of this subparagraph, or

(B) The limitation determined under subdivision (iv) of this subparagraph.

(ii) *Previously excluded subpart F income invested in less developed country shipping companies.* The amount described in this subdivision for all taxable years of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The amount of such corporation's qualified investments (determined under §1.955–2 other than paragraph (b)(5) thereof) in less developed country shipping companies described in §1.955–5(b) at the close of the last taxable year of such corporation beginning before January 1, 1976, or

(B) The limitation determined under §1.955–1(b)(2)(i)(*b*) (relating to previously excluded subpart F income) for the first taxable year of such corporation beginning after January 1, 1976.

(iii) *Amounts previously carried over.* The amount described in this subdivision for any taxable year of a controlled foreign corporation shall be the sum of the excesses determined for each prior taxable year beginning after December 31, 1976, of—

(A) The amount (determined under this paragraph) of such corporation's previously excluded subpart F income withdrawn from investment in foreign

base company shipping operations, over

(B) The sum of the earnings and profits determined under subparagraph (2)(i)(A)(*1*) and (*2*) of this paragraph.

(iv) *Extent attributable to accumulated earnings and profits.* The limitation determined under this subdivision for any taxable year of a controlled foreign corporation is the sum of such controlled foreign corporation's earnings and profits (or deficits in earnings and profits) accumulated for taxable years beginning after December 31, 1962, and before January 1, 1976. For purposes of the preceding sentence, earnings and profits shall be determined by excluding the amounts described in subparagraph (2)(ii)(A) and (B) of this paragraph.

(v) *Illustration.* The application of this subparagraph may be illustrated by the following example:

*Example.* (a) Throughout the period here involved, A is a United States shareholder of controlled foreign corporation M. M is not a foreign personal holding company, and M uses the calendar year as the taxable year.

(b) The amount described in this subparagraph for M's taxable year 1978 with respect to A is determined as follows, based on the facts shown in the following table:

| | |
|---|---|
| (1) Investment in less developed country shipping companies on December 31, 1975 (subdivision (ii)(A) amount) | $10,000 |
| (2) § 1.955–1(b)(2)(i)(*b*) limitation for 1976 (previously excluded subpart F income not withdrawn from investment in less developed countries) (subdivision (ii)(B) amount) | 50,000 |
| (3) Subdivision (ii) amount (lesser of lines (1) and (2)) | 10,000 |
| (4) Subdivision (iii) amount: Excess for 1977 of M's previously excluded subpart F income withdrawn from investment in foreign base country shipping operations, $3,000, over the sum of the amounts determined under subparagraphs (2)(i)(A)(*1*) and (*2*) of this paragraph, $1,000 | 2,000 |
| (5) Excess of line (3) over line (4) | 8,000 |
| (6) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1978 | 26,000 |
| (7) Amount described in this subparagraph for 1978 (lesser of line (5) and line (6)) | 8,000 |

(c) For 1978, M's earnings and profits (reduced as provided in §1.955–1(b)(2)(ii)(*a*)(*1*)) are $19,000, and the amount of M's previously excluded subpart F income withdrawn from investment in less developed countries determined under §1.955–1(b)) is $42,000. Consequently, $23,000 of M's earnings and profits accumulated for 1962 through 1975 are attributable to such $42,000 amount, and will therefore be excluded under subparagraph (2)(ii))(A)(*2*) of this paragraph from M's earnings and profits accumulated for 1962 through 1975, determined as of December 31, 1979. No other portion of M's earnings and profits accumulated for 1962 through 1975 is distributed or included in the gross income of a United States shareholder in 1978.

(d) The amount described in this subparagraph for M's taxable year 1979 with respect to A is determined as follows, based on the additional facts shown in the following table:

| | | |
|---|---|---|
| (1) Subdivision (ii) amount (line (3) from paragraph (b) of this example) | | $10,000 |
| (2) Subdivision (iii) amount: (i) Excess for 1977 from line (4) of paragraph (b) of this example | | 2,000 |
| (ii) Plus: excess for 1978 of M's previously excluded subpart F income withdrawn from investment in foreign base country shipping operations, $6,000, over the sum of the amounts determined under subparagraphs (2)(i)(A)(*1*) and (*2*) of this paragraph, $25,000 | 0 | |
| (iii) Subdivision (iii) amount | | 2,000 |
| (3) Excess of line (1) over line (2)(iii) | | 8,000 |
| (4) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1979 ($26,000 minus $23,000) | | 3,000 |
| (5) Amount described in this subparagraph for 1979 (lesser of line (3) and line (4)) | | 3,000 |

(4) *Amount excluded.* For purposes of subparagraph (2)(i)(B) of this paragraph, the amount excluded under section 954(b)(2) from the foreign base company income of a controlled foreign corporation for any taxable year beginning after December 31, 1975, is the excess of—

(i) The amount which would have been equal to the subpart F income of such corporation for such taxable year if such corporation had had no increase in qualified investments in foreign base company shipping operations for such taxable year, over

(ii) The subpart F income of such corporation for such taxable year.

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in foreign base company shipping operations is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this

section. See section 955(a)(3). Such pro rata share shall be determined in accordance with the principles of §1.195–1(e).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)(B) of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

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

*Example 1.* A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign coporation throughout the entire period here involved. Both A and M use the calendar year as a taxable year. The amount of M's previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $40,000, and A's pro rata share of such amount is $24,000 determined as follows based on the facts shown in the following table:

| | |
|---|---|
| (a) Qualified investments in foreign base company shipping operations at the close of 1977 | $125,000 |
| (b) Less: qualified investments in foreign base company shipping operations at the close of 1978 | 75,000 |
| (c) Balance | 50,000 |
| (d) Less: excess of recognized losses ($15,000) over recognized gains ($5,000) on sales during 1978 of qualified investments in foreign base company shipping operations | 10,000 |
| (e) Tentative decrease in qualified investment in foreign base company shipping operations for 1978 | 40,000 |
| (f) Earnings and profits for 1976, 1977, and 1978 | 45,000 |
| (g) Plus: amount determined under paragraph (b)(3) of this section | 0 |
| (h) Earnings and profits limitation | 45,000 |
| (i) Excess of amount excluded under section 954(b)(2) from foreign base company income for 1976 ($75,000) over amount of previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations ($25,000) | 50,000 |
| (j) M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations (item (e), but not to exceed the lesser of item (h) or item (i) | 40,000 |
| (k) A's pro rata share of M Corporation's amount of previously excluded subpart F in come withdrawn for 1978 from investment in foreign base company shipping operations (60 percent of $40,000) | 24,000 |

*Example 2.* The facts are the same as in example 1, except that M's earnings and profits (determined under paragraph (b)(2) of this section) for 1976, 1977, and 1978 (item (f)) are $30,000 instead of $45,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $30,000. A's pro rata share of such amount is $18,000 (60 percent of $30,000).

*Example 3.* The facts are the same as in example 1, except that the excess of the amount excluded under section 954(b)(2) for 1976 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations (item (i)) is $20,000 instead of $50,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $20,000. A's pro rata share of such amount is $12,000 (60 percent of $20,000).

[T.D. 7894, 48 FR 22530, May 19, 1983; 48 FR 40888, Sept. 12, 1983]

## § 1.955A–2 Amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations.

(a) *Qualified investments*—(1) *In general.* Under section 955(b), for purposes of sections 951 through 964, a controlled foreign corporation's ''qualified investments in foreign base company shipping operations'' are investments in—

(i) Any aircraft or vessel, to the extent that such aircraft or vessel is used (or hired or leased for use) in foreign commerce,

(ii) Related shipping assets (within the meaning of paragraph (b) of this section),

(iii) Stock or obligations of a related controlled foreign corporation, to the extent provided in paragraph (c) of this section,

(iv) A partnership, to the extent provided in paragraph (d) of this section, and

(v) Stock or obligations of a less developed country shipping company described in §1.955–5(b), as provided in paragraph (h) of this section.

(2) *Coordination of provisions.* No amount shall be counted as a qualified

investment in foreign base company shipping operations under more than one provision of this section. Thus, for example, if a $10,000 investment in stock of a controlled foreign corporation is treated as a qualified investment in foreign base company shipping operations under both subparagraphs (1)(iii) and (v) of this paragraph, then such $10,000 is counted only once as a qualified investment in foreign base company shipping operations.

(3) *Definitions.* If the meaning of any term is defined or explained in §1.954–6, then such term shall have the same meaning when used in this section.

(4) *Extent of use.* (i) For purposes of subparagraph (1)(i) of this paragraph and paragraph (b)(1) of this section, the extent to which an asset of a controlled foreign corporation is used during a taxable year in foreign base company shipping operations shall be determined on the basis of the proportion for such year which the foreign base company shipping income derived from the use of such asset bears to the total gross income derived from the use of such asset.

(ii) For purposes of determining under subdivision (i) of this subparagraph the amounts of foreign base company shipping income and gross income of a controlled foreign corporation—

(A) Such amounts shall be deemed to include an arm's length charge (see §1.954–6(h)(5)) for services performed by such corporation for itself,

(B) Such amounts shall be deemed to include an arm's length charge for the use of an asset (such as a vessel under construction or laid up for repairs) which is held for use in foreign base company shipping operations, but is not actually so used,

(C) Foreign base company shipping income shall be deemed to include amounts earned in taxable years beginning before January 1, 1976, and

(D) The district director shall make such other adjustments to such amounts as are necessary to properly determine the extent to which any asset is used in foreign base company shipping operations.

(b) *Related shipping assets*—(1) *In general.* For purposes of this section, the term ''related shipping asset'' means any asset which is used (or held for use) for or in connection with the production of income described in §1.954–6(b)(1)(i) or (ii), but only to the extent that such asset is so used (or is so held for use).

(2) *Examples.* Examples of assets of a controlled foreign corporation which are used (or held for use) for or in connection with the production of income described in subparagraph (1) of this paragraph include—

(i) Money, bank deposits, and other temporary investments which are reasonably necessary to meet the working capital requirements of such corporation in its conduct of foreign base company shipping operations,

(ii) Accounts receivable and evidences of indebtedness which arise from the conduct of foreign base company shipping operations by such corporation or by a related person,

(iii) Amounts (other than amounts described in subdivision (i) of this subparagraph) deposited in bank accounts or invested in readily marketable securities pursuant to a specific, definite, and feasible plan to purchase any tangible asset for use in foreign base company shipping operations,

(iv) Amounts paid into escrow to secure the payment of (A) charter hire for an aircraft, vessel, or other asset used in foreign base company shipping operations or (B) a debt which constitutes a specific charge against such an asset,

(v) Capitalized expenditures (such as progress payments) made under a contract to purchase any asset for use in foreign base company shipping operations,

(vi) Prepaid expense and deferred charges incurred in the course of foreign base company shipping operations,

(vii) Stock acquired and retained to insure a source of supplies or services used in the conduct of foreign base company shipping operations, and

(viii) Currency futures acquired and retained as a hedge against international currency fluctuations in connection with foreign base company shipping operations.

(3) *Limitations*—(i) *Vessels generally.* Notwithstanding any other provision of this paragraph, the term ''related shipping assets'' does not include any money or other intangible assets of a

controlled foreign corporation, to the extent that such assets are permitted to accumulate in excess of the reasonably anticipated needs of the business.

(ii) *Safe harbor.* If a controlled foreign corporation accumulates money or other intangible assets pursuant to a plan to purchase one or more vessels for use in foreign commerce, and if—

(A) The amount so accumulated, plus

(B) The sum of the amounts accumulated by other controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)) pursuant to similar plans, does not exceed 110 percent of a reasonable down payment on each vessel planned to be purchased within a reasonable period, then such plan will be considered to be feasible. For purposes of the preceding sentence, a reasonable down payment shall not exceed 28 percent of the total cost of acquisition. The determination dates applicable to the taxable year of a controlled foreign corporation are those set forth in paragraph (c)(2)(ii) of this section. In the case of accumulation of assets which do not come within the safe harbor limitation of this subdivision (ii), in determining whether such assets have accumulated beyond the reasonably anticipated needs of the business, factors to be taken into account include, but are not limited to, the availability of financing to purchase a vessel and the availability of a vessel suitable for the purposes to which the vessel is to be put.

(iii) *Other assets.* In determining whether a plan to purchase any asset other than a vessel for use in foreign base company shipping operations is feasible, principles similar to those stated in subdivision (ii) of this subparagraph shall be applied.

(4) *Cross-reference.* See §1.954–7(c) for additional illustrations bearing on the application of this paragraph.

(c) *Stock and obligations*—(1) *In general.* Investments by a controlled foreign corporation (the ''first corporation'') in stock or obligations of a second controlled foreign corporation which is a related person (within the meaning of section 954(d)(3) are considered to be qualified investments in foreign base company shipping operations to the extent that the assets of such second corporation are used (or held for use) in foreign base company shipping operations. See subparagraph (2) of this paragraph. However, an investment in an obligation of the second corporation will not be considered a qualified investment in foreign base company shipping operations if the obligation represents a liability which constitutes a specific charge (nonrecourse or otherwise) against an asset of the second corporation which is not either—

(i) An aircraft or vessel used (or held for use) to some extent in foreign commerce, or

(ii) An asset described in paragraphs (a)(1)(ii) through (v) of this section.

(2) *Extent of use.* On any determination date applicable to a taxable year of the first corporation, the extent to which the assets of the second corporation are used in foreign base company shipping operations shall be determined on the basis of the proportion which the amount of such second corporation's qualified investments in foreign base company shipping operations bears to its net worth, such proportion to be determined at the close of the second corporation's last taxable year which ends on or before such determination date. For purposes of the preceding sentence—

(i) A controlled foreign corporation's net worth is the total adjusted basis of the corporate assets reduced by the total outstanding principal amount of the corporate liabilities, and

(ii) The determination dates applicable to a taxable year of a controlled foreign corporation are—

(A) Except as provided in (B) of this subdivision, the close of such taxable year and the close of the preceding taxable year, and

(B) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in foreign base company shipping operations at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

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

*Example 1.* On December 31, 1976, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y. X and Y both use the calendar year as the taxable year. On December 31, 1976, Y's assets consist of a vessel used in foreign commerce, related shipping assets, and other assets unrelated to its foreign base company shipping operations. On such date Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) of $60,000, and a net worth of $100,000. If X's investment in the stock of Y is $50,000, then $30,000 of such amount, i.e.,

$$\frac{\$60,000}{\$100,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

*Example 2.* The facts are the same as in example 1, except that on December 31, 1976, Y's assets consist entirely of a vessel used in foreign commerce and related shipping assets, Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) of $16,000 and (therefore) a net worth of $16,000. If X's investment in the stock of Y is $50,000, then the entire $50,000, i.e.,

$$\frac{\$16,000}{\$16,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

*Example 3.* On December 31, 1980, controlled foreign corporation J owns two notes of controlled foreign corporation K, which is a related person (within the meaning of section 954(d)(3)). Both J and K use the calendar year as the taxable year. J's adjusted basis in each of the two notes is $100,000. The first note is secured only by the general credit of K. The second note is secured by (and, therefore, constitutes a specific charge on) a hotel owned by K in a foreign country. On December 31, 1980, K has qualified investments in foreign base company shipping operation with an adjusted basis of $500,000 (before applying the rules of paragraph (g) of this section). The adjusted basis of all of K's corporate assets is $1,100,000. K's only liabilities are the two notes. The amount of K's qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) is $450,000. K's net worth is $900,000. The amount of J's qualified investment in foreign base company shipping operations in respect of the first note is $50,000, *i.e.*,

$$\frac{\$450,000}{\$900,000} \times \$100,000$$

The amount of J's qualified investment in respect of the second note is zero (see the last sentence of paragraph (c)(1) of this section).

(d) *Partnerships*—(1) *In general.* A controlled foreign corporation's investment in a partnership at the close of any taxable year of such corporation shall be considered a qualified investment in foreign base company shipping operations to the extent of the proportion which such corporation's foreign base company shipping income for such taxable year would bear to its gross income for such taxable year if—

(i) Such corporation had realized no income other than its distributive share of the partnership gross income, and

(ii) Such corporation's income were adjusted in accordance with the rules stated in paragraphs (a)(4)(ii)(B) and (D) of this section.

(2) *Transitional rule.* For purposes of subparagraph (1)(i) of this paragraph, the controlled foreign corporation's distributive share of the partnership gross income shall not include any amount attributable to income earned by the partnership before the first day of such corporation's first taxable year beginning after December 31, 1975.

(3) *Cross-reference.* See paragraph (g)(4) of this section for rules relating to the determination of the amount of a controlled foreign corporation's investment in a partnership.

(e) *Trusts*—(1) *In general.* An investment in a trust is not a qualified investment in a foreign base company shipping operations.

(2) *Grantor trusts.* Notwithstanding subparagraph (1) of this pargraph, if a controlled foreign corporation is treated as the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners), then for purposes of this section such controlled foreign corporation is deemed to be the actual owner of such portion of the assets of the trust. Accordingly, its investments in such assets (as determined under paragraph (g)(5) of this section) may be treated as

a qualified investment in foreign base company shipping operations.

(3) *Definitions.* For purposes of this section, the term ''trust'' means a trust as defined in § 301.7701–4.

(f) *Excluded property.* For purposes of paragraph (a) of this section, property acquired principally for the purpose of artificially increasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized; whether an item of property is acquired principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to an item of property is whether the item is disposed of within 6 months after the date of its acquisition.

(g) *Amount attributable to property*—(1) *General rule.* For purposes of this section, the amount taken into account under section 955(b)(4) with respect to any property which constitutes a qualified investment in foreign base company shipping operations shall be its adjusted basis as of the applicable determination date, reduced by the outstanding principal amount of any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date including a liability secured only by the general credit of the controlled foreign corporation. Liabilities shall be taken into account in the following order:

(i) The adjusted basis of each and every item of corporate property shall be reduced by any specific charge (nonrecourse or otherwise) to which such item is subject. For this purpose, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the specific charge shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. The excess against property over the adjusted basis of such property shall be taken into account as a liability secured only by the general credit of the corporation.

(ii) A liability which is evidenced by an open account or which is secured only by the general credit of the controlled foreign corporation shall be apportioned against each and every item of corporate property in that ratio which the adjusted basis of such item on the applicable determination date (reduced as provided in subdivision (i) of this subparagraph) bears to the adjusted basis of all the corporate property on such date (reduced as provided in subdivision (i) of this subparagraph); provided that no liability shall be apportioned under this subdivision against any stock or obligations described in paragraph (h)(1) of this section.

(2) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a liability created principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized. Whether a liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan was both created after November 20, 1974, and is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954–1. Another such factor is whether the liability was created after March 29, 1975, in a taxable year beginning before January 1, 1976. For purposes of this paragraph (g)(2), payments on liabilities which are represented by an open account are credited against the account transactions arising earliest in time.

(3) *Statement required.* If for purposes of this section the adjusted basis of property which constitutes a qualified investment in foreign base company shipping operations by a controlled foreign corporation is reduced on the ground that such property is subject to a liability, each United States shareholder shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(4) *Partnership interest.* If a controlled foreign corporation is a partner in a partnership, its investment in the partnership taken into account under section 955(b)(4) shall be its adjusted basis in the partnership determined under section 722 or 742, adjusted as provided in section 705, and reduced as provided in subparagraph (1) of this paragraph. (However, if the partnership is not engaged solely in the conduct of foreign base company shipping operations, such amount shall be taken into account only to the extent provided in paragraph (d)(1) of this section).

(5) *Grantor trust.* If a controlled foreign corporation is deemed to own a portion of the assets of a trust under paragraph (e)(2) of this section then the amount taken into account under section 955 (b)(4) with respect to such assets shall be determined as provided in subparagraph (1) of this paragraph by the application of the following rules:

(i) Such controlled foreign corporation's adjusted basis in such assets shall be deemed to be a proportionate share of the trust's adjusted basis in such assets, and

(ii) A proportionate share of the liabilities of the trust shall be deemed to be liabilities of such controlled foreign corporation and to constitute specific charges against such assets.

(6) *Translation into United States dollars.* The amounts determined in accordance with this paragraph shall be translated into United States dollars in accordance with the principles of §1.964–1(e)(4).

(h) *Investments in shipping companies under prior law*—(1) *In general.* If an amount invested in stock or obligations of a less developed country shipping company described in §1.955–5(b) is treated as a qualified investment in less developed countries under §1.955–2 (applied without regard to paragraph (b)(5)(ii) thereof) on the applicable determination date for purposes of section 954(g) or section 955(a)(2) with respect to a taxable year beginning after December 31, 1975, then such amount shall be treated as a qualified investment in foreign base company shipping operations on such determination date. See section 955(b)(5).

(2) *Effect on prior law.* See §1.955–2(b)(5)(ii) for the rule that investments which are treated as qualified investments in foreign base company shipping operations under subparagraph (1) of this paragraph shall not be treated as qualified investments in less developed countries for purposes of section 951(a)(1)(A)(ii).

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

*Example.* (a) Throughout the period here involved, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y, X and Y each use the calendar years as the taxable year. At the close of 1975, X's $50,000 investment in the stock of Y is treated as a qualified investment in less developed countries under §1.955–2 (applied without regard to §1.955–2(b)(5)(ii), and Y is a less developed country shipping company described in §1.955–5(b).

(b) On December 31, 1976, Y is still a less developed country shipping company and X's $50,000 investment in the stock of Y is still treated as a qualified investment in less developed countries under §1.955–2 (applied without regard to §1.955–2(b)(5)(ii). Under subparagraph (1) of this paragraph X's entire $50,000 investment in the stock of Y is treated as a qualified investment in foreign base company shipping operations.

(c) For 1977, Y's gross income is $10,000 and Y's foreign base company shipping income is $7,500. Since Y fails to meet the 80-percent income test of §1.955–5(b)(1), Y is no longer a less developed country shipping company described in §1–955–5(b), and X's investment in the stock of Y is no longer treated as a qualified investment in less developed countries under §1.955–2 (applied without regard to §1.955–2(b)(5)(ii). However, assume that on December 31, 1977, Y's net worth (as defined in paragraph (c)(2)(1) of this section) is $100,000, that Y's qualified investments in foreign base company shipping operations (determined under this section) on December 31, 1977, are $75,000, and that X's investment in the stock of Y (as determined under paragraph (g) of this section) continues to be $50,000. Then $67,500, i.e.,

$$\frac{\$75,000}{\$100,000} \times \$50,000$$

of X's $50.000 investment in the stock of Y is treated as a qualified investment in foreign company shipping operations under paragraph (c) of this section.

(d) For 1978, all of Y's gross income is foreign base company shipping income. Although Y is again a less developed country shipping company described in §1.955–5(b), X's investment in the stock of Y is no longer

treated as a qualified investment in less developed countries under §1.955–2(b)(5)(iii). Thus, X's investment in the stock of Y is not treated as a qualified investment in foreign base company shipping operations under subparagraph (1) of this paragraph. However, X's investment in the stock of Y may be so treated under another provision of this section, as was the case in item (c) of this example.

(Secs. 955 (b)(2) and 7805 of the Internal Revenue Code of 1954 (89 Stat. 63; 26 U.S.C. 955(b)(2), and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7894, 48 FR 22532, May 19, 1983; 48 FR 40888, Sept. 12, 1983, as amended by T.D. 7959, 49 FR 22280, May 29, 1984]

### § 1.955A–3 Election as to qualified investments by related persons.

(a) *In general.* If a United States shareholder elects the benefits of section 955(b) 2 with respect to a related group (as defined in paragraph (b)(1) of this section) of controlled foreign corporations, then an investment in foreign base company shipping operation made by one member of such group will be treated as having been made by another member to the extent provided in paragraph (c)(4) of this section, and each member will be subject to the other provisions of paragraph (c) of this section. An election once made shall apply for the taxable year for which it is made and for all subsequent years unless the election is revoked or a new election is made to add one or more controlled foreign corporations to election coverage. For the manner of making an election under section 955(b)(2), and for rules relating to the revocation of such an election, see paragraph (d) of this section. For rules relating to the coordination of sections 955(b)(2) and 955(b)(3), see paragraph (e) of this section.

(b) *Related group*—(1) *Related group defined.* The term ''related group'' means two or more controlled foreign corporations, but only if all of the following requirements are met:

(i) All such corporations use the same taxable year.

(ii) The same United States shareholder controls each such corporation within the meaning of section 954(d)(3) at the end of such taxable year, and

(iii) Such United States shareholder elects to treat such corporations as a related group.

(iv) If any of the corporations is on a 52–53 week taxable year and if all of the taxable years of the corporations end within the same 7-day period, the rule of paragraph (b)(1)(i) of this section shall be deemed satisfied.

(v) An election under paragraph (b)(1)(iii) of this section will not be valid in the case of an election by a U.S. shareholder (the ''first U.S. shareholder'') if—

(A) The first U.S. shareholder controls a second U.S. shareholder,

(B) The second U.S. shareholder controls one or more controlled foreign corporations, and

(C) Any of the controlled foreign corporations are the subject of the election by the first U.S. shareholder,

unless the second U.S. shareholder consents to the election by the first U.S. shareholder.

(2) *Group taxable years defined.* The ''group taxable year'' is the common taxable year of a related group.

(3) *Limitation.* If a United States shareholder elects to treat two or more corporations as a related group for a group taxable year (the ''first group taxable year''), then such United States shareholder (and any other United States shareholder which is controlled by such shareholder) may not also elect to treat two or more other corporations as a related group for a group taxable year any day of which falls within the first group taxable year.

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

*Example 1.* Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporations A, B, C, D, and E. A, B, and C use the calendar year as the taxable year. D and E use the fiscal year ending on June 30 as the taxable year. M may elect to treat A, B and C as a related group. However, M may not elect to treat C, D, and E as a related group.

*Example 2.* The facts are the same as in example 1. In addition, M elects to treat A, B, and C as a related group for the group taxable year which ends on December 31, 1976. M may not also elect to treat D and E as a related group for the group taxable year ending on June 30, 1977.

*Example 3.* United States shareholder A owns 60 percent of the only class of stock of controlled foreign corporation X and 40 percent of the only class of stock of controlled

foreign corporation Y. United States shareholder B owns the other 40 percent of the stock of X and the other 60 percent of the stock of Y. Neither A nor B (nor both together) may elect to treat X and Y as a related group.

(c) *Effect of election.* If a United States shareholder elects to treat two or more controlled foreign corporations as a related group for any group taxable year then, for purposes of determining the foreign base company income (see §1.954–1) and the increase or decrease in qualified investments in foreign base company shipping operations (see §§1.954–7. 1.955A–1, and 1.955A–4) of each member of such group for such year, the following rules shall apply:

(1) *Intragroup dividends.* The gross income of each member of the related group shall be deemed not to include dividends received from any other member of such group, to the extent that such dividends are attributable (within the meaning of §1.954–6(f)(4)) to foreign base company shipping income. In determining net foreign base company shipping income, deductions allocable to intragroup dividends attributable to foreign base company shipping income shall not be allowed.

(2) *Group excess deduction.* (i) The deductions allocable under §1.954–1(c) to the foreign base company shipping income of each member of the related group shall be deemed to include such member's pro rata share of the group excess deduction.

(ii) The group excess deduction for the group taxable year is the sum of the excesses for each member of the related group (having an excess) of—

(A) The member's deductions (determined without regard to this subparagraph) allocable to foreign base company shipping income for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess deduction is the amount which bears the same ratio to such group excess deduction as—

(A) The excess of such member's foreign base company shipping income over the deductions (so determined) allocable thereto, bears to

(B) The sum of such excesses for each member of the related group having an excess.

(iv) For purposes of this subparagraph, ''foreign base company shipping income'' means foreign base company shipping income (as defined in §1.954–6), reduced by excluding therefrom all amounts which are—

(A) Excluded from subpart F income under section 952(b) (relating to exclusion of United States income) or

(B) Excluded from foreign base company income under section 954(b)(4) (relating to exception for foreign corporation not availed of to reduce taxes).

(v) The application of this subparagraph may be illustrated by the following example:

*Example.* Controlled foreign corporations X, Y, and Z are a related group for calendar year 1976. The excess group deduction for 1976 is $9, X's pro rata share of the group excess deduction is $6, and Y's pro rata share is $3, determined as follows on the basis of the facts shown in the following table:

| | X | Y | Z | Group |
|---|---|---|---|---|
| (1) Gross shipping income .... | $100 | $90 | $90 | ..... |
| (2) Shipping deductions ..... | 60 | 70 | 80 | ..... |
| (3) Net shipping income ..... | 40 | 20 | (9) | ..... |
| (4) Group excess deduction .. | ..... | ..... | ..... | 80 |
| (5) X's pro rata share of group excess deduction ($9×$40/$60) ..... | 6 | ..... | ..... | ..... |
| (6) Y's pro rata share of group excess deduction ($9×$20/$60) ..... | ..... | 3 | ..... | ..... |

(3) *Intragroup investments.* On both of the determination dates applicable to the group taxable year for purposes of section 954(g) or section 955(a)(2), the qualified investments in foreign base company shipping operations of each member of the related group shall be deemed not to include stock of any other member of the related group. In addition, neither the gains nor the losses on dispositions of such stock during the group taxable year shall be taken into account under §1.955A–1(b)(1)(ii) in determining the decrease in qualified investments in foreign base company shipping operations of any member of such related group.

(4) *Group excess investment.* (i) On the later (and only the later) of the two determination dates applicable to the group taxable year for purposes of section 954(g) or section 955(a)(2), the

qualified investments in foreign base company shipping operations of each member of the related group shall be deemed to include such member's pro rata share of the group excess investment.

(ii) The group excess investment for the group taxable year is the sum of the excess for each member of the related group (having an excess) of—

(A) The member's increase in qualified investments in foreign base company shipping operations (determined under §1.954–7 after the application of subparagraph (3) of this paragraph) for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess investment is the amount which bears the same ratio to such group excess investment as—

(A) Such member's shortfall, in qualified investments bears to

(B) the sum of the shortfalls in qualified investments of each member of such related group having a shortfall.

(iv) If a member has an increase in qualified investments in foreign base company shipping operations (determined as provided in §1.954–7 after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's ''shortfall in qualified investments'' is the excess of—

(A) Such member's foreign base company shipping income for such year, over

(B) Such increase.

(v) If a member has a decrease in qualified investments in foreign base company shipping operations (determined under §1.955A–1(b)(1) or §1.955A–4(a), whichever is applicable, after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's ''shortfall in qualified investments'' is the sum of—

(A) Such member's foreign base company shipping income for such year and

(B) Such decrease.

(vi) For purposes of this subparagraph, ''foreign base company shipping income'' means foreign base company shipping income (as defined in subparagraph (2)(iv) of this paragraph), reduced by the deductions allocable thereto under §1.954–1(c) (including the additional deductions described in subparagraph (2) of this paragraph).

(vii) The application of paragraphs (c)(1), (3), and (4) of this section may be illustrated by the following example:

*Example.* (a) Controlled foreign corporations R, S, and T are a related group for calendar year 1977. R and S do not own the stock of any member of the related group.

(b) On December 31, 1977, T has qualified investments in foreign base company shipping operations (determined without regard to paragraphs (c)(3) and (4)) of $105, of which $15 consists of stock of S. After application of paragraph (c)(3) (but before application of paragraph (c)(4)), on December 31, 1977, T has qualified investments in foreign base company shipping operations of $90, determined as follows:

| | |
|---|---|
| (1) Qualified investments (determined without regard to paragraph (c)(3)) on December 31, 1977 | $105 |
| (2) Less: Qualified investments in stock of another member of a related group (as required by paragraph (c)(3)) | 15 |
| (3) Balance | 90 |

(c) During 1977, T's foreign base company shipping income is $180, determined without regard to paragraph (c)(1). Included in the $180 is $5 in dividends in respect of T's stock in S. During 1977, T has shipping deductions of $91. Of T's shipping deductions, $1 is allocable to the dividends from S. After application of paragraph (c)(1), T's net shipping income during 1977 is $85, determined as follows:

| | | |
|---|---|---|
| (1) Foreign base company shipping income | | $180 |
| (2) Less: intragroup dividends (as required by paragraph (c)(1)) | | 5 |
| (3) Balance | | 175 |
| (4) Shipping deductions | $91 | |
| (5) Less: deductions allocable to intragroup dividends (as required by paragraph (c)(1)) | 1 | |
| (6) Balance | 90 | |
| (7) Net shipping income (line (3) minus line (6)) | | 85 |

(d) During 1977 (without regard to paragraph (c)(4)), R's increase in qualified investments in foreign base company shipping operations is $120; S's decrease is $55; and T's increase is $35, determined on the basis of the facts shown in the following table. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see §§1.955A–3 (c)(3) and (4)(i)).

| | R | S | T |
|---|---|---|---|
| (1) Qualified investments on December 31, 1977 (in the case of T, taken from line (3) of part (b) of this example) | $220 | $150 | $90 |

| | R | S | T |
|---|---|---|---|
| (2) Qualified investments on December 31, 1976 | 100 | 205 | 55 |
| (3) Increase (decrease) (line (1) minus line (2)) | 120 | (55) | 35 |

(e) In 1977, R's net shipping income is $100; S's is $95; and T's is $85, determined as follows:

| | R | S | T |
|---|---|---|---|
| (1) Gross foreign base company shipping income (in the case of T, taken from line (3) of part (c) of this example) | $200 | $180 | $175 |
| (2) Shipping deductions (in the case of T, taken from line (6) of part (c) of this example) | 100 | 85 | 90 |
| (3) Net shipping income (line (1) minus line (2)) | 100 | 95 | 85 |

(f) By application of paragraph (c)(4) for 1977, S's pro rata share of the group excess investment is $15, and T's pro rata share is $5, determined as follows:

| | R | S | T | Group |
|---|---|---|---|---|
| (1) Net shipping income (taken from line (3) of part (e) of this example) | $100 | $95 | $85 | ..... |
| (2) Increase (decrease) in qualified investments (taken from line (3) of part (d) of this example) | 120 | (55) | 35 | ..... |
| (3) Excess investment | 20 | ..... | ..... | $20 |
| (4) Shortfall | ..... | 150 | 50 | 200 |
| (5) S's pro rata share of group excess investment ($20×$150/$200) | ..... | 15 | ..... | ..... |
| (6) T's pro rata share of group excess investment ($20×$50/$200) | ..... | ..... | 5 | ..... |

(g) After application of paragraph (c)(4), for purposes of determining their increase or decrease in qualified investments in foreign base company shipping operations for 1977, on December 31, 1977, the amount of R's qualified investments is $200; the amount of S's is $165; and the amount of T's is $95, determined as follows:

| | R | S | T |
|---|---|---|---|
| (1) Qualified investments on December 31, 1977 (taken from line (1) of part (d) of this example) | $220 | $150 | $90 |
| (2) Plus: pro rata share of group excess investment (as required by paragraph (c)(4)) (taken from lines (5) and (6) of part (f) of this example) | ..... | 15 | 5 |
| (3) Minus: Excess investment treated as investments of related group members (taken from line (3) of part (f) of this example) | 20 | ..... | ..... |
| (4) Total qualified investments | 200 | 165 | 95 |

(h) After application of paragraph (c)(1), (3), and (4), during 1977, R's increase in qualified investments in foreign base company shipping operations is $100; S's decrease is $40; and T's increase is $40, determined as set forth in the table below. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any similar adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see §1.955A–3(c)(3) and (4)(i)).

| | R | S | T |
|---|---|---|---|
| (1) Qualified investments on December 31, 1977 (taken from line (4) of part (g) of this example) | $200 | $165 | $95 |
| (2) Qualified investments on December 31, 1976 (see line (2) of part (d) of this example) | 100 | 205 | 55 |
| (3) Increase (decrease) (line (1) minus line (2)) | 100 | (40) | 40 |

(5) *Collateral effect.* (i) An election under this section by a United States shareholder to treat two or more controlled foreign corporations as a related group for a group taxable year shall have no effect on—

(A) Any other United States shareholder (including a minority shareholder of a member of such related group).

(B) Any other controlled foreign corporation, and

(C) The foreign personal holding company income, foreign base company sales income, and foreign base company services income, and the deductions allocable under §1.954–1(c) thereto, of any member of such related group.

(ii) See §1.952–1(c)(2)(ii) for the effect of an election under this section on the computation of earnings and profits and deficits in earnings and profits under section 952 (c) and (d).

(iii) The application of this subparagraph may be illustrated by the following example:

*Example.* United States shareholder A owns 80 percent of the only class of stock of controlled foreign corporations X and Y. United States shareholder B owns the other 20 percent of the stock of X and Y. X and Y both use the calendar year as the taxable year. A elects to treat X and Y as a related group for 1977. For purposes of determining the amounts includible in B's gross income under section 951(a) in respect of X and Y, the election made by A shall be disregarded and all of B's computations shall be made

without regard to this section, as illustrated in §1.952–3(d).

(d) *Procedure*—(1) *Time and manner of making election.* A United States shareholder shall make an election under this section to treat two or more controlled foreign corporations as a related group for a group taxable year and subsequent years by filing a statement to such effect with the return for the taxable year within which or with which such group taxable year ends. The statement shall include the following information:

(i) The name, address, taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of each controlled foreign corporation which is a member of the related group and is to be subject to the election; and

(iii) A schedule showing the calculations by which the amounts described in this section have been determined for the taxable year for which the election is first effective. With respect to each subsequent taxable year to which the election applies, a new schedule showing calculations of such amounts for that taxable year must be filed with the return for that taxable year. A consent to an election required by paragraph (b)(1)(v) of this section shall include the same information required for the election statement.

(2) *Revocation.* (i) Except as provided in subdivision (ii) of this subparagraph, an election under this section by a United States shareholder shall be binding for the group taxable year for which it is made and for subsequent years.

(ii) Upon application by the United States shareholder (and any other United States shareholder controlled by such shareholder which consented under paragraph (b)(1)(v) of this section to the election), an election made under this section may, subject to the approval of the Commissioner, be revoked. An application to revoke the election, as of a specified group taxable year, with respect to one or more (but not all) controlled foreign corporations, subject to an election shall be deemed to be an application to revoke the election. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:C:C, Washington, DC 20224, containing a statement of the facts which justify such consent. If a member of a related group subject to an election ceases to meet the requirements of paragraph (b) of this section for membership in the group by reason of any action taken by it or any member of the group or the electing United States shareholder, then the election will be deemed to be revoked as of the beginning of the taxable year in which such action occurred. If such action is taken principally for the purpose of revoking the election without applying for and obtaining the approval of the Commissioner to the revocation, then no further election covering any member of that related group may be made by any United States shareholder for the remainder of the taxable year in which the action occurred and the five succeeding taxable years.

(e) *Coordination with section 955(b)*(). If a United States shareholder elects under this section to treat two or more controlled foreign corporations as a related group for any taxable year, and if such United States shareholder is required under §1.955A–4(c)(2) for purposes of filing any return to estimate the qualified investments in foreign base company shipping operations of any member of such group, then such United States shareholder shall, for purposes of filing such return, determine the amount includible in his gross income in respect of each member of such related group on the basis of such estimate. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by

the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder. If a United States shareholder elects under this section and if the United States shareholder has made an election under section 955(b)(3) as to at least one member of the related group, then the qualified investment amounts necessary for the calculations of paragraphs (c)(3) and (4) of this section shall be obtained, for each member of the related group, as of the determination dates applicable to each of the members.

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

*Example 1.* (a) Controlled foreign corporations X and Y are wholly owned subsidiaries of domestic corporation M, X and Y use the calendar year as the taxable year. For 1977, X and Y are not export trade corporations (as defined in section 971(a)), nor have they any income derived from the insurance of United States risks (within the meaning of section 963(a)). M does not elect to treat X and Y as a related group for 1977.

(b) For 1977, X and Y each have gross income (determined as provided in §1.951–6(h)(1)) of $1,000. X's foreign base company income is $20 and Y's foreign base company imcome is $0, determined as follows, based on the facts shown in the following table:

| | X | Y |
|---|---|---|
| (1) Foreign lease company shipping income | $1,000 | $1,000 |
| (2) Less: amounts excluded from subpart F income under section 952(b) (relating to U.S. income) and amounts excluded from foreign base company income under section 945(b)(4) (relating to corporation not availed of to reduce taxes) | 0 | 0 |
| (3) Balance | 1,000 | 1,000 |
| (4) Less: deductions allocable under §1.954–1(c) to balance | 800 | 1,040 |
| (5) Remaining balance | 200 | 0 |
| (6) Less: Increase in qualified investments in foreign base company shipping operations | 180 | ..... |
| (7) Foreign base company income | 20 | ..... |

(c) For 1977, Y has a withdrawal of previously excluded Subpart F income from investment in foreign base company shipping operations of $20, determined as follows, on the basis of the facts shown in the following table:

| | |
|---|---|
| (1) Qualified investments in foreign base company shipping operations at December 31, 1976 | $1,210 |
| (2) Less: qualified investments in foreign base company shipping operations at December 31, 1977 | 1,170 |
| (3) Balance | 40 |
| (4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations | 20 |
| (5) Tentative decrease in qualified investments in foreign base company shipping operations for 1977 | 20 |
| (6) Limitation described in §1.955A–1(b)(2) | 160 |
| (7) Y's amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations (lesser of lines (5) and (6)) | 20 |

*Example 2.* (a) The facts are the same as in example 1, except that M does elect to treat X and Y as a related group for 1977.

(b) The group excess deduction, which is solely attributable to Y's net shipping loss, is $40 (i.e., $1,040 − $1,000). Since X is the only member of the related group with net shipping income, X's pro rata share of the group excess deduction is the entire $40 amount.

(c) X's foreign base company income for 1977 is zero, determined as follows:

| | |
|---|---|
| (1) Preliminary net foreign base company shipping income (line (b)(5) of example 1) | $200 |
| (2) Less: X's pro rata share of group excess deduction | 40 |
| (3) Remaining balance | 160 |
| (4) Less: increase in qualified investments in foreign base company shipping operations | 180 |
| (5) Foreign base company income | 0 |

(d) The group excess investment, which is solely attributable to X's excess investment, is $20 (i.e., $180 minus $160). Since Y is the only member of the related group with a shortfall in qualified investments, Y's share of the group excess investment is the entire $20 amount.

(e) During 1976 and 1977, Y owns no stock of X. Y's withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations for 1977 is zero, determined as follows:

| | |
|---|---|
| (1) Qualified investments at December 31, 1976 | $1,210 |
| (2)(i) Qualified investments at December 31, 1977 (determined without regard to paragraph (c)(4) of this section) | 1,170 |
| (ii) Y's pro rata share of group excess investment | 20 |
| (iii) Total qualified investments at December 31, 1977 (Line (i) plus line (ii) | 1,190 |
| (3) Balance (line (1) minus line (2)(iii) | 20 |

| | |
|---|---|
| (4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations | 20 |
| (5) Decrease in qualified investments for 1977 | 0 |

(Secs. 955 (b)(2) and 7805 of the Internal Revenue Code of 1954 (89 Stat. 63; 26 U.S.C. 955(b)(2), and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7894, 48 FR 22535, May 19, 1983; 48 FR 40888, Sept. 12, 1983, as amended by T.D. 7959, 49 FR 22280, May 29, 1984]

### § 1.955A–4 Election as to date of determining qualified investment in foreign base company shipping operations.

(a) *Nature of election.* In lieu of determining the increase under the provisions of section 954(g) and §1.954–7(a) or the decrease under the provisions of section 955(a)(2) and §1.955A–1(b) in a controlled foreign corporation's qualified investments in foreign base company shipping operations for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of §1.954–7(b) and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of such taxable year exceed its qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under §1.955A–1(b)(1)(ii) for such taxable year subject to the limitation provided in §1.995A–1(b)(2) for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of §1.954–7(b), subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with §1.955A–1(b).

(b) *Time and manner of making election*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder is a United States shareholder, and

(ii) Such controlled foreign corporation realizes foreign base company shipping income, as defined in §1.954–6.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(2) in accordance with the election provided in this section. The application shall include the following information.

(i) The name, address, and taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(2) and §1.954–1(b)(1) from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and shall apply to all qualified investments in foreign base company shipping operations acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in foreign base company shipping operations for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(2) or 955(a) without regard to the election provided in this section. The application shall include the following information:

(i) The name, address, and taxpayer identification number of the United States shareholder:

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be computed;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(2) and §1.954–1(b)(1) from the foreign base company income of the controlled foreign corporation

for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in foreign base company shipping operations for the taxable year in which he acquires such stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of §1.954–7(b)(1). If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(2) and §1.954–1(b)(1) for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such subsequent taxable year shall be determined in accordance with the provisions of §1.954–7(b)(2).

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

*Example 1.* Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1977, M makes an election under section 955(b)(3) and the election remains in force for the taxable year 1978. At December 31, 1978, A's qualified investments in foreign base company shipping operations amount to $100,000; and, at December 31, 1979, to $80,000. For purposes of paragraph (a)(1) of this section, A Corporation's decrease in qualified investments in foreign base company shipping operations for the taxable year 1978 is $20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in foreign base company shipping operations at December 31, 1978 ($100,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 ($80,000).

*Example 2.* The facts are the same as in example 1 except that A experiences no changes in qualified investments in foreign base company shipping operations during its taxable years 1980 and 1981. If M's election were to remain in force, A's acquisitions and dispositions of qualified investments in foreign base company shipping operations during A's taxable year 1982 would be taken into account in determining whether A has experienced an increase or a decrease in qualified investments in foreign base company shipping operations for its taxable year 1981. However, M duly files before the close of A's taxable year 1981 as application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A's change in qualifed investments in foreign base company shipping operations for its taxable year 1981 is zero because the effect of the revocation of the election is to treat acquisitions and dispositions of qualified investments in foreign base company shipping operations actually occurring in 1982 as having occurred in such year rather than in 1981.

*Example 3.* The facts are the same as in example 2 except that A's qualified investments in foreign base company shipping operations at December 31, 1982, amount to $70,000. For purposes of paragraph (b)(1)(i) of §1.955A–1, the decrease in A's qualified investments in foreign base company shipping operations for the taxable year 1982 is $10,000 and is determined by ascertaining the

amount by which A's qualified investments in foreign base company shipping operations at December 31, 1981 ($80,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1982 ($70,000).

*Example 4.* The facts are the same as in example 1. Assume further that on September 30, 1979, M sells 40 percent of the only class of stock of A to N Corporation, a domestic corporation. N uses the calendar year as a taxable year. A remains a controlled foreign corporation immediately after such sale of its stock. A's qualified investments in foreign base company shipping operations at December 31, 1980, amount to $90,000. The changes in A Corporation's qualified investments in foreign base company shipping operations occurring in its taxable year 1979 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire $20,000 reduction in A Corporation's qualified investments in foreign base company shipping operations which occurs during the taxable year 1979 is taken into account by M for purposes of paragraph (c)(1) of this section in determining its tax liability for the taxable year 1978. A's increase in qualified investments in foreign base company shipping operations for the taxable year 1979 with respect to the 60-percent stock interest retained by M is $6,000 and is determined by ascertaining M's pro rata share (60 percent) of the amount by which A's qualified investments in foreign base company shipping operations at December 31, 1980 ($90,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 ($80,000). N does not make an election under section 955(b)(3) in its return for its taxable year 1980. Corporation A's increase in qualified investments in foreign base company shipping operations for the taxable year 1980 with respect to the 40-percent stock interest acquired by N is $4,000.

[T.D. 7894, 48 FR 22539, May 19, 1983]

### § 1.956–1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(a) *In general.* Section 956(a)(1) and paragraph (b) of this section provide rules for determining the amount of a controlled foreign corporation's earnings invested in United States property at the close of any taxable year. Such amount is the aggregate amount invested in United States property to the extent such amount would have constituted a dividend if it had been distributed on such date. Subject to the provisions of section 951(a)(4) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in his gross income his pro rata share, as determined in accordance with paragraph (c) of this section, of the controlled foreign corporation's increase for any taxable year in earnings invested in United States property but only to the extent such share is not excludable from his gross income under the provisions of section 959(a)(2) and the regulations thereunder.

(b) *Amount of a controlled foreign corporation's investment of earnings in United States property*—(1) *Dividend limitation.* The amount of a controlled foreign corporation's earnings invested at the close of its taxable year in United States property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 and §§ 1.316–1 and 1.316–2 (determined after the application of section 955(a)) if it had been distributed on such closing day. For purposes of this subparagraph, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) and the regulations thereunder.

(2) *Aggregate amount of United States property.* For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975, the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and

(ii) The last taxable year beginning before January 1, 1976 does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

(3) *Treatment of earnings and profits.* For purposes of making the determination under subparagraph (1) of this paragraph as to whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a controlled foreign corporation, earnings and profits of the controlled foreign corporation shall be

considered not to include any amounts which are attributable to—

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or

(ii)(*a*) Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*b*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subparagraph apply only in determining the limitation on a controlled foreign corporation's increase in earnings invested in United States property. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(4) [Reserved]

(c) *Shareholder's pro rata share of increase*—(1) *General rule.* A United States shareholder's pro rata share of a controlled foreign corporation's increase for any taxable year in earnings invested in United States property is the amount determined by subtracting the shareholder's pro rata share of—

(i) The controlled foreign corporation's earnings invested in United States property at the close of its preceding taxable year, as determined under paragraph (b) of this section, reduced by amounts paid by such corporation during such preceding taxable year to which section 959(c)(1) and the regulations thereunder apply, from his pro rata share of

(ii) The controlled foreign corporation's earnings invested in United States property at the close of its current taxable year, as determined under paragraph (b) of this section.

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

*Example 1.* A is a United States shareholder and direct owner of 60 percent of the only class of stock of R Corporation, a controlled foreign corporation during the entire period here involved. Both A and R Corporation use the calendar year as a taxable year. Corporation R's aggregate investment in United States property on December 31, 1964, which would constitute a dividend (as determined under paragraph (b) of this section) if distributed on such date is $150,000. During the taxable year 1964, R Corporation distributed $50,000 to which section 959(c)(1) applies. Corporation R's aggregate investment in United States property on December 31, 1965, is $250,000; and R Corporation's current and accumulated earnings and profits on such date (determined as provided in paragraph (b) of this section) are $225,000. A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property is $75,000, determined as follows:

| | | |
|---|---|---|
| (i) Aggregate investment in United States property on December 31, 1965 | | $250,000 |
| (ii) Current and accumulated earnings and profits on December 31, 1965 | | 225,000 |
| (iii) Amount of earnings invested in United States property on December 31, 1965, which would constitute a dividend if distributed on such date (lesser of item (i) or item (ii)) | | 225,000 |
| (iv) Aggregate investment in United States property on December 31, 1964, which would constitute a dividend if distributed on such date | $150,000 | |
| Less: Amounts distributed during 1964 to which section 959(c)(1) applies | 50,000 | 100,000 |
| (v) R Corporation's increase for 1965 in earnings invested in United States property (item (iii) minus item (iv)) | | 125,000 |
| (vi) A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property (item (v) times 60 percent) | | 75,000 |

*Example 2.* The facts are the same as in example 1, except that R Corporation's current and accumulated earnings and profits on December 31, 1965, are $100,000 instead of $225,000. Accordingly, even through R Corporation's aggregate investment in United States property on December 31, 1965, of $250,000 exceeds the net amount ($100,000) taken into account under subparagraph (1)(i) of this paragraph as of December 31, 1964, by $150,000, there is no increase for taxable year 1965 in earnings invested in United States property because of the dividend limitation of paragraph (b)(1) of this section. Corporation R's aggregate investment in United States property on December 31, 1966, is unchanged ($250,000) Corporation R's current and accumulated earnings and profits on December 31, 1966, are $175,000, and, as a consequence, its aggregate investment in United States property which would constitute a dividend if distributed on that date is

$175,000. Corporation R pays no amount during 1965 to which section 959(c)(1) applies. Corporation R's increase for the taxable year 1966 in earnings invested in United States property is $75,000, and A's pro rata share of that amount is $45,000 ($75,000 times 60 percent).

(d) *Date and basis of determinations.* The determinations made under paragraph (c)(1)(i) of this section with respect to the close of the preceding taxable year of a controlled foreign corporation and under paragraph (c)(1)(ii) with respect to the close of the current taxable year of such controlled foreign corporation, for purposes of determining the United States shareholder's pro rata share of such corporation's increased investment of earnings in United States property for the current taxable year, shall be made as of the last day of the current taxable year of such corporation but on the basis of stock owned, within the meaning of section 958(a) and the regulations thereunder, by such United States shareholder on the last day of the current taxable year of the foreign corporation on which such corporation is a controlled foreign corporation. See the last sentence of section 956(a)(2). The application of this paragraph may be illustrated from the following example:

*Example.* Domestic corporation M owns 60 percent of the only class of stock of A Corporation, a controlled foreign corporation during the entire period here involved. Both M Corporation and A Corporation use the calendar year as a taxable year. Corporation A's investment of earnings in United States property at the close of the taxable year 1963 is $100,000, as determined under paragraph (b) of this section, and M Corporation includes its pro rata share of such amount ($60,000) in gross income for its taxable year 1963. On June 1, 1964, M Corporation acquires an additional 25 percent of A Corporation's outstanding stock from a person who is not a United States person as defined in section 957(d). Corporation A's investment of earnings in United States property at the close of the taxable year 1964, as determined under paragraph (b) of this section, is unchanged ($100,000). Corporation A pays no amount during 1963 to which section 959(c)(1) applies. Corporation M is not required, by reason of the acquisition in 1964 of A Corporation's stock, to include an additional amount in its gross income with respect to A Corporation's investment of earnings in United States property even though the earnings invested in United States property by A Corporation attributable to the stock acquired by M Corporation were not previously taxed. The determination made under paragraph (c)(1)(i) of this section as well as the determination made under paragraph (c)(1)(ii) of this section with respect to A Corporation's investment for 1964 of earnings in United States property are made on the basis of stock owned by M Corporation (85 percent) at the close of 1964.

(e) *Amount attributable to property*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, for purposes of paragraph (b)(1) of this section the amount taken into account with respect to any United States property shall be its adjusted basis, as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (3) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Rule for pledges and guarantees.* For purposes of this section the amount taken into account with respect to any pledge or guarantee described in paragraph (c)(1) of §1.956–2 shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor.

(3) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to

any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investment of earnings in United States property will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954 (d)(3) and paragraph (e) of §1.954–1.

(4) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes United States property on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2600, Feb. 20, 1964, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965; T.D. 7712, 45 FR 52374, Aug. 7, 1980; T.D. 8209, 53 FR 22171, June 14, 1988]

### §1.956–1T Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property (temporary).

(a) [Reserved]

(b)(1)–(3) [Reserved]

(4) *Treatment of certain investments of earnings in United States Property*—(i) *Special rule.* For purposes of §1.956–1(b)(1) of the regulations, a controlled foreign corporation will be considered to hold indirectly (A) the investments in United States property held on its behalf by a trustee or a nominee or (B) at the discretion of the District Director, investments in U.S. property acquired by any other foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation. For purposes of this paragraph (b), a foreign corporation will be controlled by the controlled foreign corporation if the foreign corporation and the controlled foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) 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). The following examples illustrate the application of this paragraph.

*Example 1.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation, and all of the outstanding stock of FS2, also a controlled foreign corporation. FS1 sells products to FS2 in exchange for trade receivables due in 60 days. FS2 has no earnings and profits. FS1 has substantial accumulated earnings and profits. FS2 loans to P an amount equal to the debt it owes FS1. FS2 pays the trade receivables according to the terms of the receivables. FS1 will not be considered to hold indirectly the investment in United States property under this paragraph (b)(4), because there was no transfer of funds to FS2.

*Example 2.* The facts are the same as in Example 1, except that FS2 does not pay the receivables. FS1 is considered to hold indirectly the investment in United States property under this paragraph (b)(4), because there was a transfer of funds to FS2, a principal purpose of which was to avoid the application of section 956 to FS1.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

(c)–(d) [Reserved]

(e)(1)–(4) [Reserved]

(e)(5) *Excluded charges*—(i) *Special rule.* For purposes of §1.956–1(e)(1) of the regulations, in the case of an investment in United States property consisting of an obligation of a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1, a liability will not be recognized as a specific charge if the liability representing the charge is with recourse with respect to the general credit or other assets of the investing controlled foreign corporation.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

### § 1.956–2 Definition of United States property.

(a) *Included property*—(1) *In general.* For purposes of section 956(a) and §1.956–1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of such foreign corporation beginning after December 31, 1962, which is—

(i) Tangible property (real or personal) located in the United States;

(ii) Stock of a domestic corporation;

(iii) An obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)); or

(iv) Any right to the use in the United States of—

(*a*) A patent or copyright,

(*b*) An invention, model, or design (whether or not patented),

(*c*) A secret formula or process, or

(*d*) Any other similar property right, which is acquired or developed by the foreign corporation for use in the United States by any person. Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use.

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

*Example 1.* Foreign corporation R uses as a taxable year a fiscal year ending on June 30. Corporation R acquires on June 1, 1963, and holds on June 30, 1963, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States. Corporation R's aggregate investment in United States property at the close of its taxable year ending June 30, 1963, is zero since the property which is acquired on June 1, 1963, is not acquired during a taxable year of R Corporation beginning after December 31, 1962. Assuming no change in R Corporation's aggregate investment in United States property during its taxable year ending June 30, 1964, R Corporation's increase in earnings invested in United States property for such taxable year is zero.

*Example 2.* Foreign corporation S uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable year 1965. Corporation S is not a controlled foreign corporation at any time during its taxable years 1963 and 1964. Corporation S owns on December 31, 1964, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States which it acquires during taxable years beginning after December 31, 1962. Corporation S's aggregate investment in United States property on December 31, 1964, is $100,000. Corporation S's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1964, are in excess of $100,000. Assuming no change in S Corporation's aggregate investment in United States property during its taxable year 1965, S Corporation's increase in earnings invested in United States property for such taxable year is zero.

*Example 3.* Foreign corporation T uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable years 1963, 1964, and 1966. At December 31, 1964, T Corporation's investment in United States property is $100,000. Corporation T is not a controlled foreign corporation at any time during its taxable year 1965 in which it acquires $25,000 of tangible property (not described in section 956(b)(2)) located in the United States. On December 31, 1965, T Corporation holds the United States property of $100,000 which it held on December 31, 1964, and, in addition, the United States property acquired in 1965. Corporation T's aggregate investment in United States property at December 31, 1965, is $125,000. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1965, are in excess of $125,000, and T Corporation pays no amount during 1965 to which section 959 (c)(1) applies. Assuming no change in T Corporation's aggregate investment in United States property during its taxable year 1966, T Corporation's increase in earnings invested in United States property for such taxable year is zero.

(3) *Property owned through partnership.* For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns

property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in United States property. This paragraph (a)(3) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) *Exceptions*—(1) *Excluded property.* For purposes of section 956(a) and paragraph (a) of this section, United States property does not include the following types of property held by a foreign corporation:

(i) Obligations of the United States.

(ii) Money.

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of §1.956–1.

(iv) Property located in the United States which is purchased in the United States for export to, or use in, foreign countries. For purposes of this subdivision, property to be used outside the United States will be considered property to be used in a foreign country. Whether property is of a type described in this subdivision is to be determined from all the facts and circumstances in each case. Property which constitutes export trade assets within the meaning of section 971(c)(2) and paragraph (c)(3) of §1.971–1 will be considered property of a type described in this subdivision.

(v) Any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) arising in connection with the sale or processing of property if the amount of such obligation outstanding at any time during the taxable year of the foreign corporation does not exceed an amount which is ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person, or, if the sale or processing transaction occurs between related persons, would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person if such persons were unrelated persons. Whether the amount of an obligation described in this subdivision is ordinary and necessary is to be determined from all the facts and circumstances in each case.

(vi) Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Whether transportation property described in this subdivision is used in foreign commerce and predominantly outside the United States is to be determined from all the facts and circumstances in each case. As a general rule, such transportation property will be considered to be used predominantly outside the United States if 70 percent or more of the miles traversed (during the taxable year at the close of which a determination is made under section 956(a)(2)) in the use of such property are traversed outside the United States or if such property is located outside the United States 70 percent of the time during such taxable year.

(vii) An amount of assets described in paragraph (a) of this section of an insurance company equivalent to the unearned premiums or reserves which are ordinary and necessary for the proper conduct of that part of its insurance business which is attributable to contracts other than those described in section 953(a)(1) and the regulations thereunder. For purposes of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of an insurance business if, under the principles of paragraph (c) of §1.953–4, such reserve would qualify as a reserve required by law. See paragraph (d)(3) of §1.954–2 for determining, for purposes of this subdivision, the meaning of insurance company and of unearned premiums.

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined

in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958 (b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and other movable exploration and exploitation equipment (other than a vessel or an aircraft) when used on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal, or transportation of natural resources from or under ocean waters. Property used on the Continental Shelf includes property located in the United States which is being constructed or is in storage or in transit within the United States for use on the Continental Shelf. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B)(x) (without reference to sections 49 and 50).

(x) An amount of—

(*a*) A controlled foreign corporation's assets described in paragraph (a) of this section equivalent to its earnings and profits which are accumulated after December 31, 1962, and are attributable to items of income described in section 952(b) and the regulations thereunder, reduced by the amount of

(*b*) The earnings and profits of such corporation which are applied in a taxable year of such corporation beginning after December 31, 1962, to discharge a liability on property, but only if the liability was in existence at the close of such corporation's taxable year immediately preceding its first taxable year beginning after December 31, 1962, and the property would have been United States property if it had been acquired by such corporation immediately before such discharge.

For purposes of this subdivision, distributions made by such corporation for any taxable year shall be considered first made out of earnings and profits for such year other than earnings and profits referred to in (*a*) of this subdivision.

(2) *Statement required.* If a United States shareholder of a controlled foreign corporation excludes any property from the United States property of such controlled foreign corporation on the ground that section 956(b)(2) applies to such excluded property, he shall attach to his return a statement setting forth, by categories described in paragraph (a)(1) of this section, the amount of United States property of the controlled foreign corporation and, by categories described in subparagraph (1) of this paragraph, the amount of such property which is excluded.

(c) *Treatment of pledges and guarantees*—(1) *General rule.* Except as provided in subparagraph (4) of this paragraph, any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered for purposes of section 956(a) and paragraph (a) of this section to be United States property held by such controlled foreign corporation.

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to

the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) *Illustrations.* The following examples illustrate the application of this paragraph (c):

*Example 1.* A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of §1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of §1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

*Example 2.* The facts are the same as in example 1, except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $1,00,000 at maturity the note representing A's obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of §1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of §1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

*Example 3.* A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year. in the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with respect to that obligation. For purposes of paragraph (b) of §1.956–1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of §1.956–1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(4) *Special rule for certain conduit financing arrangements.* The rule contained in subparagraph (1) of this paragraph shall not apply to a pledge or a guarantee by a controlled foreign corporation to secure the obligation of a United States person if such United States person is a mere conduit in a financing arrangement. Whether the United States person is a mere conduit in a financing arrangement will depend upon all the facts and circumstances in each case. A United States person will be considered a mere conduit in a financing arrangement in a case in which a controlled foreign corporation pledges stock of its subsidiary corporation, which is also a controlled foreign corporation, to secure the obligation of such United States person, where the following conditions are satisfied:

(i) Such United States person is a domestic corporation which is not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its relending of the funds borrowed by it on such obligation to the controlled foreign corporation whose stock is pledged; and

(ii) The assets of such United States person are at all times substantially offset by its obligation to the lender.

(d) *Definitions*—(1) *Meaning of ''acquired''*—(i) *Applicable rules.* For purposes of this section—

(*a*) Property shall be considered acquired by a foreign corporation when such corporation acquires an adjusted basis in the property;

(*b*) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section) shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

(*c*) Property shall not be considered acquired by a foreign corporation if—

(*1*) Such property is acquired in a transaction in which gain or loss would not be recognized under this chapter to such corporation if such corporation were a domestic corporation;

(*2*) The basis of the property acquired by the foreign corporation is the same as the basis of the property exchanged by such corporation; and

(*3*) The property exchanged by the foreign corporation was not United States property (as defined in paragraph (a)(1) of this section) but would have been such property if it had been acquired by such corporation immediately before such exchange.

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

*Example 1.* Foreign corporation R uses the calendar year as a taxable year and acquires before January 1, 1963, stock of domestic corporation M having as to R Corporation an adjusted basis of $10,000. The stock of M Corporation is not United States property of R Corporation on December 31, 1962, since it is not acquired in a taxable year of R Corporation beginning on or after Janury 1, 1963. On June 30, 1963, R Corporation sells the M Corporation stock for $15,000 in cash and expends such amount in acquiring stock of domestic corporation N which has as to R Corporation an adjusted basis of $15,000. For purposes of determining R Corporation's aggregate investment in United States property on December 31, 1963, R Corporation has, by virtue of acquiring the stock of N Corporation, acquired $15,000 of United States property.

*Example 2.* Foreign corporation S, a controlled foreign corporation for the entire period here involved, uses the calendar year as a taxable year and purchases for $100,000 on December 31, 1963, tangible property (not described in section 956(b)(2)) located in the United States and having a remaining estimated useful life of 10 years, subject to a mortgage of $80,000 payable in 5 annual installments. The property constitutes United States property as of December 31, 1963, and the amount taken into account for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of §1.956–1 is $20,000. No depreciation is sustained with respect to the property during the taxable year 1963. During the taxable year 1964, S Corporation pays $16,000 on the mortgage and sustains $10,000 of depreciation with respect to the property. As of December 31, 1964, the amount taken into account with respect to the property for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of §1.956–1 is $26,000, computed as follows:

| | | |
|---|---|---|
| Cost of property | | $100,000 |
| Less: Reserve for depreciation | | 10,000 |
| Adjusted basis of property | | 90,000 |
| Less: Liability to which property is subject: | | |
| Gross amount of mortgage | $80,000 | |
| Payment during 1964 | 16,000 | |
| | | 64,000 |
| Amount taken into account (12–31–64) | | 26,000 |

*Example 3.* Controlled foreign corporation T uses the calendar year as a taxable year and acquires on December 31, 1963, $10,000 of United States property not described in section 956(b)(2); no depreciation is sustained with respect to the property during 1963. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1963, are in excess of $10,000, and T Corporation's United States shareholders include in their gross income under section 951(a)(1)(B) their pro rata share of T Corporation's increase ($10,000) for 1963 in earnings invested in United States property. On January 1, 1964, T Corporation acquires an additional $10,000 of United States property not described in section 956(b)(2). Each of the two items of property has an estimated useful life of 5 years, and T Corporation sustains $4,000 of depreciation with respect to such properties during its taxable year 1964. Corporation T's current and accumulated earnings and profits as of December 31, 1964, exceed $16,000, determined as provided in paragraph (b) of §1.956–1. Corporation T pays no amounts during 1963 to which section 959(c)(1) applies. Corporation T's investment of earnings in United States property at December 31, 1964, is $16,000, and its increase for

1964 in earnings invested in United States property is $6,000.

*Example 4.* Foreign corporation U uses the calendar year as a taxable year and acquires before January 1, 1963, stock in domestic corporation M having as to U Corporation an adjusted basis of $10,000. On December 1, 1964, pursuant to a statutory merger described in section 368(a)(1), M Corporation merges into domestic corporation N, and U Corporation receives on such date one share of stock in N Corporation, the surviving corporation, for each share of stock it held in M Corporation. Pursuant to section 354 no gain or loss is recognized to U Corporation, and pursuant to section 358 the basis of the property received (stock of N Corporation) is the same as that of the property exchanged (stock of M Corporation). Corporation U is not considered for purposes of section 956 to have acquired United States property by reason of its receipt of the stock in N Corporation.

*Example 5.* The facts are the same as in example 4, except that U Corporation acquires the stock of M Corporation on February 1, 1963, rather than before January 1, 1963. For purposes of determining U Corporation's aggregate investment in United States property on December 31, 1963, U Corporation has, by virtue of acquiring the stock of M Corporation, acquired $10,000 of United States property. Corporation U pays no amount during 1963 to which section 959(c)(1) applies. The reorganization and resulting acquisition on December 1, 1964, by U Corporation of N Corporation's stock also represents an acquisition of United States property; however, assuming no other change in U Corporation's aggregate investment in United States property during 1964, U Corporation's increase for such year in earnings invested in United States property is zero.

(2) [Reserved]

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2601, Feb. 20, 1964, as amended by T.D. 7712, 45 FR 52374, Aug. 7, 1980; T.D. 7797, 46 FR 57675, Nov. 25, 1981; T.D. 8209, 53 FR 22171, June 14, 1988; T.D. 9008, 67 FR 48025, July 23, 2002]

### § 1.956–2T Definition of United States Property (temporary).

(a)–(c) [Reserved]

(d)(1) [Reserved]

(2) *Obligation defined*—(i) *Rule.* For purposes of § 1.956–2 of the regulations, the term ''obligation'' includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest, except that such term shall not include:

(A) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of paragraph (a)(1) of § 1.956–2, or

(B) Any obligation of a United States person (as defined in section 957(c)) arising in connection with the provision of services by a controlled foreign corporation to the United States person if the amount of such obligation outstanding at any time during the taxable year of the controlled foreign corporation does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the controlled foreign corporation and the United States person if they were unrelated. The amount of such obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days.

See § 1.956–2(b)(1)(v) for the exclusion from United States property of obligations arising in connection with the sale or processing of property where such obligations are ordinary and necessary as to amount.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

### § 1.956–3T Certain trade or service receivables acquired from United States persons (temporary).

(a) *In general.* For purposes of section 956(a) and § 1.956–1, the term ''United States property'' also includes any trade or service receivable if the trade or service receivable is acquired (directly or indirectly) after March 1, 1984, from a related person who is a United States person (as defined in section 7701(a)(30)) (hereinafter referred to as a ''related United States person'') and the obligor under the receivable is a United States person. A trade or service receivable described in this paragraph shall be considered to be United States property notwithstanding the exceptions (other than subparagraph (H)) contained in section 956(b)(2). The terms ''trade or service receivable'' and ''related person'' have

the respective meanings given to such terms by section 864(d) and the regulations thereunder. For purposes of this section, the exception contained in §1.956–2T(d)(2)(i)(B) for short-term obligations shall not apply to service receivables described in this paragraph.

(b) *Acquisition of a trade or service receivable*—(1) *General rule.* The rules of §1.864–8T(c)(1) shall be applied to determine whether a controlled foreign corporation has acquired a trade or service receivable.

(2) *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 acquiring person.

(ii) *Acquisition by nominee or pass-through entity.* A controlled foreign corporation will be considered to have acquired a trade or service receivable of a related United States person held on its behalf:

(A) By a nominee or by a partnership, simple trust, S corporation or other pass-through entity to the extent the controlled foreign corporation owns (directly or indirectly) a beneficial interest in such partnership or other pass-through entity; or

(B) By another foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding such other foreign corporation (through capital contributions or debt) is to avoid the application of section 956. *See* §1.956–1T.

The rule of this paragraph (b)(2)(ii) does not limit the application of paragraph (b)(2)(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 examples illustrate the application of this paragraph (b)(2)(ii).

*Example 1.* FS1, a controlled foreign corporation with substantial accumulated earnings and profits, contributes $2,000,000 to PS, a partnership, in exchange for a 20 percent limited partnership interest in PS. PS purchases trade or service receivables of FS1's domestic parent, P. The obligors under the receivables are United States persons. PS does not purchase receivables of any person who is related to any other partner in PS. Under paragraph (b)(2)(ii)(A) of this section, there is an investment of the earnings of FS1 in United States property equal to 20 percent of PS's basis in the receivables of P.

*Example 2.* FS1, a controlled foreign corporation, has accumulated more than $3,000,000 in earnings and profits. It organizes a wholly-owned foreign corporation, FS2, with a $2,000,000 equity contribution. FS2 has no earnings and profits. FS2 uses the funds to purchase trade or service receivables of FS1's domestic parent, P. The obligors under the receivables are United States persons. Under paragraph (b)(2)(ii)(B) of this section, there is an investment of the earnings of FS1 in United States property equal to $2,000,000.

(iii) *Swap or pooling arrangements.* A trade or service receivable of an unrelated person will be considered to be a trade or service receivable acquired from a related United States 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 United States persons who are also parties to the arrangement, in exchange for reciprocal purchases of receivables of United States persons in the first group. The following example illustrates the application of this paragraph (b)(2)(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. The obligors under some or all of the receivables acquired by each of A, B, C, and D are United States persons. Because the effect of this arrangement is that the unrelated groups acquire each other's trade or service receivables of United States persons pursuant to the arrangement, there is an investment of the earnings of each of A, B, C, and D in United States property to the extent of the purchase price of those receivables under which the obligors are United States persons.

(iv) *Financing arrangements.* If a controlled foreign corporation participates (directly or indirectly) in a lending transaction that results in a loan to a United States person who purchases property described in section 1221(1)

(hereinafter referred to as ''inventory property'') or services of a related United States person, or to any person who purchases trade or service receivables of a related United States person under which the obligor is a United States person, or to a person who is related to any such 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 described in paragraph (a) of this section. For purposes of this paragraph (b)(2)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of the inventory property or services or trade or service receivables of a related United States person. The amount to be taken into account with respect to the controlled foreign corporation's investment in United States property (resulting from application of this paragraph (b)(2)(iv)) shall be the amount lent pursuant to a lending transaction described in this paragraph (b)(2)(iv), if the amount lent is equal to or less than 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 purchase price. The following examples illustrate the application of this paragraph (b)(2)(iv).

*Example 1.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. P sells equipment for $2,000,000 to X, an unrelated United States person. FS1 makes a $1,000,000 short-term loan to X, which loan would not have been made or maintained on the same terms but for X's purchase of P's equipment. Because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired the receivable of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $1,000,000.

*Example 2.* The facts are the same as in Example 1, except that instead of loaning money to X directly, FS1 deposits $3,000,000 with an unrelated financial institution that loans $2,000,000 to X in order for X to purchase P's equipment. The loan would not have been made or maintained on the same terms but for the corresponding deposit. Accordingly, the deposit and the loan are treated as a direct loan from FS1 to X. *See* Rev. Rul. 87–89, 1987–37 I.R.B. 16. Because FS1 indirectly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired the receivable of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $2,000,000.

*Example 3.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. FS1 makes a $3,000,000 loan to U, an unrelated foreign corporation, in connection with U's purchase for $2,000,000 of receivables from the sale of inventory property by P to United States obligors. Because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired receivables of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $2,000,000.

(c) *Substitution of obligor.* For purposes of this section, the substitution of another person for a United States obligor may be disregarded. Thus, if a purchaser who is a United States person arranges for a foreign person to pay a United States seller of inventory property or services and the seller transfers by sale or otherwise to its own controlled foreign corporation the foreign person's obligation for payment, then the acquisition of the foreign person's obligation shall constitute an investment in United States property by the seller's controlled foreign corporation, unless it can be demonstrated by the parties to the transaction that the primary purpose for the arrangement was not the avoidance of section 956. The following example illustrates the application of this paragraph.

*Example.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation with substantial accumulated earnings and profits. P sells equipment to X, a domestic corporation unrelated to P. To pay for the equipment, X arranges for a foreign financing entity to issue a note to P. P then sells the note to FS1. FS1 has made an investment in United States property in the amount of the purchase price of the note.

[T.D. 8209, 53 FR 22169, June 14, 1988]

### § 1.957–1 Definition of controlled foreign corporation.

(a) *In general.* The term *controlled foreign corporation* means any foreign corporation of which more than 50 percent (or such lesser amount as is provided in section 957(b) or section 953(c)) of either—

(1) The total combined voting power of all classes of stock of the corporation entitled to vote; or

(2) The total value of the stock of the corporation, is owned within the meaning of section 958(a), or (except for purposes of section 953(c)) is considered as owned by applying the rules of section 958(b) and §1.958–2, by United States shareholders on any day during the taxable year of such foreign corporation. For the definition of the term *United States shareholder*, see sections 951(b) and 953(c)(1)(A). For the definition of the term *foreign corporation*, see §301.7701–5 of this chapter (Procedure and Administration Regulations). For the treatment of associations as corporations, see section 7701(a)(3) and §§301.7701–1 and 301.7701–2 of this chapter. For the definition of the term *stock*, see sections 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint stock company or insurance company as a shareholder, see section 7701(a)(8).

(b) *Percentage of total combined voting power owned by United States shareholders*—(1) *Meaning of combined voting power.* In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation—

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corporation by a person whom such shareholders have the power to elect, appoint, or replace.

(2) *Shifting of formal voting power.* Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights,

and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

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

*Example 1.* Foreign corporation R has two classes of capital stock outstanding, 60 shares of class A stock, and 40 shares of class B stock. Each share of each class of stock has one vote for all purposes. E, a United States person, owns 51 shares of class A stock. Corporation R is a controlled foreign corporation.

*Example 2.* Foreign corporation S has three classes of capital stock outstanding, consisting of 60 shares of class A stock, 40 shares of class B stock, and 200 shares of class C stock. The owners of a majority of class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. Class C stock has no voting rights. D, a United States person, owns all of the shares of the class C stock. He also owns 31 shares of class A stock and as such an owner can elect 6 members of the board of directors. None of the remaining shares of class A stock, or the 40 shares of class B stock, is owned, or considered as owned, within the meaning of section 958, by a United States person. Since, as owner of 31 shares of the class A stock, D has sufficient voting power to elect 6 directors, D has more than 50 percent of the total combined voting power of all classes of stock entitled to vote, and S Corporation is a controlled foreign corporation.

*Example 3.* M, a United States person, owns a 51-percent interest in R Company, a foreign company of which he is a member. The company, if it were domestic, would be taxable as a corporation. The remaining interest of 49 percent in the company is owned by seven other members none of whom is a United States person. The memorandum of association of R Company provides for only one manager, who with respect to the company exercises the powers ordinarily exercised by a board of directors of a domestic corporation. The manager is to be elected by unanimous agreement of all the members. Since M owns 51 percent of the company, he will be deemed to own more than 50 percent of the total combined voting power of all classes of stock of R Company entitled to vote, notwithstanding that he has power to elect a manager only with the agreement of the other members. Company R is a controlled foreign corporation.

*Example 4.* Domestic corporation M owns a 49-percent interest in S Company, a foreign company of which it is a member. The company, if it were domestic, would be taxable as a corporation. Company S is formed under the laws of foreign country Y. The remaining interest of 51 percent in S Company is owned by persons who are not United States persons. The organization contract of S Company provides for one manager, B, a citizen and resident of country Y who is an officer of M Corporation in charge of its foreign operations in such country, or any person M Corporation may at any time appoint to succeed B in such capacity. The manager has the sole authority with respect to S Company to exercise powers ordinarily exercised by a board of directors of a domestic corporation. Since M Corporation has the discretionary power to replace B and to appoint his successor as manager of S Company, the company is a controlled foreign corporation.

*Example 5.* N, a United States person, owns 50 percent of the outstanding shares of the only class of capital stock of foreign corporation R. An additional 48 percent of the outstanding shares is owned by foreign corporation S. The remaining 2 percent of shares is owned by P, a citizen and resident of foreign country T, who regularly acts as attorney for N in the conduct of N's business affairs in country T. All of the shares of the outstanding capital stock of R Corporation are bearer shares. At the time of the issuance of the shares to him, P places the certificates for such shares in a depository to which N has access. On several occasions N, with P's acquiescence, has taken such shares from the depository and, on one such occasion, used the shares as collateral in borrowing funds on a loan. Although dividends, when paid, are paid to P on his shares, his charges to N for legal fees are reduced by the amount of the dividends paid on such shares. Although P votes his shares at meetings of shareholders, the facts set forth above indicate an implied agreement between P and N that N is really to retain dominion over the stock. N is deemed to own the voting rights ostensibly attached to the stock owned by P, and R Corporation is a controlled foreign corporation.

*Example 6.* M, a domestic corporation which manufactures in the United States and distributes all of its production for foreign consumption through N, a person other than a related person or a United States person, forms foreign corporation S to purchase products from M Corporation and sell them to N. Corporations S and M have common directors. The outstanding capital stock of S Corporation consists of 10,000 shares of $100 par value class A stock, which has no voting rights except to vote for dissolution of the corporation on a share-for-share basis, and 500 shares of no par class B stock which has full voting rights. Each class of the outstanding stock is to participate on a share for share basis in any dividend. The class A

stock has a preference as to assets on dissolution of the corporation to the extent of its par value as well as the right to participate with the class B stock in all other assets on a share for share basis. All of the shares of class A stock are issued to M Corporation in return for property having a value of $1 million. Of the class B stock, 300 of the shares are issued to N in return for $3,000 in cash and 200 shares are issued to M Corporation for $2,000 in cash. At stockholder meetings N never votes in opposition to M Corporation on important issues. Corporation S has average annual earnings of $200,000, all of which will be subpart F income if S Corporation is held to be a controlled foreign corporation. All such earnings are accumulated. Although N ostensibly has 60 percent of the voting power of S Corporation by virtue of his ownership of 300 shares of class B stock, he has the right to only approximately 3 percent of any dividends which may be paid by S Corporation; in addition, upon liquidation of S Corporation, N is entitled to share in the assets only after M Corporation has received the par value of its 10,000 shares of class A stock, or $1 million. Thus, the voting power owned by N is substantially greater than its proportionate share of the earnings of S Corporation. In addition, the facts set forth above indicate that N is not exercising his voting rights independently and that a principal purpose of the capitalization arrangement is to avoid classification of S Corporation as a controlled foreign corporation. For these reasons, the voting power ostensibly provided the class B stock will be deemed owned by M Corporation, and S Corporation is a controlled foreign corporation.

*Example 7.* Foreign corporation A, authorized to issue 100 shares of one class of capital stock, issues, for $1,000 per share, 45 shares to domestic corporation M, 45 shares to foreign corporation B, and 10 shares to foreign corporation C. Corporation C, a bank, lends $3 million to finance the operations of A Corporation. In the course of negotiating these financial arrangements, D, an officer of C Corporation, and E, an officer of M Corporation, orally agree that C Corporation will vote its stock as M Corporation directs. By virtue of such oral agreement M Corporation possesses the voting power ostensibly owned by C Corporation, and A Corporation is a controlled foreign corporation.

*Example 8.* For its prior taxable year, *JV*, a foreign corporation, had outstanding 1000 shares of class A stock, which is voting common, and 1000 shares of class B stock, which is nonvoting preferred. *DP*, a domestic corporation, and *FP*, a foreign corporation, each owned precisely 500 shares of both class A and class B stock, and each elected 5 of the 10 members of *JV*'s board of directors. The other facts and circumstances were such that *JV* was not a controlled foreign corporation on any day of the prior taxable year. On the first day of the current taxable year, *DP* purchased one share of class B stock from *FP*. *JV* was a controlled foreign corporation on the following day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b). See §1.951–1(f).

*Example 9.* The facts are the same as in *Example 8* except that the stock of *FP* was publicly traded, *FP* had one class of stock, and on the first day of the current taxable year *DP* purchased one share of *FP* stock on the foreign stock exchange instead of purchasing one share of *JV* stock from *FP*. *JV* became a controlled foreign corporation on the following day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b).

*Example 10. X*, a foreign corporation, is incorporated under the laws of country *Y*. Under the laws of country *Y*, *X* is considered a mutual insurance company. *X* issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid. Only policyholders are provided with the right to vote for directors, share in assets upon liquidation, and receive distributions. United States policyholders contribute 25 percent of the premiums and have 25 percent of the outstanding rights to vote for the board of directors. Based on these facts, the United States policyholders are United States shareholders owning the requisite combined voting power and value. Thus, *X* is a controlled foreign corporation for purposes of taking into account related person insurance income under section 953(c).

(d) *Effective date.* Paragraphs (a) and (c) *Examples 8* through *10* of this section are effective for taxable years of a controlled foreign corporation beginning after November 6, 1995.

[T.D. 6688, 28 FR 11631, Oct. 31, 1963, as amended by T.D. 8216, 53 FR 27510, July 21, 1988; T.D. 8618, 60 FR 46529, Sept. 7, 1995; 60 FR 62026, Dec. 4, 1995; T.D. 8704, 62 FR 21, Jan. 2, 1997]

### §1.957–2 Controlled foreign corporation deriving income from insurance of United States risks.

(a) *In general.* For purposes of taking into account only the income derived from the insurance of United States risks under §1.953–1, the term ''controlled foreign corporation'' means any foreign corporation of which more than

25 percent, but not more than 50 percent, of the total combined voting power of all classes of stock entitled to vote is owned within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day of the taxable year of such foreign corporation, but only if the gross amount of premiums received by such foreign corporation during such taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with United States risks, as defined in §1.953–2 or 1.953–3, exceeds 75 percent of the gross amount of all premiums received by such foreign corporation during such year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks. The subpart F income for a taxable year of a foreign corporation which is a controlled foreign corporation for such taxable year within the meaning of this paragraph shall, subject to the provisions of section 952(b), (c), and (d), and §1.952–1, include only the income derived from the insurance of United States risks, as determined under §1.953–1.

(b) *Gross amount of premiums defined.* For a foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as—

(1) A life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies,

(2) A mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies, or

(3) A mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies,

the term ''gross amount of premiums'' means, for purposes of paragraph (a) of this section, the gross amount of premiums and other consideration which are taken into account by a life insurance company under section 809(c)(1). Determinations for purposes of this paragraph shall be made without regard to section 501(a).

[T.D. 6795, 30 FR 942, Jan. 29, 1965]

### §1.957–3 United States person defined.

[Reserved]. For further guidance, see §1.957–3T.

[T.D. 9194, 70 FR 18945, Apr. 11, 2005]

### §1.957–3T United States person defined (temporary).

(a) *Basic rule*—(1) *In general.* The term *United States person* has the same meaning for purposes of sections 951 through 965 which it has under section 7701(a)(30) and the regulations thereunder, except as provided in paragraphs (b) and (c) of this section which provide, with respect to corporations organized in possessions of the United States, that certain residents of such possessions are not United States persons. The effect of determining that an individual is not a United States person for such purposes is to exclude such individual in determining whether a foreign corporation created or organized in, or under the laws of, a possession of the United States is a controlled foreign corporation. See §1.957–1 for the definition of the term *controlled foreign corporation.*

(2) *Special provisions applicable to possessions of the United States.* For purposes of this section—

(i) The term *possession of the United States* means the Commonwealth of Puerto Rico (Puerto Rico) or any section 931 possession.

(ii) The term *section 931 possession* has the same meaning which it has under §1.931–1T(c)(1).

(iii) The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of a possession of the United States.

(iv) The rules of §1.937–2T shall apply for determining whether income is from sources within a possession of the United States.

(v) The rules of §1.937–3T shall apply for determining whether income is effectively connected with the conduct of a trade or business in a possession of the United States.

(b) *Puerto Rico corporation and resident.* An individual (who, without regard to this paragraph (b), is a United States person) shall not be considered a United States person with respect to a foreign corporation created or organized in, or under the laws of, Puerto

Rico for the taxable year of such corporation which ends with or within the taxable year of such individual if—

(1) Such individual is a bona fide resident of Puerto Rico during his entire taxable year in which or with which the taxable year of such foreign corporation ends; and

(2) A dividend received by such individual from such corporation during the taxable year of such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico.

(c) *Section 931 possession corporation and resident.* An individual (who, without regard to this paragraph (c), is a United States person) shall not be considered a United States person with respect to a foreign corporation created or organized in, or under the laws of, a section 931 possession for the taxable year of such corporation which ends with or within the taxable year of such individual if—

(1) Such individual is a bona fide resident of such section 931 possession during his entire taxable year in which or with which the taxable year of such foreign corporation ends; and

(2) Such corporation satisfies the following conditions—

(i) 80 percent or more of its gross income for the 3-year period ending at the close of the taxable year (or for such part of such period as such corporation or any predecessor has been in existence) was derived from sources within section 931 possessions or was effectively connected with the conduct of a trade or business in section 931 possessions; and

(ii) 50 percent or more of its gross income for such period (or part) was derived from the active conduct of a trade or business within section 931 possessions.

(d) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18945, Apr. 11, 2005]

### § 1.958–1 Direct and indirect ownership of stock.

(a) *In general.* Section 958(a) provides that, for purposes of sections 951 to 964 (other than sections 955(b)(1)(A) and (B) and 955(c)(2)(A)(ii) (as in effect before the enactment of the Tax Reduction Act of 1975), and 960(a)(1)), stock owned means—

(1) Stock owned directly; and

(2) Stock owned with the application of paragraph (b) of this section.

The rules of section 958(a) and this section provide a limited form of stock attribution primarily for use in determining the amount taxable to a United States shareholder under section 951(a). These rules also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(a).

(b) *Stock ownership through foreign entities.* For purposes of paragraph (a)(2) of this section, stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, foreign trust (within the meaning of section 7701(a)(31)) described in sections 671 through 679, or other foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock, or beneficiaries, respectively. Stock considered to be owned by reason of the application of this paragraph shall, for purposes of reapplying this paragraph, be treated as actually owned by such person. Thus, this rule creates a chain of ownership; however, since the rule applies only to stock owned by a foreign entity, attribution under the rule stops with the first United States person in the chain of ownership running from the foreign entity. The application of this paragraph may be illustrated by the following example:

*Example.* Domestic corporation M owns 75 percent of the one class of stock in foreign corporation R, which in turn owns 80 percent of the one class of stock in foreign corporation S, which in turn owns 90 percent of the one class of stock in foreign corporation T. Under this paragraph, R Corporation is considered as owning 80 percent of the 90 percent of the stock which S Corporation owns in T Corporation, or 72 percent. Corporation M is considered as owning 75 percent of such 72 percent of the stock in T Corporation, or 54 percent. Since M Corporation is a domestic corporation, the attribution under this paragraph stops with M Corporation, even though, illustratively, such corporation is wholly owned by domestic corporation N.

(c) *Rules of application*—(1) *Special rule for mutual insurance companies.* For purposes of applying paragraph (a) of this section in the case of a foreign mutual insurance company, the term ''stock'' shall include any certificate entitling the holder to voting power in the corporation.

(2) *Amount of interest in foreign corporation, foreign partnership, foreign trust, or foreign estate.* The determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person. However, any arrangement which artificially decreases a United States person's proportionate interest will not be recognized. See §§ 1.951–1 and 1.957–1.

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

*Example 1.* United States persons A and B own 25 percent and 50 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 80 percent of the one class of stock in foreign corporation N, and N Corporation owns 60 percent of the one class of stock in foreign corporation P. Under paragraph (b) of this section, M Corporation is considered to own 48 percent (80 percent of 60 percent) of the stock in P Corporation; such 48 percent is treated as actually owned by M Corporation for the purpose of again applying paragraph (b) of this section. Thus, A and B are considered to own 12 percent (25 percent of 48 percent) and 24 percent (50 percent of 48 percent), respectively, of the stock in P Corporation.

*Example 2.* United States person C is a 60-percent partner in foreign partnership X. Partnership X owns 40 percent of the one class of stock in foreign corporation Q. Corporation Q is a 50-percent partner in foreign partnership Y, and partnership Y owns 100 percent of the one class of stock in foreign corporation R. By the application of paragraph (b) of this section, C is considered to own 12 percent (60 percent of 40 percent of 50 percent of 100 percent) of the stock in R Corporation.

*Example 3.* Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (⅓ of 90 percent) of the stock in S Corporation.

*Example 4.* Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

[T.D. 6889, 31 FR 9455, July 12, 1966, as amended by T.D. 7893, 48 FR 22509, May 19, 1983; T.D. 8955, 66 FR 37897, July 20, 2001]

### § 1.958–2 Constructive ownership of stock.

(a) *In general.* Section 958(b) provides that, for purposes of sections 951(b), 954(d)(3), 956(b)(2), and 957, the rules of section 318(a) as modified by section 958(b) and this section shall apply to the extent that the effect is to treat a United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a

United States shareholder of a controlled foreign corporation under section 956(b)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957. The rules contained in this section also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(b).

(b) *Members of family*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, an individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) His spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance); and

(ii) His children, grandchildren, and parents.

(2) *Effect of adoption.* For purposes of subparagraph (1)(ii) of this paragraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) *Stock owned by nonresident alien individual.* For purposes of this paragraph, stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a United States citizen or a resident alien individual. However, this limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and §1.956–2(b)(1)(viii). See section 958(b)(1).

(c) *Attribution from partnerships, estates, trusts, and corporations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—

(i) *From partnerships and estates.* Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(ii) *From trusts—(a) To beneficiaries.* Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

(*b*) *To owner.* Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under sections 671 to 679 (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(iii) *From corporations.* If 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. See section 958(b)(3).

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote in a corporation, it shall be considered as owning all the stock entitled to vote. See section 958(b)(2).

(d) *Attribution to partnerships, estates, trusts, and corporations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—

(i) *To partnerships and estates.* Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(ii) *To trusts—(a) From beneficiaries.* Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(*b*) *From owner.* Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under sections 671 to 678 (relating to grantors and others treated as

substantial owners) shall be considered as owned by the trust.

(iii) *To corporations.* If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. This subdivision shall not be applied so as to consider a corporation as owning its own stock.

(2) *Limitation.* Subparagraph (1) of this paragraph shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. This limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and §1.956–2(b)(1)(viii). See section 958(b)(4).

(e) *Options.* If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of the preceding sentence, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(f) *Rules of application.* For purposes of this section—

(1) *Stock treated as actually owned*—(i) *In general.* Except as provided in subdivisions (ii) and (iii) of this subparagraph, stock constructively owned by a person by reason of the application of paragraphs (b), (c), (d), and (e) of this section shall, for purposes of applying such paragraphs, be considered as actually owned by such person.

(ii) *Members of family.* Stock constructively owned by an individual by reason of the application of paragraph (b) of this section shall not be considered as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(iii) *Partnerships, estates, trusts, and corporation.* Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (d) of this section shall not be considered as owned by it for purposes of applying paragraph (c) of this section in order to make another the constructive owner of such stock.

(iv) *Option rule in lieu of family rule.* For purposes of this subparagraph, if stock may be considered as owned by an individual under paragraph (b) or (e) of this section, it shall be considered as owned by him under paragraph (e).

(2) *Coordination of different attribution rules.* For purposes of any one determination, stock which may be owned under more than one of the rules of §1.958–1 and this section, or by more than one person, shall be owned under that attribution rule which imputes to the person, or persons, concerned the largest total percentage of such stock. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* (a) United States persons A and B, and domestic corporation M, own 9 percent, 32 percent, and 10 percent, respectively, of the one class of stock in foreign corporation R. A also owns 10 percent of the one class of stock in M Corporation. For purposes of determining whether A is a United States shareholder with respect to R Corporation, 10 percent of the 10-percent interest of M Corporation in R Corporation is considered as owned by A. See paragraph (c)(1)(iii) of this section. Thus, A owns 10 percent (9 percent plus 10 percent of 10 percent) of the stock in R Corporation and is a United States shareholder with respect to such corporation. Corporation M and B, by reason of owning 10 percent and 32 percent, respectively, of the stock in R Corporation are United States shareholders with respect to such corporation.

(b) For purposes of determining whether R Corporation is a controlled foreign corporation, the 1 percent of the stock in R Corporation directly owned by M Corporation and considered as owned by A cannot be counted twice. Therefore, the total amount of stock in R Corporation owned by United States shareholders is 51 percent, determined as follows:

STOCK OWNERSHIP IN R CORPORATION

[percent]

| | |
|---|---|
| A | 9 |
| B | 32 |
| M Corporation | 10 |
| Total | 51 |

*Example 2.* United States person C owns 10 percent of the one class of stock in foreign corporation N, which owns 60 percent of the one class of stock in foreign corporation S. Under paragraph (a)(2) of §1.958–1, C is considered as owning 6 percent (10 percent of 60

percent) of the stock in S Corporation. Under paragraph (c)(1)(iii) and (2) of this section N Corporation is considered as owning 100 percent of the stock in S Corporation and C is considered as owning 10 percent of such 100 percent, or 10 percent of the stock in S Corporation. Thus, for purposes of determining whether C is a United States shareholder with respect to S Corporation, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used inasmuch as C owns a larger total percentage of the stock of S Corporation under such rules.

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

*Example 1.* United States persons A and B own 5 percent and 25 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 60 percent of the one class of stock in foreign corporation N. Under paragraph (a)(2) of §1.958–1, A and B are considered as owning 3 percent (5 percent of 60 percent) and 15 percent (25 percent of 60 percent), respectively, of the stock in N Corporation. Under paragraph (c)(2) of this section, M Corporation is treated as owning all the stock in N Corporation, and, under paragraph (c)(1)(iii) of this section, B is considered as owning 25 percent of such 100 percent, or 25 percent of the stock in N Corporation. Inasmuch as A owns less than 10 percent of the stock in M Corporation, he is not considered as owning, under paragraph (c)(1)(iii) of this section, any of the stock in N Corporation owned by M Corporation. Thus, the attribution rules of paragraph (a)(2) of §1.958–1 are used with respect to A inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules; and the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to B inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules.

*Example 2.* United States person C owns 60 percent of the one class of stock in domestic corporation P; corporation P owns 60 percent of the one class of stock in foreign corporation Q; and corporation Q owns 60 percent of the one class of stock in foreign corporation R. Under paragraph (a)(2) of §1.958–1, P Corporation is considered as owning 36 percent (60 percent of 60 percent) of the stock in R Corporation, and C is considered as owning none of the stock in R Corporation inasmuch as the chain of ownership stops at the first United States person and P Corporation is such a person. Under paragraph (c)(2) of this section, Q Corporation is treated as owning 100 percent of the stock in R Corporation, and under paragraph (c)(1)(iii) of this section, P Corporation is considered as owning 60 percent of such 100 percent, or 60 percent of the stock in R Corporation. For purposes of determining the amount of stock in R Corporation which C is considered as owning, P Corporation is treated under paragraph (c)(2) of this section as owning 100 percent of the stock in R Corporation; therefore, C is considered as owning 60 percent of the stock in R Corporation. Thus, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to C and P Corporation inasmuch as they each own a larger total percentage of the stock of R Corporation under such rules.

*Example 3.* United States person D owns 25 percent of the one class of stock in foreign corporation S. D is also a 40-percent partner in domestic partnership X, which owns 50 percent of the one class of stock in domestic corporation T. Under paragraph (d)(1)(i) of this section, the 25 percent of the stock in S Corporation owned by D is considered as being owned by partnership X; since such stock is treated as actually owned by partnership X under paragraph (f)(1)(i) of this section, such stock is in turn considered as being owned by T Corporation under paragraph (d)(1)(iii) of this section. Thus, under paragraphs (d)(1) and (f)(1)(i) of this section, T Corporation is considered as owning 25 percent of the stock in S Corporation.

*Example 4.* Foreign corporation U owns 100 percent of the one class of stock in domestic corporation V and also 100 percent of the one class of stock in foreign corporation W. By virtue of paragraph (d)(2) of this section, V Corporation may not be considered under paragraph (d)(1) of this section as owning the stock owned by its sole shareholder, U Corporation, in W Corporation.

*Example 5.* United States citizen E owns 15 percent of the one class of stock in foreign corporation Y, and United States citizen F, E's spouse, owns 5 percent of such stock. E and F's four nonresident alien grandchildren each own 20 percent of the stock in Y Corporation. Under paragraph (b)(1) of this section, E is considered as owning the stock owned by F in Y Corporation; however, by virtue of paragraph (b)(3) of this section, E may not be considered under paragraph (b)(1) of this section as owning any of the stock in Y Corporation owned by such grandchildren.

*Example 6.* United States person F owns 10 percent of the one class of stock in foreign corporation Z; corporation Z owns 10 percent of the one class of stock in foreign corporation K; and corporation K owns 100 percent of the one class of stock in foreign corporation L. United States person G, F's spouse, owns 9 percent of the stock in K Corporation. Under paragraph (c)(1)(iii) of this section or paragraph (a)(2) of §1.958–1, F is considered as owning 1 percent (10 percent of 10 percent of 100 percent) of the stock in L Corporation by reason of his ownership of stock in Z Corporation, and, under paragraph (b)(1) of this section, G is considered as owning such 1 percent of the stock in L Corporation. Under

paragraph (a)(2) of §1.958–1, G is considered as owning 9 percent (9 percent of 100 percent) of the stock in L Corporation by reason of her ownership of stock in K Corporation, and, under paragraph (b)(1) of this section, F is considered as owning such 9 percent of the stock in L Corporation. Thus, for the purpose of determining whether F or G is a United States shareholder with respect to L Corporation, each of F and G is considered as owning a total of 10 percent of the stock in L Corporation by applying the rules of paragraph (a)(2) of §1.958–1 and paragraphs (b)(1) and (c)(1)(iii) of this section.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6889, 31 FR 9455, July 12, 1966, as amended by T.D. 7712, 45 FR 52375, Aug. 7, 1980; T.D. 8955, 66 FR 37897, July 20, 2001]

### § 1.959–1 Exclusion from gross income of United States persons of previously taxed earnings and profits.

(a) *In general.* Sections 951 through 964 provide that certain types of income of controlled foreign corporations will be subject to United States income tax even though such amounts are not currently distributed to the United States shareholders of such corporations. The amounts so taxed to certain United States shareholders are described as subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and increases in earnings invested in United States property. Section 959 provides that amounts taxed as subpart F income, as previously excluded subpart F income withdrawn from investment in less developed countries, or as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations are not taxed again as increases in earnings invested in United States property. Section 959 also provides an exclusion whereby none of the amounts so taxed are taxed again when actually distributed directly, or indirectly through a chain of ownership described in section 958(a), to United States shareholders or to such shareholders' successors in interest. The exclusion also applies to amounts taxed to United States shareholders as income of one controlled foreign corporation and later distributed to another controlled foreign corporation in such a chain of ownership where such amounts would otherwise be again included in the income of such shareholders or their successors in interest as subpart F income of the controlled foreign corporation to which they are distributed. Section 959 also provides rules for the allocation of distributions to earnings and profits and for the nondividend treatment of actual distributions which are excluded from gross income.

(b) *Actual distributions to United States persons.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a) shall not, when such amounts are distributed to such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. See section 959(a)(1). Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951 (a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, or under section 951(a)(1)(B) as earnings invested in United States property, shall not be again included in the gross income of such shareholder when such amounts are actually distributed, directly or indirectly, to such shareholder. See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

*Example.* (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $100 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). Corporation R's current and accumulated earnings and profits (before taking into account distributions made during 1964) are $150. Also, during 1964, R Corporation distributes $50 to A. The $50 distribution is excludable from A's gross income for 1964 under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a).

(c) If instead of deriving the $100 of subpart F income in 1964, R Corporation derives such amount during 1963 and has earnings and profits for 1963 in excess of $100, A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i). However, the $50 distribution made by R Corporation to A during 1964 is excludable from A's gross income for such year under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a).

(d) If, with respect to 1964—

(1) Instead of owning the stock of R Corporation directly, A owns such stock through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) Both M and N Corporations use the calendar year as a taxable year and are controlled foreign corporations throughout the period here involved,

(3) Corporation R derives $100 of subpart F income and has earnings and profits in excess of $100,

(4) Neither M Corporation nor N Corporation has earnings and profits or a deficit in earnings and profits, and

(5) The $50 distribution is from R Corporation to N Corporation to M Corporation to A,

A must include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of R Corporation. However, the $50 distribution is excludable from A's gross income for 1964 under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a) and are distributed indirectly to A through a chain of ownership described in section 958(a).

(c) *Excludable investment of earnings in United States property.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a)(1)(A) shall not, when such amounts would, but for section 959(a)(2) and this paragraph, be included under section 951(a)(1)(B) in the gross income of such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, or under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, may be invested in United States property without being again included in such shareholder's income under section 951 (a). Moreover, the first amount deemed invested in United States property are amounts previously included in the gross income of a United States shareholder under section 951(a)(1)(A). See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

*Example.* (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $35 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). During 1964, R Corporation also invests $50 in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation R makes no distributions during the year, and its current earnings and profits are in excess of $50. Of the $50 investment of earnings in United States property, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits which are attributable to amounts which are included in A's gross income for such year under section 951(a)(1)(A)(i) and therefore may be invested in United States property without again

being included in A's gross income. The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(c) If, instead of deriving $35 of subpart F income in 1964, R Corporation has no subpart F income for 1964 but derives the $35 of subpart F income during 1963 and has earnings and profits for such year in excess of $35, A must include $35 in his gross income for 1963 under section 951(a)(1)(A)(i). However, of the $50 investment of earnings in United States property made by R Corporation during 1964, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a)(1)(A)(i). The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(d) *Application of exclusions to shareholder's successor in interest.* If a United States person (as defined in §1.957–4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in paragraph (b) or (c) of this section, the rules of such paragraph shall apply to such acquiring person but only to the extent that the acquiring person establishes to the satisfaction of the district director his right to the exclusion provided by such paragraph. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(1) The name, address, and taxable year of the foreign corporation from which the distribution is received and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The name, address, and (in the case of information required to be furnished after June 20, 1983) taxpayer identification number of the person from whom the stock interest was acquired;

(3) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(4) The amount for which an exclusion under section 959(a) is claimed; and

(5) Evidence showing that the earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a), that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amounts.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

*Example.* (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1964, and a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation has $100 of subpart F income and earnings and profits in excess of $100. A includes $100 in his gross income for 1964 under section 951(a)(1)(A)(i). During 1965, A sells 40 percent of his stock in R Corporation to B, a United States person who uses the calendar year as a taxable year. In 1965, R Corporation has no earnings and profits and experiences no increase in earnings invested in United States property. Corporation R distributes $40 to B on December 1, 1965. If B establishes his right to the exclusion to the satisfaction of the district director, he may exclude $40 from his gross income for 1965 under section 959(a)(1).

(c) If, instead of selling his 40-percent interest directly to B, A sells on February 1, 1965, 40 percent of his stock in R Corporation to C, a nonresident alien, and on October 1, 1965, B acquires the 40-percent interest in R Corporation from C, the result is the same as in paragraph (b) of this example, if B establishes his right to the exclusion to the satisfaction of the district director.

(d) If, instead of acquiring 40 percent, B acquires only 5 percent of A's stock in R Corporation and R Corporation distributes $5 to B during 1965, B is not a United States shareholder (within the meaning of section 951(b)) with respect to R Corporation since he owns only 5 percent of the stock of R Corporation. Notwithstanding, B may exclude the $5 distribution from his gross income for 1965 under section 959(a)(1) if he establishes his right to the exclusion to the satisfaction of the district director.

(e) If the facts are assumed to be the same as in paragraphs (a) and (b) of this example except that—

(1) A owns the stock of R Corporation indirectly through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) B acquires from N Corporation 40 percent of the stock in R Corporation,

(3) Both M Corporation and N Corporation are controlled foreign corporations which use the calendar year as a taxable year,

(4) Neither M Corporation nor N Corporation has any amount in 1964 or 1965 which is includible in gross income of United States shareholders under section 951(a), and

(5) Neither M Corporation nor N Corporation has a deficit in earnings and profits for 1964;

the result is the same as in paragraph (b) of this example if B establishes his right to the exclusion to the satisfaction of the district director.

[T.D. 6795, 30 FR 943, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22509, May 19, 1983]

### § 1.959–2 Exclusion from gross income of controlled foreign corporations of previously taxed earnings and profits.

(a) *Applicable rule.* The earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder. See section 959(b). The exclusion from the income of such other foreign corporation also applies with respect to any other United States shareholder who acquires from such United States shareholder or any other person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent the acquiring shareholder establishes to the satisfaction of the district director his right to such exclusion. An acquiring shareholder claiming the exclusion under section 959(b) shall furnish to the district director with his return for the taxable year the information required under paragraph (d) of §1.959–1 to support the exclusion under this paragraph.

(b) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* (a) A, a United States shareholder, owns 100 percent of the only class of stock of M Corporation which in turn owns 100 percent of the only class of stock of N Corporation. A and corporations M and N use the calendar year as a taxable year and corporations M and N are controlled foreign corporations throughout the period here involved.

(b) During 1963, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100. A is required to include $100 in his gross income for 1963 under section 951(a)(1)(B) by reason of his indirect ownership of the stock of N Corporation. During 1963, M Corporation has no income or investments other than the income derived from a distribution of $100 from N Corporation. Corporation M has earnings and profits of $100 for 1963. Under paragraph (a) of §1.954–2, the $100 distribution received by M Corporation from N Corporation would otherwise constitute subpart F income of M Corporation; however, by reason of section 959(b) and this section, this amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i).

(c) During 1964, N Corporation derives $100 of subpart F income and distributes $100 to M Corporation which has no subpart F income for 1964 but which invests the $100 distribution in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation N's earnings and profits for 1964 are in excess of $100, and M Corporation's current and accumulated earnings and profits (before taking into account distributions made during 1964) are in excess of $100. A is required with respect to N Corporation to include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of the stock of N Corporation. The investment by M Corporation in United States property would otherwise constitute an investment of earnings in United States property to which section 956 applies; however, by reason of section 959(b) and this section, such amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B).

(d) If during 1965, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100, A will be required with respect to N Corporation to include $100 in his gross income for 1965 under section 951(a)(1)(B), because the $100 of earnings and profits for 1964 attributable to N Corporation's subpart F income which was taxed to A in 1964 was distributed to M Corporation in such year.

(e) If, with respect to 1966—

(1) Corporation N owns 100 percent of the only class of stock of R Corporation,

(2) Corporation R derives $100 of subpart F income, has earnings and profits in excess of $100, and makes no distributions to N Corporation,

(3) Corporation N invests $25 in tangible property (other than property described in section 956(b)(2)) located in the United States and has current and accumulated earnings and profits in excess of $25, and

(4) Corporation M has no income or investments and does not have a deficit in earnings and profits,

the $100 of subpart F income derived by R Corporation is includible in A's gross income for 1966 under section 951(a)(1)(A)(i) and the $25 investment of earnings in United States property by N Corporation is includible in A's gross income for 1966 under section 951(a)(1)(B).

(f) If, however, the facts are the same as in paragraph (e) of this example except that—

(1) During 1966, R Corporation distributes $20 to N Corporation, and

(2) Corporation N makes no distributions during such year to M Corporation,

of the $25 investment in United States property by N Corporation, $20 is not includible in A's gross income for 1966 because such amount represents earnings and profits which are attributable to amounts included in A's gross income for such year under section 951(a)(1)(A)(i) with respect to R Corporation and which have been distributed to N Corporation by R Corporation. By reason of section 959(B) and this section, such $20 distribution to N Corporation does not constitute gross income of N Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B); however, the remaining $5 of investment of earnings in United States property by N Corporation in 1966 is includible in A's gross income for such year under section 951(a)(1)(B).

[T.D. 6795, 30 FR 944, Jan. 29, 1965]

### § 1.959–3 Allocation of distributions to earnings and profits of foreign corporations.

(a) *In general.* For purposes of §§ 1.959–1 and 1.959–2, the source of the earnings and profits from which distributions are made by a foreign corporation as between earnings and profits attributable to increases in earnings invested in United States property, previously taxed subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and other amounts shall be determined in accordance with section 959(c) and paragraphs (b) through (e) of this section.

(b) *Applicability of section 316(a).* For purposes of this section, section 316(a) shall be applied, in determining the source of distributions from the earnings and profits of a foreign corporation, by first applying section 316(a)(2) and then by applying section 316(a)(1)—

(1) First, as provided by section 959(c)(1), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2) and paragraph (c) of § 1.959–1),

(2) Secondly, as provided by section 959(c)(2), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(A) (but reduced by amounts not included in such gross income under section 951(a)(1)(B) because of the exclusion provided by section 959(a)(2) and paragraph (c) of § 1.959–1), and

(3) Finally, as provided by section 959(c)(3), to other earnings and profits. Thus, distributions shall be considered first attributable to amounts, if any, described in subparagraph (1) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), secondly to amounts, if any, described in subparagraph (2) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts, if any, described in subparagraph (3) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year). See, however, paragraph (e) of § 1.963–3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) for a special rule for determination of the source of distributions counting as minimum distributions. Earnings and profits are classified as to year and as to section 959(c) amount in the year in which such amounts are included in

gross income of a United States shareholder under section 951(a) and are reclassified as to section 959(c) amount in the year in which such amounts would be so included but for the provisions of section 959(a)(2); any subsequent distribution of such amounts to a higher tier in a chain of ownership described in section 958(a) does not of itself change such classifications. For example, earnings and profits of a foreign corporation attributable to amounts of previously excluded subpart F income withdrawn from investment in less developed countries (or from investments in export trade assets or foreign base company shipping operations) shall be reclassified as amounts to which subparagraph (2), rather than subparagraph (3), of this paragraph applies for purposes of determining priority of distribution, and such earnings and profits shall be considered attributable to the taxable year in which the withdrawal occurs. This paragraph shall apply to distributions by one foreign corporation to another foreign corporation and by a foreign corporation to a United States person. The application of this paragraph may be illustrated by the following example:

*Example.* (a) M, a controlled foreign corporation, is organized on January 1, 1963, and is 100-percent owned by A, a United States shareholder. Both A and M Corporation use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. As of December 31, 1966, M Corporation's accumulated earnings and profits of $450 (before taking into account distributions made in 1966) applicable to A's interest in such corporation are classified for purposes of section 959(c) as follows:

| Year | Classification of earnings and profits for purposes of section 959 | | |
|---|---|---|---|
| | (c)(1) | (c)(2) | (c)(3) |
| 1963 | $100 | | |
| 1964 | 100 | $75 | |
| 1965 | | 75 | $50 |
| 1966 | | | 50 |

(b) During 1966, M Corporation makes three separate distributions to A of $150 each, and the source of such distributions under section 959(c) is as follows:

| | Amount | Year | Allocation of distributions under section 959 |
|---|---|---|---|
| Distribution No. 1 | $100 | 1964 | (c)(1) |
| | 50 | 1963 | (c)(1) |
| | 150 | | |
| Distribution No. 2 | 50 | 1963 | (c)(1) |
| | 75 | 1965 | (c)(2) |
| | 25 | 1964 | (c)(2) |
| | 150 | | |
| Distribution No. 3 | 50 | 1964 | (c)(2) |
| | 50 | 1966 | (c)(3) |
| | 50 | 1965 | (c)(3) |
| | 150 | | |

(c) If, in addition to the above facts—

(1) M Corporation owns throughout the period here involved 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year,

(2) Corporation N derives $60 of subpart F income for 1963 which A includes in his gross income for such year under section 951(a)(1)(A)(i),

(3) Corporation N has earnings and profits for 1963 of $60 but has neither earnings or profits nor a deficit in earnings and profits for 1964, 1965, or 1966, and

(4) During 1966, N Corporation invests $20 in tangible property (not described in section 956(b)(2)) located in the United States and distributes $45 to M Corporation,

the $20 investment of earnings in United States property is excludable from A's gross income for 1966, under section 959(a)(2) and paragraph (c) of §1.959–1, with respect to N Corporation and the $45 dividend received by M Corporation does not, under section 959(b) and §1.959–2, constitute gross income of M Corporation for 1966 for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i) with respect to M Corporation. However, the $45 dividend paid by N Corporation to M Corporation is allocated under section 959(c) and this paragraph to the earnings and profits of N Corporation as follows: $20 to 1963 earnings described in section 959(c)(1) and $25 to 1963 earnings described in section 959(c)(2). In such case, M Corporation's earnings and profits of $495 (before taking into account distributions made in 1966) would be classified as follows for purposes of section 959(c):

| Year | Classification of earnings and profits for purposes of section 959 | | |
|---|---|---|---|
| | (c)(1) | (c)(2) | (c)(3) |
| 1963 | $120 | $25 | |
| 1964 | 100 | 75 | |
| 1965 | | 75 | $50 |

| Year | Classification of earnings and profits for purposes of section 959 | | |
|---|---|---|---|
| | (c)(1) | (c)(2) | (c)(3) |
| 1966 | | | 50 |

(d) The three distributions to A in 1966 of $150 each would then have the following source under section 959(c):

| | Amount | Year | Allocation of distributions under section 959 |
|---|---|---|---|
| Distribution No. 1 | $100 | 1964 | (c)(1) |
| | 50 | 1963 | (c)(1) |
| | 150 | | |
| Distribution No. 2 | 70 | 1963 | (c)(1) |
| | 75 | 1965 | (c)(2) |
| | 5 | 1964 | (c)(2) |
| | 150 | | |
| Distribution No. 3 | 70 | 1964 | (c)(2) |
| | 25 | 1963 | (c)(2) |
| | 50 | 1966 | (c)(3) |
| | 5 | 1965 | (c)(3) |
| | 150 | | |

(c) *Treatment of deficits in earnings and profits.* For purposes of this section, a United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of §1.951–1) of a foreign corporation's deficit in earnings and profits, determined under section 964(a) and §1.964–1, for any taxable year shall be applied only to earnings and profits described in paragraph (b)(3) of this section.

(d) *Treatment of certain foreign taxes.* For purposes of this section, any amount described in subparagraph (1), (2), or (3) of paragraph (b) of this section which is distributed by a foreign corporation through a chain of ownership described in section 958(a)(2) shall be reduced by any income, war profits, or excess profits taxes imposed on or with respect to such distribution by any foreign country or possession of the United States.

*Example.* (a) Domestic corporation M owns 100 percent of the only class of stock of foreign corporation A, which is incorporated under the laws of foreign country X and which, in turn, owns 100 percent of the only class of stock of foreign corporation B, which is incorporated under the laws of foreign country Y. All corporations use the calendar year as a taxable year and corporations A and B are controlled foreign corporations throughout the period here involved.

(b) During 1963, B Corporation (a less developed country corporation for 1963 within the meaning of §1.955–5) derives $90 of subpart F income, after incurring $10 of foreign income tax allocable to such income under paragraph (c) of §1.954–1, has earnings and profits in excess of $90, and makes no distributions. Corporation M must include $90 in its gross income for 1963 under section 951(a)(1)(A)(i). As of December 31, 1963, with respect to M Corporation, B Corporation has earnings and profits for 1963 described in section 959(c)(2) of $90.

(c) During 1964, B Corporation has neither earnings and profits nor a deficit in earnings and profits but distributes $90 to A Corporation, and, by reason of section 959(b) and §1.959–2, such amount is not includible in the gross income of M Corporation for 1964 under section 951(a) with respect to A Corporation. Corporation A incurs a withholding tax of $13.50 on the $90 dividend distributed from B Corporation (15 percent of $90) and an additional foreign income tax of 10 percent or $7.65 by reason of the inclusion of the net distribution of $76.50 ($90 minus $13.50) in its taxable income for 1964. As of December 31, 1964, with respect to M Corporation, B Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to zero ($90 minus $90); and A Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to $68.85 ($90 minus $13.50 minus $7.65).

(e) *Determination of foreign tax credit.* For purposes of applying section 902 and section 960 in determining the foreign tax credit allowable under section 901 in a case in which distributions are made by a second-tier corporation or a first-tier corporation, as the case may be, from its earnings and profits for a taxable year which are attributable to an amount included in the gross income of a U.S. shareholder under section 951(a) or which are attributable to amounts excluded from the gross income of such foreign corporation under section 959(b) and §1.959–2 with respect to a U.S. shareholder, the rules of paragraph (b) of this section shall apply except that in applying subparagraph (1) or (2) of such paragraph—

(1) Distributions from the earnings and profits for such taxable year of the second-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the foreign corporation, if any, next

lower in the chain of ownership described in section 958(a), to the extent of such earnings and profits of the second-tier corporation, and then to the other earnings and profits of such second-tier corporation, and

(2) Distributions from the earnings and profits for such taxable year of the first-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the second-tier corporation, to the extent of such earnings and profits of the first-tier corporation, and then to the other earnings and profits of such first-tier corporation. For purposes of this paragraph, a second-tier corporation is a foreign corporation referred to in section 960(a)(1)(B), and a first-tier corporation is a foreign corporation referred to in section 960 (a)(1)(A). The application of this paragraph may be illustrated by the following examples:

*Example 1.* (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation R which, in turn, owns 100 percent of the only class of stock of foreign corporation S. All corporations use the calendar year as a taxable year, and corporations R and S are controlled foreign corporations throughout the period here involved.

(b) Neither R Corporation nor S Corporation has subpart F income for 1963. During 1963, S Corporation increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to S Corporation. During 1963, R Corporation also increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to R Corporation.

(c) During 1964, S Corporation distributes $100 to R Corporation, and R Corporation distributes $100 to A Corporation. Neither corporation has any earnings or profits or deficit in earnings and profits for such year. On December 31, 1964, R Corporation has earnings and profits (computed before distributions to A Corporation made for the year) of $200, consisting of $100 of section 959(c)(1) amounts of R Corporation for 1963 and of $100 of section 959(c)(1) amounts of S Corporation for 1963. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution by R Corporation shall be considered attributable to S Corporation's earnings and profits for 1963 described in section 959(c)(1).

*Example 2.* (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation T which, in turn, owns 100 percent of the only class of stock of foreign corporation U. All corporations use the calendar year as a taxable year, and corporations T and U are controlled foreign corporations throughout the period here involved.

(b) During 1964, T Corporation invests $100 in tangible property (not described in section 956(b)(2)) located in the United States. For 1964, T Corporation has no subpart F income and makes no distributions; A must include $100 in its gross income for 1964 under section 951(a)(1)(B) with respect to T Corporation. For 1964, U Corporation has no subpart F income or investment of earnings in United States property but U Corporation has $100 of earnings and profits which it distributes to T Corporation. At December 31, 1964, T Corporation has earnings and profits of $300, consisting of operating income of $100 for each of the years 1963 and 1964 and $100 in dividends received from the earnings and profits of U Corporation for 1964. These earnings and profits are classified as follows under section 959(c): $100 of section 959(c)(1) amounts of T Corporation for 1964, $100 of section 959(c)(3) amounts of U Corporation for 1964, and $100 of section 959(c)(3) amounts of T Corporation for 1963.

(c) During 1965 neither T Corporation nor U Corporation has any earnings and profits or deficit in earnings and profits or investment of earnings in U.S. property, but T Corporation distributes $100 to A Corporation. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution of T Corporation shall be considered attributable to T Corporation's earnings and profits for 1964 described in section 959(c)(1).

(f) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* (a) M, a controlled foreign corporation is organized on January 1, 1963, and is wholly owned by A, a United States shareholder. Both A and Corporation M use the calendar year as a taxable year.

(b) Corporation M's earnings and profits (before distributions) for 1963 are $200, $100, of which is attributable to subpart F income. Corporation M's earnings and profits for such year also include $25 attributable to subpart F income which is excluded from M Corporation's foreign base company income under section 954(b)(1) as dividends, interest, and gains invested in qualified investments in less developed countries. Corporation M's

increase in earnings invested in tangible property (not described in section 956(b)(2)) located in the United States for 1963, is $50, and M Corporation makes a distribution of such property during such year of $20. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1963, determined after the distributions of $20, is classified as follows:

| | | | |
|---|---|---|---|
| Section 959(c)(1) amounts: | | | |
| Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of section 959(a)(2) and § 1.959–1(c) | | $50 | |
| Less: Distribution for 1963 allocated under section 959(c)(1) and paragraph (b)(1) of this section to such amounts | | 20 | $30 |
| Section 959(c)(2) amounts: | | | |
| Earnings for 1963 attributable to subpart F income included in A's gross income under section 951(a)(1)(A)(i) | | 100 | |
| Less: Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of section 959(a)(2) and § 1.959–1(c) | | 50 | 50 |
| Section 959(c)(3) amounts: | | | |
| Predistribution earnings for 1963 | | 200 | |
| Less: Earnings for 1963 classified as: | | | |
| Section 959(c)(1) amounts | $50 | | |
| Section 959(c)(2) amounts | 50 | 100 | 100 |
| A's total interest in M Corporation's earnings and profits | | | 180 |

For 1963, A is required to include $100 of subpart F income in his gross income under section 951(a)(1)(A)(i). He would have been required to include $50 in his gross income under section 951(a)(1)(B) as M Corporation's increase in earnings invested in United States property, except that section 959(a)(2) and paragraph (c) of § 1.959–1 provide in effect that earnings and profits taxed to A under section 951(a)(1)(A) with respect to M Corporation (whether in the current taxable year or in prior years) may be invested in United States property without again being included in gross income under section 951(a). The $20 dividend from M Corporation is excluded from A's gross income under section 959(a)(1) and paragraph (b) of § 1.959–1, since such distribution is allocated under section 959(c)(1) and paragraph (b)(1) of this section to amounts described in section 959(c)(1).

(c) During 1964, M Corporation's earnings and profits (before distributions) are $300, $75 of which is attributable to subpart F income. Corporation M has no change in investments in United States property during such year and withdraws $15 of previously excluded subpart F income from investment in less developed countries. Corporation M makes a cash distribution of $250 to A during 1964. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1964, determined after the distribution of $250, is classified as follows:

| | | | | |
|---|---|---|---|---|
| Section 959 (c)(1) amounts: | | | | |
| Section 959(c)(1) net amount for 1963 (as determined under paragraph (b) of this example) | | | $30 | |
| Less: Distribution for 1964 allocated under section 959(c)(1) and paragraph (b)(1) of this section to such amount | | | 30 | |
| Section 959(c)(2) amounts: | | | | |
| Section 959(c)(2) net amount for 1963 (as determined under paragraph (b) of this example) | | | 50 | |
| Plus: Earnings for 1964 attributable to: | | | | |
| Subpart F income for 1964 included in A's gross income under section 951(a)(1)(A)(i) | | | 75 | |
| Previously excluded subpart F income withdrawn in 1964 from investment in less developed countries and included in A's gross income under section 951(a)(1)(A)(ii) | | | 15 | |
| | | | 140 | |
| Less: Distribution for 1964 allocated under section 959(c)(2) and paragraph (b)(2) of this section to such amounts | | | 140 | |
| Section 959(c)(3) amounts: | | | | |
| Section 959(c)(3) net amount for 1963 (as determined under paragraph (b) of this example) | | | 100 | |
| Plus: Section 959(c)(3) net amount for 1964: | | | | |
| Predistribution earnings for 1964 | | $300 | | |
| Less: | | | | |
| Earnings for 1964 classified as section 959(c)(1) amounts ($0) and as section 959(c)(2) amounts ($75+$15) | $90 | | | |
| Distributions for 1964 allocated under section 959(c)(3) and paragraph (b)(3) of this section | 80 | 170 | 130 | $230 |

A's total interest in M Corporation's earnings and profits ..... 230

For 1964, A is required to include in his gross income under section 951(a)(1)(A)(i) $75 of subpart F income, and under section 951 (a)(1)(A)(ii) $15 of previously excluded subpart F income withdrawn from investment in less developed countries. Of the $250 cash distribution, A may exclude $170 from his gross income under section 959(a)(1) and paragraph (b) of §1.959–1 and $80 is includible in his gross income as a dividend.

(d) The source under section 959(c) of the 1964 distribution of $250 to A is as follows:

| Year | Amount | Allocation of distribution under section 959 |
|---|---|---|
| 1963 | $30 | (c)(1). |
| 1964 | 90 | (c)(2). |
| 1963 | 50 | (c)(2). |
| 1964 | 80 | (c)(3). |
| | 250 | |

[T.D. 6795, 30 FR 945, Jan. 29, 1965, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; T. D. 7545, 43 FR 19652, May 8, 1978; T.D. 7893, 48 FR 22510, May 19, 1983]

### § 1.959–4 Distributions to United States persons not counting as dividends.

Except as provided in section 960(a)(3) and §1.960–2, any distribution to a United States person which is excluded from the gross income of such person under section 959(a)(1) and §1.959–1 shall be treated for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend. However, see paragraph (b)(1) of §1.956–1, relating to the dividend limitation on the amount of a controlled foreign corporation's investment of earnings in United States property.

[T.D. 7120, 36 FR 10860, June 4, 1971]

### § 1.960–1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

(a) *Scope of regulations under section 960.* This section prescribes rules for determining the foreign income taxes deemed paid under section 960(a)(1) by a domestic corporation which is required under section 951 to include in gross income an amount attributable to a first-, second-, or third-tier corporation's earnings and profits. Section 1.960–2 prescribes rules for applying section 902 to dividends paid by a third-, second-, or first-tier corporation from earnings and profits attributable to an amount which is, or has been, included in gross income under section 951. Section 1.960–3 provides special rules for the application of the gross-up provisions of section 78 where an amount is included in gross income under section 951. Section 1.960–4 prescribes rules for increasing the applicable foreign tax credit limitation under section 904(a) of the domestic corporation for the taxable year in which it receives a distribution of earnings and profits in respect of which it was required under section 951 to include an amount in its gross income for a prior taxable year. Section 1.960–5 prescribes rules for disallowing a deduction for foreign income taxes for such taxable year of receipt where the domestic corporation received the benefits of the foreign tax credit for such previous taxable year of inclusion. Section 1.960–6 provides that the excess of such an increase in the applicable limitation under section 904(a) over the tax liability of the domestic corporation for such taxable year of receipt results in an overpayment of tax. Section 1.960–7 prescribes the effective dates for application of these rules.

(b) *Definitions.* For purposes of section 960 and §§1.960–1 through 1.960–7—

(1) *First-tier corporation.* The term ''first-tier corporation'' means a foreign corporation at least 10 percent of the voting stock of which is owned by the domestic corporation described in paragraph (a) of this section.

(2) *Second-tier corporation.* In the case of amounts included in the gross income of the taxpayer under section 951—

(i) For taxable years beginning before January 1, 1977, the term ''second-tier corporation'' means a foreign corporation at least 50 percent of the voting stock of which is owned by such first-tier corporation.

(ii) For taxable years beginning after December 31, 1976, the term ''second-tier corporation'' means a foreign corporation as least 10 percent of the voting stock of which is owned by such first-tier corporation.

(3) *Third-tier corporation.* In the case of amounts included in the gross income of a domestic shareholder under section 951 for taxable years beginning after December 31, 1976, the term ''third-tier corporation'' means a foreign corporation at least 10 percent of the voting stock of which is owned by such second-tier corporation.

(4) *Immediately lower-tier corporation.* In the case of a first-tier corporation the term ''immediately lower-tier corporation'' means a second-tier corporation. In the case of a second-tier corporation, the term ''immediately lower-tier corporation'' means a third-tier corporation. In the case of a third-tier corporation, the term ''immediately lower-tier corporation'' means a fourth-tier corporation.

(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.

(c) *Amount of foreign income taxes deemed paid by domestic corporation in respect of earnings and profits of foreign corporation attributable to amount included in income under section 951*—(1) *In general.* For purposes of section 901—

(i) 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 first- or second-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid, accrued, or deemed (in accordance with paragraph (b) of §1.960–2) to be paid by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (in the case of a first-tier corporation, determined without regard to section 958(a)(2); in the case of a second-tier corporation, determined without regard to section 958(a)(1)(A) and, to the extent that stock of such second-tier corporation is owned by the domestic corporation through a foreign corporation other than the first-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation for its taxable year. This paragraph (c)(1)(i) shall not apply to amounts included in the gross income of the domestic corporation under section 951 with respect to the second-tier corporation unless the percentage-of-voting-stock requirement of section 902(b)(3)(A) is satisfied.

(ii) 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 third-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid or accrued by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (determined without regard to section 958(a)(1)(A) and, to the extent that stock of such third-tier corporation is owned by the domestic corporation through a foreign corporation other than the second-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation. This paragraph (c)(1)(ii) shall not apply unless the percentage-of-voting-stock requirement of section 902(b)(3)(B) is satisfied.

(iii) In applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to a first-, second-, or third-tier corporation which for the taxable year has income excluded under section 959(b), paragraph (c)(3) of this section shall apply for purposes of excluding certain earnings and profits of such foreign corporation and foreign income taxes, if any, attributable to such excluded income.

(iv) This paragraph (c)(1) applies whether or not the first-, second-, or

third-tier corporation makes a distribution for the taxable year of its earnings and profits which are attributable to the amount included in the gross income of the domestic corporation under section 951.

(v) This paragraph (c)(1) does not apply to an increase in current earnings invested in United States property which, but for paragraph (e) of §1.963–3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), would be included in the gross income of the domestic corporation under section 951(a)(1)(B) but which, pursuant to such paragraph, counts toward a minimum distribution for the taxable year. This subdivision shall apply in taxable years subsequent to the Tax Reduction Act of 1975 only in those cases where an adjustment is required as a result of an election made under section 963 prior to the Act.

(2) *Taxes paid or accrued on or with respect to earnings and profits of foreign corporation.* For purposes of paragraph (c)(1) of this section, the foreign income taxes paid or accrued by a first-, second- or third-tier corporation on or with respect to its earnings and profits for its taxable years shall be the total amount of the foreign income taxes paid or accrued by such foreign corporation for such taxable year.

(3) *Exclusion of earnings and profits and taxes of a first-, second-, or third-tier corporation having income excluded under section 959(b).* If in the case of a first-, second-, or third-tier corporation to which paragraph (c)(1)(i) or (c)(1)(ii) of this section is applied—

(i) The earnings and profits of such foreign corporation for its taxable year consist of (A) earnings and profits attributable to dividends received from an immediately lower-tier corporation which are attributable to amounts included in the gross income of a domestic corporation under section 951 with respect to the immediately lower- or lower-tier corporations, and (B) other earnings and profits, and

(ii) The effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the dividends to which its earnings and profits described in paragraph (c)(3)(i)(A) of this section are attributable is higher or lower than the effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable,

then, for the purposes of applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation on or with respect to its earnings and profits for such taxable year, the earnings and profits of such foreign corporation for such taxable year shall be considered not to include the earnings and profits described in paragraph (c)(3)(i)(A) of this section and only the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable shall be taken into account. For purposes of applying this paragraph (c)(3), the effective rate of foreign income taxes paid or accrued in respect to income shall be determined consistently with the principles of paragraphs (b)(3)(iv) and (viii) and (c) of §1.954–1. Thus, for example, the effective rate of foreign income taxes paid or accrued in respect to dividends received by such foreign corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

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

*Example 1.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $50 attributable to the earnings and profits of A Corporation for such year, but A Corporation does not distribute any earnings and profits for such year. The foreign income taxes paid by A Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

| | |
|---|---|
| Pretax earnings and profits of A Corporation | $100.00 |
| Foreign income taxes (20%) | 20.00 |
| Earnings and profits | 80.00 |
| Amount required to be included in N Corporation's gross income under section 951 | 50.00 |
| Dividends paid to N Corporation | 0 |

| | |
|---|---|
| Foreign income taxes paid on or with respect to earnings and profits of A Corporation | 20.00 |
| Foreign income taxes of A Corporation deemed paid by N Corporation under section 960(a)(1) ($50/$80×$20) | 12.50 |

*Example 2.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation for such year. Neither B Corporation nor A Corporation distributes any earnings and profits for 1978. The foreign income taxes paid by B Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

| | |
|---|---|
| Pretax earnings and profits of B Corporation | $100.00 |
| Foreign income taxes (40%) | 40.00 |
| Earnings and profits | 60.00 |
| Amounts required to be included in N Corporation's gross income under section 951 with respect to B Corporation | 45.00 |
| Dividends paid | 0 |
| Foreign income taxes paid on or with respect to earnings and profits of B Corporation | 40.00 |
| Foreign income taxes of B Corporation deemed paid by N Corporation under section 960(a)(1) ($45/$60×$40) | 30.00 |

*Example 3.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $80 attributable to the earnings and profits of C Corporation for such year, $45 attributable to the earnings and profits of B Corporation for such year and $50 attributable to the earnings and profits of A Corporation for such year. Neither C Corporation nor B corporation distributes any earnings and profits for 1978. The foreign income taxes which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

*C Corporation (third-tier corporation):*

| | |
|---|---|
| Pretax earnings of C Corporation | $150.00 |
| Foreign income taxes (40%) | 60.00 |
| Earnings and profits | 90.00 |
| Amounts required to be included in N Corporation's gross income under section 951 | 80.00 |
| Dividends paid to B Corporation | 0 |
| Foreign income taxes paid on or with respect to earnings and profits of C Corporation | 60.00 |

*B Corporation (second-tier corporation):*

| | |
|---|---|
| Pretax earnings of B Corporation | $100.00 |
| Foreign income taxes (40%) | 40.00 |
| Earnings and profits | 60.00 |
| Amount required to be included in N Corporation's gross income under section 951 | 45.00 |
| Dividends paid to A Corporation | 0 |
| Foreign income taxes paid on or with respect to earnings and profits of B Corporation | 40.00 |

*A Corporation (first-tier corporation):*

| | |
|---|---|
| Pretax earnings and profits of A Corporation | $100.00 |
| Foreign income taxes (20%) | 20.00 |
| Earnings and profits | 80.00 |
| Amount required to be included in N Corporation's gross income under section 951 | 50.00 |
| Dividends paid to N Corporation | 0 |
| Foreign income taxes paid on or with respect to earnings and profits of A Corporation | 20.00 |

*N Corporation (domestic corporation):*

| | |
|---|---|
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1): | |
| Taxes of C Corporation $80/$90×$60 | $53.33 |
| Taxes of B Corporation $45/$60×$40 | 30.00 |
| Taxes of A Corporation $50/$80×$20 | 12.50 |
| Total taxes deemed paid under section 960(a)(1) | $95.83 |

*Example 4.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns 5 percent of the one class of stock of controlled foreign corporation B. N Corporation also directly owns 95 percent of the one class of stock of B Corporation. (Under these facts, B Corporation is only a first-tier corporation with respect to N Corporation) all such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $60 attributable to the earnings and profits of B Corporation and $79.20 attributable to the earnings and profits of A Corporation. For 1978, B Corporation distributes $19 to N Corporation and $1 to A Corporation, but A Corporation makes no distribution to N Corporation. The foreign income taxes paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed in accordance with § 1.960–1(c)(1)(i):

*B Corporation (first-tier corporation):*

| | |
|---|---|
| Pretax earnings and profits | $100.00 |
| Foreign income taxes (40%) | 40.00 |
| Earnings and profits | 60.00 |
| Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation | 60.00 |

*A Corporation (first-tier corporation):*

| | |
|---|---|
| Pretax earnings and profits (including $1 dividend from B Corporation) | $100.00 |
| Foreign income taxes (20%) | 20.00 |
| Earnings and profits | 80.00 |
| Amount required to be included in N Corporation's gross income with respect to A Corporation ($99 − [$99×0.20] | 79.20 |

*N Corporation (domestic corporation):*

| | |
|---|---|
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to— | |
| B Corporation ([$60×0.95/$60]×$40) | $38.00 |

| | | |
|---|---|---|
| A Corporation ($79.20/$80×$20) | | 19.80 |
| Total taxes deemed paid under section 960(a)(1) | | $57.80 |

*Example 5.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $175 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation has earnings and profits of $225, on which it pays foreign income taxes of $75. In 1978, B Corporation distributes $150, which, under paragraph (b) of §1.960–2, consists of $100 to which section 902(b)(1) does not apply (from B Corporation's earnings and profits attributable to an amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation) and $50 to which section 902(b)(1) applies (from B Corporation's other earnings and profits). The country under the laws of which A Corporation is incorporated imposes an income tax of 40 percent on all income but exempts from tax dividends received from a subsidiary corporation. A Corporation makes no distribution for 1978. Under paragraph (b) of §1.960–2, A Corporation is deemed to have paid $25 ($50/$150×$75) of the $75 foreign income taxes paid by B Corporation on its pretax earnings and profits of $225. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) with respect to A Corporation are determined as follows upon the basis of the following assumed facts:

| | | | |
|---|---|---|---|
| Pretax earnings and profits of A Corporation: | | | |
| Dividends received from B Corporation | | | $150.00 |
| Other income | | | 250.00 |
| Total pretax earnings and profits | | | $400.00 |
| Foreign income taxes: | | | |
| On dividends received from B Corporation | | 0 | |
| On other income ($250×0.40) | | 100.00 | |
| Total foreign income taxes | | | 100.00 |
| Earnings and profits: | | | |
| Attributable to dividends received from B Corporation which are attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation | | 100.00 | |
| Attributable to other income: | | | |
| Attributable to dividends received from B Corporation which are attributable to amounts not included in N Corporation's gross income under 951 with respect to B Corporation | $50.00 | | |
| Attributable to other income ($250 − $100 [$250×0.40]) | 150.00 | $200.00 | |
| Total earnings and profits | | | $300.00 |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation: | | | |
| Tax paid by A Corporation in respect to its income other than dividends received from B Corporation attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation ($175/$200×$100) | | | 87.50 |
| Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) in respect to such income ($175/$200×$25) | | | 21.88 |
| Total foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation | | | $109.38 |

(d) *Time for meeting stock ownership requirements*—(1) *In general.* For the purposes of applying paragraph (c) of this section to amounts included in the gross income of a domestic corporation attributable to the earnings and profits of a first-, second-, or third-tier corporation, the stock ownership requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirements of paragraph (c)(1)(i) and (ii) of this section, if applicable, must be satisfied on the last day in the taxable year of such first-, second-, or third-tier corporation, as the case may be, on which such foreign corporation is a controlled foreign corporation. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a second-tier corporation, the requirements of paragraph (b)(1) and (2) of this section and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section must be met on such date. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a third-tier corporation, the requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section must be met on such date.

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

*Example 1.* Domestic corporation N is required for its taxable year ending June 30,

1978, to include in gross income under section 951 an amount attributable to the earnings and profits of controlled foreign corporation A for 1977 and another amount attributable to the earnings and profits of controlled foreign corporation B for such year. Corporations A and B use the calendar year as the taxable year. Such amounts are required to be included in N Corporation's gross income by reason of its ownership of stock in A Corporation and in turn by A Corporation's ownership of stock in B Corporation. Corporation A is a controlled foreign corporation throughout 1977, but B Corporation is a controlled foreign corporation only from January 1, 1977, through September 30, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on December 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

*Example 2.* The facts are the same as in example 1, except that A Corporation is a controlled foreign corporation only from January 1, 1977, through March 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on March 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

*Example 3.* Domestic Corporation N owns 100 percent of the stock of controlled foreign corporation A. A Corporation owns 20 percent of the stock of controlled foreign corporation B. B Corporation owns 10 percent of the voting stock of controlled foreign corporation C. For calendar year 1983, N Corporation is required to include amounts in its gross income attributable to the earnings and profits of A, B, and C Corporations. A, B, and C Corporations were all controlled foreign corporations throughout their respective taxable years ending as follows: A Corporation, December 31, 1983; B Corporation, November 31, 1983; and C Corporation, August 31, 1983. Paragraph (c) of this section applies to amounts included in gross income of N Corporation with respect to the earnings and profits of A Corporation because the 10 percent ownership requirement of paragraph (b)(1) of this section is met on December 31, 1983. Paragraph (c) of this section applies to amounts included in the gross income of N Corporation with respect to the earnings and profits of B Corporation because the 10 percent stock ownership requirements of paragraphs (b)(1) and (2) of this section are met on November 30, 1983, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section (5 percent) is also met on such date. The percentage of voting stock in A Corporation owned by N Corporation (100 percent) multiplied by the percentage of voting stock in B Corporation owned by A Corporation (20 percent) is 20 percent. Paragraph (c) of this section will not apply to amounts included in N Corporation's gross income attributable to the earnings and profits of C Corporation even though on August 31, 1983, the 10 percent stock ownership requirements of paragraphs (b)(1), (2), and (3) of this section are met, because the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section (5 percent) is not met on such date. The percentage of voting stock of C Corporation owned by B Corporation (10 percent) multiplied by 20 percent (the percentage of voting stock of A Corporation owned by N Corporation multiplied by the percentage of voting stock of B Corporation owned by A Corporation) is 2 percent.

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed paid under section 960(a)(1), the domestic corporation must furnish the same information with respect to the taxes so deemed paid 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 corporation for the annual accounting period of certain foreign corporations ending with or within such corporation's taxable year, see section 6038(a) and the regulations thereunder.

(f) *Reduction of foreign income taxes paid or deemed paid.* For reduction of the amount of foreign income taxes paid or deemed paid by a foreign corporation for purposes of section 960, see section 6038(c) (as amended by section 338 of the Tax Equity and Fiscal Responsibility Act of 1982) and the regulations thereunder, relating to failure to furnish information with respect to

certain foreign corporations. For reduction of the foreign income taxes deemed paid by a domestic corporation under section 960 with respect to foreign oil and gas extraction income, see section 907(a).

(g) *Amounts under section 951 treated as distributions for purposes of applying effective dates.* For purposes of applying section 902 in determining the amount of credit allowed under section 960(a)(1) and paragraph (c) of this section, the effective date provisions of the regulations under section 902 shall apply, and for purposes of so applying the regulations under section 902, any amount attributable to the earnings and profits for the taxable year of a first-, second-, or third-tier corporation which is included in the gross income of a domestic corporation under section 951 shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such foreign corporation is a controlled foreign corporation.

(h) *Source of income and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904—

(i) The amount included in gross income of a domestic corporation under section 951 for the taxable year with respect to a first-, second-, or third-tier corporation, plus

(ii) Any section 78 dividend to which such section 951 amount gives rise by reason of taxes deemed paid by such domestic corporation under section 960(a)(1),

shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

(2) *Country to which taxes deemed paid.* For purposes of section 904, the foreign income taxes paid by the first-, second-, or third-tier corporation and deemed to be paid by the domestic corporation under section 960(a)(1) by reason of the inclusion of the amount described in paragraph (h)(1)(i) of this section in the gross income of such domestic 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, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

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

*Example.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, incorporated under the laws of foreign country X, which owns all the one class of stock of controlled foreign corporation B, incorporated under the laws of foreign country Y. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year and $50 attributable to the earnings and profits of A Corporation for such year. For 1978, because of the inclusion of such amounts in gross income, N Corporation is deemed under section 960(a)(1) and paragraph (c) of this section to have paid $15 of foreign income taxes paid by B Corporation for such year and $10 of foreign income taxes paid by A Corporation for such year. For purposes of section 904, the amount ($95) included in N Corporation's gross income under section 951 attributable to the earnings and profits of corporations A and B is deemed to be derived from sources within country X, and the section 78 dividend consisting of the foreign income taxes ($25) deemed paid by N Corporation under section 960(a)(1) with respect to such $95 is deemed to be derived from sources within country X. The $25 of foreign income taxes so deemed paid by N Corporation are deemed to be paid to country X for purposes of section 904.

(i) *Computation of deemed-paid taxes in post-1986 taxable years*—(1) *General rule.* If a domestic corporation is eligible to compute deemed-paid taxes under section 960(a)(1) with respect to an amount included in gross income under section 951(a), then, such domestic corporation shall be deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes determined under section 902 and the regulations under that section in the same manner as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B)).

(2) *Ordering rule for computing deemed-paid taxes under sections 902 and 960.* If a domestic corporation computes deemed-paid taxes under both sections 902 and 960 in the same taxable year,

section 960 shall be applied first. After the deemed-paid taxes are computed under section 960 with respect to a deemed income inclusion, post-1986 undistributed earnings and post-1986 foreign income taxes in each separate category shall be reduced by the appropriate amounts before deemed-paid taxes are computed under section 902 with respect to a dividend distribution.

(3) *Computation of post-1986 undistributed earnings.* Post-1986 undistributed earnings (or an accumulated deficit in post-1986 undistributed earnings) are computed under section 902 and the regulations under that section.

(4) *Allocation of accumulated deficits.* For purposes of computing post-1986 undistributed earnings under sections 902 and 960, a post-1986 accumulated deficit in a separate category shall be allocated proportionately to reduce post-1986 undistributed earnings in the other separate categories. However, a deficit in any separate category shall not permanently reduce earnings in other separate categories, but after the deemed-paid taxes are computed the separate limitation deficit shall be carried forward in the same separate category in which it was incurred. In addition, because deemed-paid taxes may not exceed taxes paid or accrued by the controlled foreign corporation, in computing deemed-paid taxes with respect to an inclusion out of a separate category that exceeds post-1986 undistributed earnings in that separate category, the numerator of the deemed-paid credit fraction (deemed inclusion from the separate category) may not exceed the denominator (post-1986 undistributed earnings in the separate category).

(5) *Examples.* The application of this paragraph (i) may be illustrated by the following examples. See §1.952–1(f)(4) for additional illustrations of these rules.

*Example 1.* (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1998, whose functional currency is the u. In 1998 CFC earns 100u of general limitation income described in section 904(d)(1)(I) that is not subpart F income and 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A). In 1998 CFC also incurs a (50u) loss in the shipping category described in section 904(d)(1)(D). CFC's subpart F income for 1998, 100u, does not exceed CFC's current earnings and profits of 150u. Accordingly, all 100u of CFC's subpart F income is included in A's gross income under section 951(a)(1)(A). Under section 904(d)(3)(B) of the Internal Revenue Code and paragraph (i)(1) of this section, A includes 100u of passive limitation income in gross income for 1998.

(ii) For purposes of computing post-1986 undistributed earnings under sections 902, 904(d) and 960 with respect to the subpart F inclusion, the shipping limitation deficit of (50u) is allocated proportionately to reduce general limitation earnings of 100u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 25u to 75u (100u general limitation earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction), and passive limitation earnings are reduced by 25u to 75u (100u passive earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction). All of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the 100u subpart F inclusion of passive income (75u inclusion (numerator limited to denominator under paragraph (i)(4) of this section)/75u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 100u of general limitation earnings, 0 of passive limitation earnings (100u of foreign personal holding company income − 100u inclusion), and a (50u) deficit in shipping limitation earnings.

*Example 2.* (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1999, CFC distributes 150u to A. CFC has 100u of previously-taxed earnings and profits described in section 959(c)(2) attributable to 1998, all of which is passive limitation earnings and profits. Under section 959(c), 100u of the 150u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). The entire dividend distribution of 50u is treated as made out of CFC's general limitation earnings and profits. See section 904(d)(3)(D).

(ii) For purposes of computing post-1986 undistributed earnings under section 902 with respect to the 1999 dividend of 50u, the shipping limitation accumulated deficit of (50u) reduces general limitation earnings and profits of 100u to 50u. Thus, 100% of CFC's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by A under section 902 with respect to the 1999 dividend of 50u (50u dividend/50u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1999 CFC has 50u of general limitation earnings (100u opening balance—50u distribution), 0 of

passive limitation earnings, and a (50u) deficit in shipping limitation earnings.

(6) *Effective date.* This paragraph (i) applies to taxable years of a controlled foreign corporation beginning after March 3, 1997.

[T.D. 7120, 36 FR 10852, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; T.D. 7649, 44 FR 60088, 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50472, Nov. 8, 1982; 47 FR 55477, Dec. 10, 1982; T.D. 7961, 49 FR 26225, June 27, 1984; T.D. 8704, 62 FR 21, Jan. 2, 1997]

### § 1.960–2 Interrelation of section 902 and section 960 when dividends are paid by third-, second-, or first-tier corporation.

(a) *Scope of this section.* This section prescribes rules for the application of section 902 in a case where dividends are paid by a third-, second-, or first-tier corporation, as the case may be, from its earnings and profits for a taxable year when an amount attributable to such earnings and profits is included in the gross income of a domestic corporation under section 951, or when such earnings and profits are attributable to an amount excluded from the gross income of such foreign corporation under section 959(b) and §1.959–2, with respect to the domestic corporation. In making determinations under this section, any portion of a distribution received from a first-tier corporation by the domestic corporation which is excluded from the domestic corporation's gross income under section 959(a) and §1.959–1, or any portion of a distribution received from an immediately lower-tier corporation by the third-, second-, or first-tier corporation which is excluded from such foreign corporation's gross income under section 959(b) and §1.959–2, shall be treated as a dividend for purposes of taking into account under section 902 any foreign income taxes paid by such third-, second-, or first-tier corporation which are not deemed paid by the domestic corporation under section 960(a)(1) and §1.960–1.

(b) *Application of section 902(b) to dividends received from an immediately lower-tier corporation.* For purposes of paragraph (a) of this section and paragraph (c)(1)(i) of §1.960–1, section 902(b) shall apply to all dividends received by the first- or second-tier corporation from the immediately lower-tier corporation other than dividends attributable to earnings and profits of such immediately lower-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such immediately lower-tier corporation.

(c) *Application of section 902(a) to dividends received by domestic corporation from first-tier corporation.* For purposes of paragraph (a) of this section, section 902 (a) shall apply to all dividends received by the domestic corporation for its taxable year from the first-tier corporation other than dividends attributable to earnings and profits of such first-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier corporation.

(d) *Allocation of earnings and profits of a first- or second-tier corporation having income excluded under section 959(b)*—(1) *First-tier corporations.* If the first-tier corporation for its taxable year receives dividends from the second-tier corporation to which in accordance with paragraph (b) of this section 902(b)(1) or section 902(b)(2) applies and other dividends from the second-tier corporation to which such sections do not apply, then in applying section 902(a) pursuant to this section and in applying section 960(a)(1) pursuant to §1.960–1(c)(1)(i), with respect to the foreign income taxes paid and deemed paid by the second-tier corporation which are deemed paid by the first-tier corporation for such taxable year under section 902(b)(1)—

(i) The earnings and profits of the first-tier corporation for such taxable year shall be considered not to include its earnings and profits which are attributable to the dividends to which section 902(b)(1) does not apply (in determining the domestic corporation's credit for the taxes paid by the second-tier corporation) or which are attributable to the dividends to which sections 902(b)(1) and 902(b)(2) do not apply (in determining the domestic corporation's credit for taxes deemed paid by the second-tier corporation) and

(ii) For the purposes of so applying section 902(a), distributions to the domestic corporation from such earnings and profits which are attributable to the dividends to which section 902(b)(1) does not apply (in determining the domestic corporation's credit for taxes paid by the second-tier corporation) or which are attributable to the dividends to which sections 902(b)(1) and 902(b)(2) do not apply (in determining the domestic corporation's credit for taxes deemed paid by the second-tier corporation) shall not be treated as a dividend.

(2) *Second-tier corporations.* If the second-tier corporation for its taxable year receives dividends from the third-tier corporation to which, in accordance with paragraph (b) of this section, section 902(b)(2) applies and other dividends from the third-tier corporation to which such section does not apply, then in applying section 902(b)(1) pursuant to this section, and in applying section 960(a)(1) pursuant to paragraph (c)(1)(i) of §1.960–1, with respect to the foreign taxes deemed paid by the second-tier corporation for such taxable year under section 902(b)(2)—

(i) The earnings and profits of the second-tier corporation for such taxable year shall be considered not to include its earnings and profits which are attributable to such other dividends from the third-tier corporation, and

(ii) For the purposes of so applying section 902(b)(1), distributions to the first-tier corporation from such earnings and profits which are attributable to such other dividends from the third-tier corporation shall not be treated as a dividend.

(e) *Separate determinations under sections 902(a), 902(b)(1), and 902(b)(2) in the case of a first-, second-, or third-tier corporation having income excluded under section 956(b).* If in the case of a first-, second-, or third-tier corporation to which paragraph (b) or (c) of this section is applied—

(1) The earnings and profits of such foreign corporation for its taxable year consist of—

(i) Dividends received from an immediately lower-tier corporation which are attributable to amounts included in the gross income of a domestic corporation under section 951 with respect to the immediately lower- or lower-tier corporations, and

(ii) Other earnings and profits, and

(2) The effective rate of foreign income taxes paid or accrued by such foreign corporation on the dividends described in paragraph (e)(1)(i) of this section is higher or lower than the effective rate of foreign income taxes attributable to its earnings and profits described in paragraph (e)(1)(ii) of this section,

then, for purposes of applying paragraph (b) or (c) of this section to dividends paid by such foreign corporation to the domestic corporation or the first- or second-tier corporation, sections 902(a), 902(b)(1), and 902(b)(2) shall be applied separately to the portion of the dividend which is attributable to the earnings and profits described in paragraph (e)(1)(i) of this section and separately to the portion of the dividend which is attributable to the earnings and profits described in paragraph (e)(1)(ii) of this section. In making a separate determination with respect to the earnings and profits described in paragraph (e)(1)(i) or (e)(1)(ii) of this section, only the foreign income taxes paid or accrued (or, in the case of earnings and profits of a first- or second-tier corporation described in paragraph (e)(1)(ii) of this section, deemed to be paid) by such foreign corporation on the income attributable to such earnings and profits shall be taken into account. For purposes of applying this paragraph (e), no part of the foreign income taxes paid, accrued, or deemed to be paid which are attributable to the earnings and profits described in paragraph (e)(1)(ii) of this section shall be attributed to the dividend described in paragraph (e)(1)(i) of this section; and no part of the foreign income taxes paid or accrued on the dividend described in paragraph (e)(1)(i) of this section shall be attributed to the earnings and profits described in paragraph (e)(1)(ii) of this section. Furthermore, the effective rate of foreign income taxes paid or accrued shall be determined consistently with the principles of paragraphs (b)(3)(iv) and (viii) and (c) of §1.954–1. Thus, for example, the effective rate of foreign income taxes on dividends received by such foreign corporation shall be determined by

taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(f) *Illustrations.* The application of this section may be illustrated by the following examples. In all of the examples other than examples 6, 7, 9 and 10, it is assumed that the effective rate of foreign income taxes paid or accrued by the first- or second-tier corporation, as the case may be, in respect to dividends received from the immediately lower-tier corporation, is the same as the effective rate of foreign income taxes paid or accrued by the first- or second-tier corporation with respect to its other income:

*Example 1.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $50 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. For such year, B Corporation distributes a dividend of $45, but A Corporation does not make any distributions. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1), after applying section 902(b)(1) for such year of A Corporation, are determined as follows upon the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (second-tier corporation): | | |
| Pretax earnings and profits | | $100.00 |
| Foreign income taxes (40%) | | 40.00 |
| Earnings and profits | | 60.00 |
| Dividends paid to A Corporation | | $45.00 |
| Foreign income taxes paid by B Corporation on or with respect to its accumulated profits | | 40.00 |
| Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($45/$60×$40) | | 30.00 |
| A Corporation (first-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends from B Corporation | $45.00 | |
| Other income | 100.00 | |
| Total pretax earnings and profits | | 145.00 |
| Foreign income taxes (20%) | | 29.00 |
| Earnings and profits | | 116.00 |
| Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($29+$30) | | 59.00 |
| Amount required to be included in N Corporation's gross income under section 951 with respect to A Corporation | | 50.00 |
| Dividends paid to N Corporation | | 0 |
| N Corporation (domestic corporation): | | |
| Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under section 960(a)(1) ($50/$116×$59) | | 25.43 |

*Example 2.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year, which B Corporation distributes during such year. Corporation N is not required for 1978 to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation, but A Corporation distributes for such year $135 from its earnings and profits attributable to B Corporation's dividend. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1)(C) and section 902(a) are determined as follows upon the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (second-tier corporation): | | |
| Pretax earnings and profits | | $250.00 |
| Foreign income taxes (20%) | | 50.00 |
| Earnings and profits | | 200.00 |
| Amounts required to be included in N Corporation's gross income under section 951 with respect to B Corporation | | 150.00 |
| Dividends paid to A Corporation | | 150.00 |
| Foreign income taxes paid on or with respect to earnings and profits of B Corporation | | 50.00 |
| A Corporation (first-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends from B Corporation | $150.00 | |
| Other income | 200.00 | |
| Total pretax earnings and profits | | 350.00 |
| Foreign income taxes (10%) | | 35.00 |
| Earnings and profits | | 315.00 |
| Dividends paid to N Corporation | | 135.00 |
| Foreign income taxes paid by A Corporation on or with respect to its accumulated profits | | 35.00 |
| N Corporation (domestic corporation): | | |
| Foreign income taxes of B Corporation deemed paid by N Corporation for 1978 under section 960(a)(1) ($150/$200×$50) | | 37.50 |
| Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under section 902(a) ($135/$315×$35) | | 15.00 |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | 52.50 |

*Example 3.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $180 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. Corporation B distributes from its earnings and profits for 1978 a dividend of $50. For 1978, A Corporation distributes $180 from its earnings and profits attributable to the amount required under section 951 to be

included in N Corporation's gross income for such year with respect to A Corporation and $20 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows upon the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (second-tier corporation): | | |
| Pretax earnings and profits | | $100.00 |
| Foreign income taxes (40%) | | 40.00 |
| Earnings and profits | | 60.00 |
| Dividends paid to A Corporation | | 50.00 |
| Foreign income taxes paid by B Corporation on or with respect to its accumulated profits | | 40.00 |
| Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($50/$60×$40) | | 33.33 |
| A Corporation (first-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends from B Corporation | $50.00 | |
| Other income | 200.00 | |
| Total pretax earnings and profits | | 250.00 |
| Foreign income taxes (10%) | | 25.00 |
| Earnings and profits | | 225.00 |
| Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($25.00+$33.33) | | 58.33 |
| Amounts required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation | | 180.00 |
| Dividends paid to N Corporation: | | |
| Dividends to which section 902(a) does not apply (from A Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to A Corporation) | 180.00 | |
| Dividends to which section 902(a) applies (from A Corporation's other earnings and profits) | 20.00 | |
| Total dividends paid to N Corporation | | $200.00 |
| N Corporation (domestic corporation): | | |
| Foreign income taxes of corporations A and B deemed paid by N Corporation under section 960(a)(1) ($180/$225×$58.33) | | 46.66 |
| Foreign income taxes of corporations A and B deemed paid by N Corporation under section 902(a) ($20/$225×$58.33) | | 5.18 |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | 51.84 |

*Example 4.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. Corporation A does not distribute any dividends for 1978. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (second-tier corporation): | | |
| Pretax earnings and profits | | $250.00 |
| Foreign income taxes (20%) | | 50.00 |
| Earnings and profits | | 200.00 |
| Amounts required to be included in N Corporation's gross income under section 951 for 1978 with respect to B Corporation | | 150.00 |
| Dividends paid by B Corporation: | | |
| Dividends to which section 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to B Corporation) | $150.00 | |
| Dividends to which section 902(b)(1) applies (from B Corporation's other earnings and profits) | 25.00 | |
| Total dividends paid to A Corporation | | 175.00 |
| Foreign income taxes paid by B Corporation on or with respect to its accumulated profits | | 50.50 |
| Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($25/$200×$50) | | 6.25 |
| A Corporation (first-tier corporation): | | |
| Pretax earnings and profits | | 175.00 |
| Foreign income tax (10 percent) | | 17.50 |
| Earnings and profits | | 157.50 |
| Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($157.50 less [$150 − ($150×0.10)]) | | 22.50 |
| Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation | | 22.50 |
| Dividends paid to N Corporation | | 0 |
| N Corporation (domestic corporation): | | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1)(C) with respect to A Corporation: | | |
| Tax actually paid by A Corporation ($22.50/$157.50×$17.50) | 2.50 | |
| Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) ($22.50/$22.50×$6.25) | 6.25 | |
| | | 8.75 |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1)(C) with respect to B Corporation ($150/$200×$50) | | 37.50 |
| Total taxes deemed paid under section 960(a)(1)(C) | | 46.20 |

*Example 5.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N

Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. For 1978, A Corporation distributes $225, consisting of $135 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross, income with respect to B Corporation, $22.50 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to A Corporation, and $67.50 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a)(1) are determined as follows upon the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (second-tier corporation): | | |
| Pretax earnings and profits | | $250.00 |
| Foreign income taxes (20%) | | 50.00 |
| Earnings and profits | | 200.00 |
| Amounts required to be included in N Corporation's gross income for 1978 under section 951 with respect to B Corporation | | 150.00 |
| Dividends paid by B Corporation: | | |
| Dividends to which section 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to B Corporation) | $150.00 | |
| Dividends to which section 902(b) applies (from B Corporation's other earnings and profits) | $25.00 | |
| Total dividends paid to A Corporation | | $175.00 |
| Foreign income taxes paid by B Corporation on or with respect to its accumulated profits | | 50.00 |
| Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($25/$200×$50) | | 6.25 |
| A Corporation (first-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends received from B Corporation | 175.00 | |
| Other income | 100.00 | |
| Total pretax earnings and profits | | 275.00 |
| Foreign income taxes (10 percent) | | 27.50 |
| Earnings and profits | | 247.50 |
| Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($247.50 less [$150 − ($150×0.10)]) | | 112.50 |
| Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation | | 22.50 |
| Distributions paid by A Corporation: | | |
| Dividends to which section 902(a) does not apply (From A Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to A Corporation) | 22.50 | |
| Dividends to which section 902(a) applies (from A Corporation's other earnings and profits) | 202.50 | |
| Total dividends paid to N Corporation | 225.00 | |
| N Corporation (domestic corporation): | | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to— | | |
| B Corporation ($150/$200×$50) | | 37.50 |
| A Corporation: | | |
| Tax paid by A Corporation ($22.50/$247.50×$27.50) | 2.50 | |
| Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) ($22.50/$112.50×$6.25) | 1.25 | 3.75 |
| Total taxes deemed paid under section 960(a)(1) | | 41.25 |
| Foreign income taxes deemed paid by N Corporation under section 902(a)(1) with respect to A Corporation: | | |
| Tax paid by A Corporation ($200.50/$247.50×$27.50) | 22.50 | |
| Tax of B Corporation deemed paid by A Corporation ($67.50/ $112.50×$6.25) | 3.75 | |
| Total taxes deemed paid under section 902(a)(1) | | 26.52 |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | 67.05 |

*Example 6.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. A and B corporations are organized under the laws of foreign country X. All of B corporation's assets used in a trade or business are located in country X. Country X imposes an income tax of 20 percent on B corporation's income. For 1978, N Corporation is required under section 951 to include in gross income $100 attributable to the earnings and profits of B Corporation for such year. For 1978, B Corporation distributes $150, consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. Country X imposes an income tax of 10 percent on A Corporation's income but exempts from tax dividends received from B Corporation. N is not

required to include any amount in gross income under section 951 for 1978 attributable to the earnings and profits of A Corporation for such year. For 1978, A Corporation distributes $175, consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation, and $75 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (2d-tier corporation): | | |
| Pretax earnings and profits | | $200.00 |
| Foreign income taxes (20%) | | 40.00 |
| Earnings and profits | | 160.00 |
| Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to B Corporation | | 100.00 |
| Dividends paid by B Corporation: | | |
| Dividends to which section 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to B corporation) | $100.00 | |
| Dividends to which section 902(b)(1) applies (from B corporation's other earnings and profits) | 50.00 | |
| Total dividends paid to A corporation | | 150.00 |
| Foreign income taxes of B corporation deemed paid by A corporation for 1978 under section 902(b)(1) ($50/$100× $40) | 12.50 | |
| A corporation (1st-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends received from B corporation | 150.00 | |
| Other income | 100.00 | |
| Total pretax earnings and profits | | 250.00 |
| Foreign income taxes: | | |
| On dividends received from B corporation | None | |
| On other income ($100×0.10) | 10.00 | |
| Total foreign income taxes | | 10.00 |
| Earnings and profits: | | |
| Attributable to dividends received from B corporation to which section 902(b) does not apply | | 100.00 |
| Attributable to other income: | | |
| Attributable to dividends received from B Corporation to which section 902(b)(1) applies | 50.00 | |
| Attributable to other income ($100 − $10) | 90.00 | |
| Subtotal | | 140.00 |
| Total earnings and profits | | 240.00 |
| Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($240 − $100) | | 140.00 |
| Amount required to be included in N corporation's gross income for 1978 under section 951 with respect to A corporation | | None |
| Dividends paid by A corporation: | | |
| Dividends to which section 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to A corporation) | None | |
| Dividends to which section 902(a) applies (from A corporation's other earnings and profits) | $175.00 | |
| Total dividends paid to N corporation | | $175.00 |
| N corporation (domestic corporation): | | |
| Foreign income taxes deemed paid by N corporation under section 960(a)(1) with respect to B corporation ($100/$160×$40) | | 25.00 |
| Foreign income taxes deemed paid by N corporation under section 902(a) with respect to A corporation (allocation of earnings and profits being made under pars. (c)(2) and (d) of this section): | | |
| Tax paid by A corporation in respect to dividends received from B Corporation to which section 902(b) does not apply ($100/ $100×$0) | None | |
| Tax paid by A corporation in respect to its other income ($75/ $140×$10) | 5.36 | |
| Tax paid by B corporation deemed paid by A corporation in respect to such other income ($75/$140×$12.50) | 6.70 | |
| Total taxes deemed paid under section 902(a) | | 12.06 |
| Total foreign income taxes deemed paid by N corporation under section 901 | 37.06 | |

*Example 7.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $47.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $200, consisting of $150 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. The country under the laws of which A Corporation is incorporated imposes an income tax of 5 percent on dividends received from a subsidiary corporation and 20 percent on other income. For 1978, A Corporation distributes $100 from its earnings and profits to N Corporation, such amount being attributable under paragraph (e) of §1.959–3 to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation.

The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

| | | |
|---|---|---|
| B Corporation (2d-tier corporation): | | |
| Pretax earnings and profits | | $250.00 |
| Foreign income taxes (20 percent) | | 150.00 |
| Earnings and profits | | 200.00 |
| Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to B corporation | | 150.00 |
| Dividends paid by B corporation: | | |
| Dividends to which section 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to B corporation) | $150.00 | |
| Dividends to which section 902(b)(1) applies (from B corporation's other earnings and profits) | 50.00 | |
| Total dividends paid to A corporation | | 200.00 |
| Foreign income taxes of B corporation deemed paid by A corporation for 1978 under section 902(b)(1) ($50/$200×$50) | | 12.50 |
| A corporation (1st-tier corporation): | | |
| Pretax earnings and profits: | | |
| Dividends received from B corporation | 200.00 | |
| Other income | 100.00 | |
| Total pretax earnings and profits | | 300.00 |
| Foreign income taxes: | | |
| On dividends received from B corporation to which section 902(b) does not apply ($150× 0.05) | | 7.50 |
| On other income: | | |
| Dividends received from B corporation to which section 902(b)(1) applies ($50× 0.05) | 2.50 | |
| Other income of A corporation ($100×0.20) | 20.00 | |
| Total | | 22.50 |
| Total foreign income taxes | | 30.00 |
| Earnings and profits: | | |
| Attributable to dividends received from B corporation to which section 902(b) does not apply ($150 − $7.50) | | 142.50 |
| Attributable to other income: | | |
| Attributable to dividends received from B corporation to which section 902(b)(1) applies ($50 − $2.50) | 47.50 | |
| Attributable to other income ($100 − $20 | 80.00 | |
| Total | | 127.50 |
| Total earnings and profits | | 270.00 |
| Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($270 less $142.50) | | 127.50 |
| Amount required to be included in N corporation's gross income for 1978 under section 951 with respect to A corporation | | 47.50 |
| Dividends paid by A Corporation: | | |
| Dividends to which section 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to A corporation) | None | |
| Dividends to which section 902(a)(1) applies (from A corporation's other earnings and profits) | $100.00 | |
| Total dividends paid to N corporation | | $100.00 |
| N Corporation (domestic corporation): | | |
| Foreign income taxes deemed paid by N corporation under section 960(a)(1) with respect to—B corporation ($150/$200×$50) | | 37.50 |
| A corporation (allocation of earnings and profits being made under § 1.960–1(c)(3) and par. (d) of this section): | | |
| Tax paid by A corporation ($47.50/$127.50×$22.50) | 8.38 | |
| Tax of B corporation deemed paid by A corporation under section 902(b)(1) ($47.50/$127.50×$12.50) | 4.66 | |
| Total | | 13.04 |
| Total taxes deemed paid under section 960(a)(1) | | 50.54 |
| Foreign income taxes deemed paid by N corporation under section 902(a) with respect to A corporation (allocations of earnings and profits being made under pars. (c)(2) and (d) of this section) ($100/$142.50×$7.50) | 5.26 | |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | 55.80 |

*Example 8.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $50 attributable to the earnings and profits of C Corporation and $15 attributable to the earnings and profits of B Corporation in its gross income. N Corporation is not required to include any amount in its gross income with respect to A Corporation under section 951 in 1978. For such year, C Corporation distributes $75 to B Corporation. B Corporation in turn distributes $60 of its earnings and profits to A Corporation. A Corporation has no other earnings and profits for 1978 and distributes $45 of its earnings and profits to N Corporation. The foreign income taxes deemed paid by N Corporation under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

*C Corporation (third-tier corporation):*

| | |
|---|---|
| Pretax earnings and profits | $150.00 |
| Foreign taxes paid by C Corporation (30%) | 45.00 |
| Earnings and profits | 105.00 |

| | |
|---|---|
| Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation | 50.00 |
| Dividend to B Corporation | 75.00 |
| Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | 50.00 |
| Dividend from earnings and profits to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income with respect to C Corporation) | $25.00 |

Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and § 1.960–2(b):

$$\frac{\text{Dividend to B Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to C Corporation}}{\text{Earnings and profits of C Corporation}} \times \text{Taxes paid by C Corporation}$$

| | |
|---|---|
| ($25/$105×$45) | $10.71 |

*B Corporation (second-tier corporation):*

| | | |
|---|---|---|
| Pretax earnings and profits: | | |
| Dividend from C Corporation | $75.00 | |
| Other earnings and profits | 225.00 | |
| Total pretax earnings and profits | | $300.00 |
| Foreign income taxes paid by B Corporation (40%) | | 120.00 |
| Earnings and profits | | 180.00 |
| Earnings and profits attributable to amounts to which section 902(b)(2) does not apply (amounts included in N Corporation's gross income under section 951 with respect to C Corporation ($50 − ($50×.40)) | 30.00 | |
| Other earnings and profits | 150.00 | |
| Earnings and profits of B Corporation after exclusion for amounts to which section 902(b)(2) does not apply (amounts attributable to earnings and profits which are included in N Corporation's gross income under section 951 with respect to C Corporation) ($180 − $30) | | 150.00 |

| | |
|---|---|
| Amount to be included in gross income under section 951 of N Corporation with respect to B Corporation | 15.00 |
| Amount of dividend to A Corporation | 60.00 |
| Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | 30.00 |
| Dividend from earnings and profits to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) | 15.00 |
| Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income under section 951 with respect to B or C Corporation) | 15.00 |

Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) and § 1.960–2(b):

$$\frac{\text{Dividend to A Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation}} \times \text{Taxes paid by B Corporation}$$

| | |
|---|---|
| ($45/$180×120) | $30.00 |

Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1) in accordance with § 1.960–2(b) and § 1.960–2(d)(2)(i) and (ii):

$$\frac{\text{Dividend to A Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to B Corporation and C Corporation}}{\text{Earnings and profits of B Corporation less earnings and profits attributable to amounts included in N Corporation's gross income with respect to C Corporation}} \times \text{Taxes paid by C Corporation which are deemed paid by B Corporation}$$

($15/$150×$10.71) ..... 1.07

*A Corporation (first-tier corporation):*

Pretax earnings and profits:

| | |
|---|---|
| Dividend from B Corporation ..... | $60.00 |
| Other earnings and profits ..... | 0 |
| Total pretax earnings and profits ..... | $60.00 |

Foreign income taxes paid by A Corporation (10%) 6.00

Earnings and profits ..... 54.00

| | |
|---|---|
| Earnings and profits attributable to amounts to which section 902(b)(2) does not apply (attributable to amounts previously included in N Corporation's gross income under section 951 with respect to C Corporation) ($30 – ($30X.10)) ..... | 27.00 |
| Earnings and profits attributable to amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($15 – ($15X.10)) | 13.50 |
| Other earnings and profits ($15—($15X.10)) ..... | 13.50 |

Earnings and profits of A Corporation after exclusion for amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($54.00 – $13.50) ..... 40.50

Earnings and profits of A Corporation after exclusion for amounts to which sections 902(b)(1) and (2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B or C Corporation) ($40.50 – $27.00) ..... 13.50

Dividend to N Corporation ..... 45.00

| | |
|---|---|
| Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ..... | $27.00 |
| Dividend from earnings and profits to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ..... | 13.50 |
| Dividend from earnings and profits to which section 902(a) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to A Corporation) ..... | 0 |
| Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income under section 951 with respect to A, B, or C Corporation) ..... | 4.50 |

*N Corporation (domestic corporation):*

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and §1.960–1(c)(1)(ii) with respect to C Corporation:

$$\frac{\text{Amount included in N Corporation's gross income under section 951 with respect to C Corporation}}{\text{Earnings and profits of C Corporation}} \times \text{Taxes paid by C Corporation}$$

($50/$105×$45.00) ..... $21.43

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and §1.960–1(c)(1)(i) with respect to B Corporation ..... 11.07

Taxes paid by B Corporation:

$$\frac{\text{Amount included in N Corporation's gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation}} \times \text{Taxes paid by B Corporation}$$

($15/$180×$120) ..... $10.00

Taxes deemed paid by B Corporation in accordance with § 1.960–2(d)(2)(i):

$$\frac{\text{Amount included in N Corporation's gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation less earnings and profits attributable to amounts included in N Corporation's gross income with respect to C Corporation}} \times \text{Taxes paid by C Corporation which are deemed paid by B Corporation}$$

($15/$150×$10.71) ..... $1.07

Foreign income taxes deemed paid by N Corporation under section 902(a):

Total taxes deemed paid by N Corporation under section 960(a)(1) ..... $32.50

Taxes paid by A Corporation in accordance with § 1.960–2(c):

$$\frac{\text{Dividend to N Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to A Corporation}}{\text{Earnings and profits of A Corporation}} \times \text{Taxes paid by A Corporation}$$

($45/$54×$6) ..... $5.00

Taxes paid by B Corporation deemed paid by A Corporation in accordance with §§ 1.960–2(c) and 1.960–2(d)(1)(i) and (ii):

$$\frac{\text{Dividend to N Corportion less portionof dividend from earnings included in N Corporation's gross income under section 951 with respect to A and B Corporations}}{\text{Earnings and profits of A Corporation less earnings and profits attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation}} \times \text{Taxes paid by B Corporation which are deemed paid by A Corporation}$$

($31.50/$40.50×$30.00) ..... 23.33

Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation in accordance with §§ 1.960–2(c) and 1.960–2(d)(1)(i) and (ii):

$$\frac{\text{Dividend to N Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to A, B, and C Corporations}}{\text{Earnings and profits of A Corporation less earnings and profits attributable to amounts included in N Corporation's gross income under section 951 with respect to B and C Corporations}} \times \text{Taxes deemed paid by B Corporation which are deemed paid by A Corporation}$$

| | | |
|---|---|---|
| ($4.50/$13.50×$1.07) | .36 | |
| Total taxes deemed paid by N Corporation under section 902(a) | | $28.69 |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | $61.19 |

*Example 9.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of controlled foreign corporation C. A and B Corporations are organized under the laws of foreign country X. C Corporation is organized under the laws of foreign country Y. All of B Corporation's assets used in a trade or business are located in country X. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required to include in its gross income under section 951, $50 attributable to the earnings and profits of C Corporation and $100 attributable to the earnings and profits of B Corporation. N Corporation is not required to include any amount in its gross income under section 951 with respect to A Corporation. Country X imposes an income tax of 10 percent on dividends from foreign subsidiaries, 20 percent on dividends from domestic subsidiaries, and 40 percent on other earnings and profits. For 1978, C Corporation distributes $75 to B Corporation. For such year, B Corporation distributes $175 of its earnings and profits to A Corporation. A Corporation has no other earnings and profits for 1978 and distributes $130 of its earnings and profits to N Corporation. The foreign income taxes deemed paid by N Corporation under sections 960(a)(1) and 902(a) are determined as follows on the basis of the facts assumed:

*C Corporation (third-tier corporation):*

| | | |
|---|---|---|
| Pretax earnings and profits | | $150.00 |
| Foreign income taxes paid by C Corporation (30%) | | 45.00 |
| Earnings and profits | | 105.00 |
| Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation | | 50.00 |
| Dividend to B Corporation | | 75.00 |
| Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | $50.00 | |
| Dividend to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) | 25.00 | |
| Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and § 1.960–2(b) ($25/$105×$45) (For formula see § 1.960–2(g)(1)(i)(A)) | | 10.71 |

*B Corporation (second-tier corporation):*

| | | |
|---|---|---|
| Pretax earnings and profits: | | |
| Dividend from C Corporation | $75.00 | |
| Other earnings and profits | 225.00 | |
| Total pretax earnings and profits | | $300.00 |
| Foreign income taxes paid by B Corporation | | 97.50 |
| On dividends received from C Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50×.10) | $5.00 | |
| On dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25×.10) | 2.50 | |
| On other income of B Corporation ($225×.40) | 90.00 | |
| Earnings and profits | | 202.50 |
| Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50 − $5) | 45.00 | |
| Attributable to dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25 − $2.50) | $22.50 | |
| Attributable to other income of B Corporation ($225 − $90) | 135.00 | |

| | |
|---|---|
| Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($202.50 − $45) | $157.50 |
| Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation | 100.00 |
| Dividend paid by B Corporation | 175.00 |
| Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | $45.00 |
| Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) | 100.00 |
| Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation) | 30.00 |

Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) (separate tax rate applicable to dividend received by B Corporation allocation in accordance with § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(ii)(A)(*2*) (*i*) and (*ii*)):

Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower-tiers which is deemed paid by A Corporation:

$$\frac{\text{Portion of dividend to A Corporation from earnings included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}}{\text{Earnings and profits of B Corporation included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}} \times \text{Tax paid by B Corporation on dividend received by B Corporation from earnings included in N Corporation's gross income with respect to C Corporation or lower-tiers}$$

| | |
|---|---|
| ($45/$45×$5) | $5.00 |

Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower-tiers which is deemed paid by A Corporation:

$$\frac{\text{Portion of dividend to A Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to B Corporation or lower-tiers}}{\text{Earnings and profits of B Corporation not included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}} \times \text{Tax paid by B Corporation on earnings not included in N Corporation's gross income with respect to C Corporation or lower-tiers}$$

| | |
|---|---|
| ($30/157.50×$92.50) | $17.62 |
| Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1) ($30/$157.50×$10.71) | 2.04 |
| (For formula see § 1.960–2(g)(1)(ii)(B)(*1*)) | |
| *A Corporation (first-tier corporation):* | |
| Pretax earnings and profits: | |
| Dividend from B Corporation $175.00 | |
| Other income 0 | |
| Total pretax earnings and profits | $175.00 |
| Foreign income taxes paid by A Corporation (20%) | 35.00 |
| Earnings and profits | 140.00 |
| Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45 − ($45×.20)) | $36.00 |
| Attributable to amounts to which section 902(b)(1) does not apply (Attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($100 − ($100×.20)) | 80.00 |

| | |
|---|---|
| Attributable to other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation) | 24.00 |
| Earnings and profits after exclusion for amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($140 − $80) | $60.00 |
| Earnings and profits after exclusion for amounts to which sections 902(b)(1) and 902(b)(2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B or C Corporation) ($60 − $36) | 24.00 |
| Amount required to be included in N Corporation's gross income under section 1951 with respect to A Corporation | None |
| Dividend to N Corporation | $130.00 |
| Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | $36.00 |
| Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) | 80.00 |
| Dividend to which section 902(a) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to A Corporation) | 0 |
| Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to A, B, or C Corporation) | 14.00 |

*N Corporation (domestic corporation):*

| | |
|---|---|
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and § 1.960–1(c) with respect to C Corporation ($50/$105×$45) | $21.43 |
| (for formula see § 1.960–2(g)(2)(i)(A)) | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to B Corporation (allocation of earnings and profits being made in accordance with § 1.960–1(c)(3) and § 1.960–2(e)) (Separate tax rate applicable to dividend received by B Corporation) | 65.53 |

Taxes paid by B corporation (for formula see § 1.960–2(g)(2)(ii) (A)(*2*)):

$$\frac{\text{Amount included in N Corporation's gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation not included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings not included in N Corporation's gross income with respect to C Corporation or lower tiers}$$

| | |
|---|---|
| ($100/$157.50×$92.50) | $58.73 |
| Taxes (of C Corporation) deemed paid by B Corporation under section 902(b)(2) which are deemed paid by N Corporation under section 960(a)(1) ($100/$157.50×$10.71) | 6.80 |
| (for formula see § 1.960–2(g)(2)(ii)(B)(*1*)) | |
| Total taxes deemed paid by N Corporation under section 960(a)(1) | $86.96 |

Foreign income taxes deemed paid by N Corporation under section 902(a):

| | |
|---|---|
| Taxes paid by A Corporation ($130/$140×$35) | $32.50 |
| (for formula see § 1.960–2(g)(1)(iii)(A)(*1*)) | |

Taxes paid by B Corporation deemed paid by A Corporation (Separate tax rate applicable to dividend received by B Corporation allocation required by § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(iii)(B)(*2*) (*i*) and (*ii*)):

Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}}{\text{Earnings and profits of A Corporation included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower tiers which is deemed paid by A Corporation}$$

| | |
|---|---|
| ($36/$36×$5) | $5.00 |

Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to A Corporation or lower tiers}}{\text{Earnings and profits of A Corporation not included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower tiers which is deemed paid by A Corporation}$$

| | | |
|---|---|---|
| ($14/$24×$17.62) | $10.28 | |
| Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation ($14/$24×$2.04) | 1.19 | |
| (for formula see § 1.960–2(g)(1)(iii)(C)(*1*)) | | |
| Total taxes deemed paid by N Corporation under section 902(a) | | $48.97 |
| Total foreign income taxes deemed paid by N Corporation under section 901 | | 135.93 |

*Example 10.* The facts are the same as in example 9 except that A Corporation has other earnings and profits of $200 in 1978 and country X imposes a tax of 50 percent on A Corporation's other earnings and profits. A Corporation distributes $200 of its earnings and profits to N Corporation in 1978. The foreign income taxes paid by N Corporation under sections 960 (a)(1) and 902 (a) are determined as follows on the basis of the facts assumed:

*C Corporation (third-tier corporation):*

| | |
|---|---|
| Pretax earnings and profits | $150.00 |
| Foreign income taxes paid by C Corporation (30%) | 45.00 |
| Earnings and profits | 105.00 |
| Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation | $50.00 |
| Dividend to B Corporation | 75.00 |
| Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | 50.00 |
| Dividend to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) | 25.00 |
| Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and § 1.960–2(b) ($25/$105×$45) (for formula see § 1.960–2(g)(1)(i)(A)) | 10.71 |

*B Corporation (second-tier corporation):*

| | | |
|---|---|---|
| Pretax earnings and profits: | | |
| Dividend from C Corporation | $75.00 | |
| Other earnings and profits | 225.00 | |
| Total pretax earnings and profits | | $300.00 |
| Foreign income taxes of B Corporation | | $97.50 |
| On dividends received from C Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50×.10) | | $5.00 |
| On dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25×.10) | | 2.50 |

| | | |
|---|---|---|
| On other income of B Corporation ($225×.40) | 90.00 | |
| Earnings and profits | | $202.50 |
| Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50–$5) | $45.00 | |
| Attributable to dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25–$2.50) | 22.50 | |
| Attributable to other income of B Corporation ($225–$90) | 135.00 | |
| Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($202.50–$45) | | 157.50 |
| Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation | | 100.00 |
| Dividend paid by B Corporation | | 175.00 |
| Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | $45.00 | |
| Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) | 100.00 | |
| Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation) | 30.00 | |
| Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) with allocation required by § 1.960–2 (e): | | |
| ($45/$45×$5) | | 5.00 |
| ($30/$157.50×$92.50) | | 17.62 |
| (for formula see § 1.960–2(g)(1)(ii)(A)(*2*) (*i*) and (*ii*)) | | |
| Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1): ($30/$157.50 × $10.71) | | 2.04 |
| (for formula see § 1.960–2(g)(1)(ii)(B)(*1*)) | | |
| *A Corporation (first-tier corporation):* | | |
| Pretax earnings and profits: | | |
| Dividend from B Corporation | $175.00 | |
| Other earnings and profits | 200.00 | |
| Total pretax earnings and profits | | $375.00 |
| Foreign income taxes paid by A Corporation | | 135.00 |
| On dividend received from B Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45×.20) | 9.00 | |
| On dividend received from B Corporation to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($100×.20) | 20.00 | |
| On dividend from B Corporation attributable to B Corporation's other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation) ($30×.20) | 6.00 | |
| On other income of A Corporation ($200×.50) | 100.00 | |
| Earnings and profits | | 240.00 |
| Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45 − $9) | 36.00 | |
| Attributable to dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income with respect to B Corporation) ($100 − $20) | 80.00 | |
| Attributable to other earnings and profits of A Corporation (attributable to amounts not included in N Corporation's gross income with respect to A, B, or C Corporation) [($30 − $6)+($200 − $100)] | 124.00 | |
| Amount required to be included in N Corporation's gross income under section 951 with respect to A Corporation | | None |
| Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) | | 160.00 |
| Earnings and profits after exclusion of amounts attributable to dividend to which sections 902(b)(1) and 902(b)(2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B and C Corporation) | | 124.00 |
| Dividend to N Corporation | | 200.00 |
| Dividend attributable to amounts to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) | $36.00 | |
| Dividend attributable to amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income with respect to B Corporation) | 80.00 | |
| Dividend attributable to amounts to which section 902(a) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to A Corporation) | 0 | |
| Dividend attributable to A Corporation's other earnings and profits (attributable to amounts not included in N Corporation's gross income under section 951 with respect to A, B, or C Corporation) | $84.00 | |

*N Corporation (domestic corporation).*

| | |
|---|---|
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and § 1.960–1(c) with respect to C Corporation ($50/$150×$45) ... (for formula see § 1.960–2(g)(2)(i)(A)) | $21.43 |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to B Corporation (allocation of earning and profits being made in accordance with § 1.960–1(c)(3) and § 1.960–2(e)) ..... | 65.53 |
| Taxes paid by B Corporation ($100/$157.50×$92.50) ..... (for formula see § 1.960–2(g)(2)(ii)(A)(*2*)) | $58.73 |
| Taxes deemed paid by B Corporation ($100×$157.50×$10.71) ..... | 6.80 |

$$\frac{\text{Portion of dividend to N Corporation which is from earnings included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}}{\text{Earnings and profits of A Corporation included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on dividends received by A Corporation from earnings included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

| | |
|---|---|
| ($116/$116×$29) ..... | $29.00 |

$$\frac{\text{Portion of dividend to N Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to A Corporation or lower tiers}}{\text{Earnings and profits of A Corporation not included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on earnings not included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

| | |
|---|---|
| ($84/$124×$106) ..... | $71.81 |
| Taxes (paid by B Corporation) deemed paid by A Corporation allocation required by § 1.960–2(e): | |
| ($36/$36×$5) ..... | 5.00 |
| ($84/$124×$17.62) ..... | 11.94 |
| (for formula see § 1.960–2(g)(1)(iii)(B)(*2*) (*i*) and (*ii*)) | |
| Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation ($84/$124×$2.04) ..... | 1.38 |
| (for formula see § 1.960–2(g)(2)(ii)(B)(*1*)) | |
| Total taxes deemed paid by N Corporation under section 960(a)(1) ..... | 86.96 |

Foreign income taxes deemed paid by N Corporation under section 902(a) (separate tax rate applicable to dividends received by A Corporation allocation required by § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(iii)(A)(*2*) (*i*) and (*ii*)):

Tax paid by A Corporation on earnings previously taxed with respect to B Corporation or lower tiers which is deemed paid by N Corporation:

Tax paid by A Corporation on earnings not previously taxed with respect to B Corporation or lower tiers which is deemed paid by N Corporation:

| | |
|---|---|
| (for formula see § 1.960–2(g)(1)(iii)(C)(*1*)) | |
| Total taxes deemed paid by N Corporation under section 902(a) credit ..... | $119.13 |
| Total foreign income taxes deemed paid by N Corporation under section 901 ..... | 206.09 |

(g) *Formulas.* This paragraph contains formulas for determining a domestic corporation's section 902 and 960 credits when amounts distributed through a chain of ownership have been included in whole or in part in the gross income of a domestic corporation

under section 951 with respect to first-, second-, third-, or lower-tier corporations.

(1) *Determination of the section 902 credit*—(i) *Section 902(b)(2) credit.* If the second-tier corporation receives a dividend from a third-tier corporation attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the third- or lower-tier corporations, the second-tier corporation's credit for taxes paid by the third-tier corporation under section 902(b)(2) is determined as follows:

(A) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to second-tier corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation}} \times \text{Taxes paid by third-tier corporation}$$

(B) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*1*) Credit for tax paid by third-tier corporation on earnings included in domestic corporation's gross income with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividends to second-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of third-tier corporation included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on dividend received by third-tier corporation from earnings included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(*2*) Credit for tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to second-tier corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of third-tier corporation not included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(ii) *Section 902(b)(1) credit.* If the first-tier corporation receives a dividend from a second-tier corporation attributable in a whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the second- or lower-tier corporations, the first-tier corporation's credit for taxes paid and deemed paid by the second-tier corporation under section 902(b)(1) is determined as follows:

(A) *Taxes paid by the second-tier corporation which are deemed paid by the first-tier corporation—*(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to first-tier corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation}} \times \text{Taxes paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by second-tier corporation on earnings previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on dividend received by second-tier corporation from earnings included in domestic corporation's gross income with respect to third- or lower-tier corporations}$$

(*ii*) Credit for tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings not included in domestic corporation' s gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation' s gross income under section 951 with respect to third- or lower- tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not included in domestic corporation' s gross income with respect to third- or lower-tier corporations}$$

(B) *Taxes deemed paid by the second-tier corporation which are deemed paid by the first-tier corporation*—(*1*) If the effective rate of tax dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to first-tier corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to second- and third-tier corporations}}{\text{Earnings and profits of second-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income under section 951 with respect to third-tier corporation}} \times \text{Taxes paid by third-tier corporation which are deemed paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by third-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporations included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by second-tier corporation}$$

(*ii*) Credit for tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by second-tier corporation}$$

(iii) *Section 902(a) credit.* If the domestic corporation receives a dividend from a first-tier corporation attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the first- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the first-tier corporation under section 902(a) is determined as follows:

(A) *Taxes paid by the first-tier corporation which are deemed paid by domestic corporation—(1)* If the effective rate of tax on dividends received by the first-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation}} \times \text{Taxes paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the first-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by first-tier corporation on earnings previously taxed with respect to second- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on dividends received by first-tier corporation from earnings included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(*ii*) Credit for tax paid by first-tier corporation on earnings not previously taxed with respect to second- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on earnings not included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(B) *Taxes (paid by second-tier corporation) deemed paid by first-tier corporation which are deemed paid by domestic corporation*—(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as its tax rate on other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first- and second-tier corporations}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income under section 951 with respect to second-tier corporation}} \times \text{Taxes paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by second-tier corporation on earnings previously taxed with respect to third-tier or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(*ii*) Credit for tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(C) *Taxes (of third-tier corporation) deemed paid by first-tier corporation which are deemed paid by domestic corporation*—(*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first- second- and third-tier corporations}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to second- and third-tier corporations}} \times \text{Taxes deemed paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax (of third-tier corporation) deemed paid by second-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax deemed paid by second-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(*ii*) Credit for tax (of third-tier corporation) deemed paid by second-tier on earnings not previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corpation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax deemed paid by second-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(2) *Determination of domestic corporation's section 960 credit for amounts included in its gross income with respect to a first-, second-, or third-tier corporation which has received a distribution previously included in the gross income of a domestic corporation under section 951*—(i) *Third-tier credit.* If a domestic corporation is required to include an amount in its gross income under section 951 with respect to a third-tier corporation which has received a distribution from a fourth-tier corporation of amounts included in a domestic corporation's gross income under section 951 with respect to the fourth- or lower-tier corporations, the domestic corporation's credit for taxes paid by the third-tier corporation under section 960(a)(1) is determined as follows:

(A) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation}} \times \text{Taxes paid by third-tier corporation}$$

(B) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation not included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(ii) *Second-tier credit.* If a domestic corporation is required to include an amount in its gross income under section 951 with respect to a second-tier corporation which has received a distribution from a third-tier corporation of amounts included in a domestic corporation's gross income under section 951 with respect to the third- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the second-tier corporation under section 960(a)(1) is determined as follows:

(A) *Credit for taxes paid by the second-tier corporation which are deemed paid by the domestic corporation.*

(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earning and profits of second-tier corporation}} \times \text{Taxes paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not included in domestic corporation's gross income with respect to third- or lower-tier corporations}$$

(B) *Credit for taxes (of the third-tier corporation) deemed paid by the second-tier corporation under section 902(b)(2).*

(*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to third-tier corporation}} \times \text{Taxes paid by third-tier corporation which are deemed paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporation}} \times \text{Tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corproations which is deemed paid by second-tier corporation}$$

(iii) *First-tier credit.* If a domestic corporation is required to include amounts in its gross income under section 951 with respect to a first-tier corporation which has received a distribution from a second-tier corporation of amounts included in a domestic corporation's gross income under section 951 with respect to the second- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the first-tier corporation under section 960(a)(1) shall be determined as follows:

(A) *Credit for taxes paid by the first-tier corporation.*

(*1*) If the effective rate of tax on dividends received by the first-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporations}} \times \text{Taxes paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the first-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on earnings not included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(B) *Credit for taxes paid by the second-tier corporation deemed paid by the first-tier corporation under section 902(b)(1).*

(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective

rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income under section 951 with respect to second-tier corporations}} \times \text{Tax paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(C) *Credit for taxes (of the third-tier corporation) deemed paid by the second-tier corporation which are deemed paid by first-tier corporation under section 902(b)(1).*

(*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to second- and third-tier corporation}} \times \text{Taxes deemed paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporation}} \times \text{Tax deemed paid by second-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by first-tier corporation}$$

[T.D. 7120, 36 FR 10854, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44212, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; 40 FR 2802, Jan. 16, 1975; T.D. 7649, 44 FR 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50476, Nov. 8, 1982; 47 FR 55477, Dec. 10, 1982]

### § 1.960–3 Gross-up of amounts included in income under section 951.

(a) *General rule for including taxes in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 960(a)(1) shall, except as provided in paragraph (b) of this section, be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and §1.78–1.

(b) *Certain taxes not included in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 902(a) or section 960(a)(1) shall not be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and §1.78–1 to the extent that such taxes are paid or accrued by the first-, second-, or third-tier corporation, as the case may be, on or with respect to an amount which is excluded from the gross income of such foreign corporation under section 959(b) and §1.959–2 as distributions from the earnings and profits of another controlled foreign corporation attributable to an amount which is, or has been, required to be included in the gross income of the domestic corporation under section 951.

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

*Example 1.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, B Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to B Corporation and all of which are distributed to A Corporation in such year. The dividend so received from B Corporation is excluded from A Corporation's gross income under section 959(b) and §1.959–2. An income tax of 10 percent is required to be withheld from such dividend by the foreign country under the laws of which B Corporation is created, and the foreign country under the laws of which A Corporation is created imposes an income tax of $22 on the dividend received from B Corporation. For 1978, A Corporation's earnings and profits are $50 ($80−[0.10×$80]−$22), which it distributes in such year to N Corporation. For 1978, N Corporation is required under section 951 to include $80 in gross income with respect to B Corporation and also is required under the gross-up provisions of section 78 to include in gross income $20 ($80/$80×$20), the amount equal to the foreign income taxes of B Corporation which are deemed paid by N Corporation under section 960(a)(1). Under paragraph (b) of this section N Corporation is not required to include in gross income the $30 ($8+$22) of foreign income taxes which are paid by A Corporation in connection with the dividend received from B Corporation and which are deemed paid by N Corporation under section 902(a) and paragraph (c) of §1.960–2.

*Example 2.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which in turn owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, C Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to C Corporation and all of which are distributed to B Corporation in such year. After having

paid foreign income taxes of $10 on the dividend received from C Corporation, B Corporation distributes the balance of $70 to A Corporation. After having paid foreign income taxes of $5 on the dividend received from B Corporation, A Corporation distributes the balance of $65 to N Corporation. The dividend so received by B Corporation, and in turn by A Corporation, is excluded from the gross income of such corporations under section 959(b) and §1.959–2. Under paragraph (b) of this section N Corporation is not required to include in gross income the $15 ($10+$5) of foreign income taxes which are paid by corporations B and A, respectively, in connection with the dividend so received and which are deemed paid by N Corporation under section 902(a) and paragraphs (b) and (c) of §1.960–2.

[T.D. 7120, 36 FR 10856, June 4, 1971, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977; T.D. 7649, 44 FR 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50484, Nov. 8, 1982]

### §1.960–4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.

(a) *Increase in section 904(a) limitation for the taxable year of exclusion*—(1) *In general.* The applicable limitation under section 904(a) for a taxpayer's taxable year (hereinafter in this section referred to as the ''taxable year of exclusion'') in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to a controlled foreign corporation's earnings and profits in respect of which an amount was required to be included in the gross income of such taxpayer under section 951(a) for a taxable year (hereinafter in this section referred to as the ''taxable year of inclusion'') previous to the taxable year of exclusion shall be increased under section 960(b)(1) by the amount described in paragraph (b) of this section if the conditions described in subparagraph (2) of this paragraph are satisfied.

(2) *Conditions under which increase in limitation is allowed for the taxable year of exclusion.* The increase in limitation described in subparagraph (1) of this paragraph for the taxable year of exclusion shall be made only if the taxpayer—

(i) For the taxable year of inclusion either chose to claim a foreign tax credit as provided in section 901 or did not pay or accrue any foreign income taxes,

(ii) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year of exclusion, and

(iii) For the taxable year of exclusion pays, accrues, or is deemed to have paid foreign income taxes with respect to the amount, described in subparagraph (1) of this paragraph, which is excluded from his gross income for such year under section 959(a)(1).

(b) *Amount of increase in limitation for the taxable year of exclusion.* The amount of increase under section 960(b)(1) in the applicable limitation under section 904(a) for the taxable year of exclusion shall be—

(1) The amount by which the applicable section 904(a) limitation for the taxable year of inclusion was increased, determined as provided in paragraph (c) of this section, by reason of the inclusion of the amount in the taxpayer's income for such year under section 951(a), reduced by

(2) The amount of foreign income taxes allowed as a credit under section 901 for such taxable year of inclusion and which were allowable to such taxpayer solely by reason of the inclusion of such amount in his gross income under section 951(a), as determined under paragraph (d) of this section, and then by

(3) The additional reduction for such taxable year of inclusion arising by reason of increases in limitation under section 960(b)(1) for taxable years intervening between such taxable year of inclusion and such taxable year of exclusion, as determined under paragraph (e) of this section in respect of such inclusion under section 951(a),

except that the amount of increase determined under this paragraph for the taxable year of exclusion shall in no case exceed the amount of foreign income taxes paid, accrued, or deemed to be paid by such taxpayer for such taxable year of exclusion with respect to the amount, described in paragraph (a)(1) of this section, which is excluded from gross income for such year under section 959(a)(1).

(c) *Determination of increase in limitation for the taxable year of inclusion.* The amount of the increase in the applicable limitation under section 904(a) for

the taxable year of inclusion which arises by reason of the inclusion of the amount in gross income under section 951(a) shall be the amount of the applicable limitation under section 904(a) for such year reduced by the amount which would have been the applicable limitation under section 904(a) for such year if the amount had not been included in gross income for such year under section 951(a).

(d) *Determination of foreign income taxes allowed for taxable year of inclusion by reason of section 951(a) amount.* The amount of foreign income taxes allowed as a credit under section 901 for the taxable year of inclusion which were allowable solely by reason of the inclusion of the amount in gross income for such year under section 951(a) shall be the amount of foreign income taxes allowed as a credit under section 901 for such year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for such year if the amount had not been included in gross income for such year under section 951(a). For purposes of this paragraph, the term ''foreign income taxes'' includes foreign income taxes paid or accrued, and foreign income taxes deemed paid under section 902, section 904(d), and section 960(a), for the taxable year of inclusion.

(e) *Additional reduction for the taxable year of inclusion arising by reason of increases in limitation for intervening years.* The amount of increase in the applicable limitation under section 904(a) for the taxable year of inclusion shall also be reduced, after first deducting the foreign income taxes described in paragraph (b)(2) of this section, by any increases in limitation which arise under section 960(b)(1)—by reason of any earlier exclusions under section 959(a)(1) in respect of the same inclusion under section 951(a) for such taxable year of inclusion—for the first, second, third, fourth, etc., succeeding taxable years of exclusion, in that order, which follow such taxable year of inclusion and precede the taxable year of exclusion in respect of which the increase in limitation under section 960(b)(1) and paragraph (b) of this section is being determined. The amount of any increase in limitation which arises under section 960(b)(1) for any such succeeding taxable year of exclusion shall be the amount of foreign income taxes allowed as a credit under section 901 for each such taxable year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for each such year if the limitation for each such year were not increased under section 960(b)(1). For any such succeeding taxable year of exclusion for which the taxpayer does not choose to claim a foreign tax credit as provided in section 901, the same increase in limitation under section 960(b)(1) shall be treated as having been made, for purposes of this paragraph, which would have been made for such taxable year if the taxpayer had chosen to claim the foreign tax credit for such year.

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

*Example 1.* Domestic corporation N owns all of the one class of stock of controlled foreign corporation A. Corporation A, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which are attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978. Both corporations use the calendar year as the taxable year. For 1979 and 1980, A Corporation has no earnings and profits attributable to an amount required to be included in N Corporation's gross income under section 951(a); for each such year it makes a distribution of $35 (from its earnings and profits for 1978) from which a foreign income tax of $6 is withheld. For each of 1978, 1979, and 1980, N Corporation derives taxable income of $50 from sources within the United States and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2).

The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

| | 1978 |
|---|---|
| Taxable income of N Corporation: | |
| U.S. sources | $50.00 |
| Sources without the U.S.: | |
| Amount required to be included in N Corporation's gross income under section 951(a) | $70.00 |

| | | |
|---|---|---|
| 1978 | | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($30×$70/$70) | 30.00 | 100.00 |
| Total taxable income | | 150.00 |
| U.S. tax payable for 1978: | | |
| U.S. tax before credit ($150×0.48) | | 72.00 |
| Credit: Foreign income taxes of $30, but not to exceed overall limitation of $48 for 1978 ($100/$150×$72) | | 30.00 |
| U.S. tax payable | | 42.00 |
| 1979 | | |
| Taxable income of N Corporation, consisting of income from U.S. sources | | $50.00 |
| U.S. tax before credit ($50×0.48) | | 24.00 |
| Section 904(a)(2) overall limitation for 1979: | | |
| Limitation for 1979 before increase under section 960(b)(1) ($24×$0/$50) | | 0 |
| Plus: Increase in overall limitation for 1979 under section 960(b)(1): | | |
| Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48 − [($50×0.48)×$0/$50]) | $48.00 | |
| Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($30 − $0) | 30.00 | |
| Balance | 18.00 | |
| But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $35 distribution excluded under section 959(a)(1) ($6 tax withheld) | 6.00 | 6.00 |
| Overall limitation for 1979 | | 6.00 |
| U.S. tax payable for 1979: | | |
| U.S. tax before credit ($50×0.48) | | 24.00 |
| Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1966 | | 6.00 |
| U.S. tax payable | | 18.00 |
| 1980 | | |
| Taxable income of N Corporation, consisting of income from U.S. sources | | $50.00 |
| U.S. tax before credit ($50×0.48) | | 24.00 |
| Section 904(a)(2) overall limitation for 1980: | | |
| Limitation for 1980 before increase under section 960(b)(1) ($24×$0/$50) | | 0 |
| Plus: Increase in overall limitation for 1980 under section 960(b)(1): | | |
| Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48 − [($50×0.48)×$0/$50]) | $48.00 | |
| Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($30 − $0) | 30.00 | |
| Tentative balance | 18.00 | |
| Less: Increase in overall limitation under section 960(b)(1) for 1979 by reason of such section 951(a) inclusion | $6.00 | |
| Balance | 12.00 | |
| But: Such balance not to exceed foreign income taxes paid by N Corporation for 1980 with respect to $35 distribution excluded under section 959(a)(1) ($6 tax withheld) | 6.00 | $6.00 |
| Overall limitation for 1980 | | 6.00 |
| U.S. tax payable for 1980: | | |
| U.S. tax before credit ($50×0.48) | | 24.00 |
| Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1967 | | 6.00 |
| U.S. tax payable | | 18.00 |

*Example 2.* The facts for 1978, 1979, and 1980, are the same as in example 1, except that in 1977, to which the section 904(a)(2) overall limitation applies, N Corporation pays $18 of foreign income taxes in excess of the overall limitation and that such excess is not absorbed as a carryback to 1975 or 1976 under section 904(c). Therefore, there is no increase under section 960(b)(1) in the overall limitation for 1979 or 1980 since the amount ($48) by which the 1978 overall limitation was increased by reason of the inclusion in N Corporation's gross income for 1978 under section 951(a), less the foreign income taxes ($48) allowed as a credit which were allowable solely by reason of such inclusion, is zero. The foreign income taxes so allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion consist of the $30 of foreign income taxes deemed paid for 1978 under section 960(a)(1) and the $18 of foreign income taxes for 1977 carried over and deemed paid for 1978 under section 904(c).

*Example 3.* (a) Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which in turn owns all the one class of stock of controlled foreign corporation B. All corporations use the calendar years as the taxable year. Corporation B, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which is attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978, and $35 of

which it distributes in such year to A Corporation. For 1978, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes in such year to N Corporation, a foreign income tax of $3 being withheld therefrom.

(b) For 1979, B Corporation has no earnings and profits, but distributes in such year to A Corporation the $35 remaining of its earnings and profits for 1965. For 1979, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes to N Corporation, a foreign income tax of $3 being withheld therefrom.

(c) For each of 1978 and 1979, N Corporation has taxable income of $100 from United States sources and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2). The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

1978

| | | |
|---|---|---|
| Taxable income of N Corporation: | | |
| U.S. sources | | $100 |
| Sources without the U.S.: | | |
| Amount required to be included in N Corporation's gross income under section 951(a) with respect to B Corporation | $70 | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($30×$70/$70) | 30 | 100 |
| Total taxable income | | 200 |
| U.S. tax payable for 1978: | | |
| U.S. tax before credit ($200×0.48) | | 96 |
| Credit: Foreign income taxes of $38 ([$30×$70/$70]+$3), but not to exceed overall limitation of $48 ($96×$100/$200) | | 38 |
| U.S. tax payable | | 58 |

1979

| | | |
|---|---|---|
| Taxable income of N Corporation, consisting of income from U.S. sources | | $100 |
| U.S. tax before credit ($100×0.48) | | 48 |
| Section 904(a)(2) overall limitation for 1979: | | |
| Limitation for 1979 before increase under section 960(b)(1) ($48×$0/$100) | | 0 |
| Plus: Increase in overall limitation for 1979 under section 960(b)(1): | | |
| Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48 − [($100×0.48)×$0/$100]) | $48 | |
| Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($38 − $0) | 38 | |
| Balance | 10 | |
| But: Such balance not to exceed foreign income taxes paid and deemed paid by N Corporation for 1979 with respect to $30 distribution excluded under section 959(a)(1) ([$5×$30/$30]+$3) | 8 | 8 |
| Overall limitation for 1979 | | 8 |
| U.S. tax payable for 1979: | | |
| U.S. tax before credit ($100×0.48) | | 48 |
| Credit: Foreign income taxes of $8 ($3+$5), but not to exceed overall limitation of $8 for 1979 | | 8 |
| U.S. tax payable | | 40 |

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

### § 1.960–5 Credit for taxable year of inclusion binding for taxable year of exclusion.

(a) *Taxes not allowed as a deduction for taxable year of exclusion.* In the case of any taxpayer who—

(1) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year for which he is required to include in gross income under section 951(a) an amount attributable to the earnings and profits of a controlled foreign corporation, and

(2) Does not choose to claim a foreign tax credit as provided in section 901 for a taxable year in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to such earnings and profits of such controlled foreign corporation,

No deduction shall be allowed under section 164 for the taxable year of such exclusion for any foreign income taxes paid or accrued on or with respect to such excluded amount.

(b) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* Domestic Corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. All of A Corporation's earnings and profits of $80 for 1978 (after payment of foreign income taxes of $20 on its total income of $100 for such year) are attributable to amount required under section 951(a) to be included in N Corporation's gross income for 1978. For 1978, N Corporation chooses to claim a foreign tax credit for the $20 of foreign income taxes which for such year are paid by A Corporation and deemed paid by N Corporation

under section 960(a)(1) and paragraph (c)(1) of §1.960–1. For 1979, A Corporation distributes the entire $80 of 1978 earnings and profits, a foreign income tax of $8 being withheld therefrom. Although N Corporation does not choose to claim a foreign tax credit for 1979, it may not deduct such $8 of foreign income taxes under section 164. Corporation N may, however, deduct under such section a foreign income tax of $4 which is withheld from a distribution of $40 by A Corporation during 1979 from its 1979 earnings and profits.

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

### § 1.960–6 Overpayments resulting from increase in limitation for taxable year of exclusion.

(a) *Amount of overpayment.* If an increase in the limitation under section 960(b)(1) and §1.960–4 for a taxable year of exclusion exceeds the tax (determined before allowance of any credits against tax) imposed by chapter 1 of the Code for such year, the amount of such excess shall be deemed an overpayment of tax for such year and shall be refunded or credited to the taxpayer in accordance with chapter 65 (section 6401 and following) of the Code.

(b) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, A Corporation has total income of $100,000 on which it pays foreign income taxes of $20,000. All of A Corporation's earnings and profits for 1978 of $80,000 are attributable to an amount which is required under section 951(a) to be included in N Corporation's gross income for 1978. By reason of such income inclusion N Corporation is deemed for 1978 to have paid under section 960(a)(1), and is required under section 78 to include in gross income for such year, the $20,000 ($20,000×$80,000/$80,000) of foreign income taxes paid by A Corporation for such year. Corporation N also derives $100,000 taxable income from sources within the United States for 1978. For 1979, N Corporation has $25,000 of taxable income, all of which is derived from sources within the United States. No part of A Corporation's earnings and profits for 1979 is attributable to an amount required under section 951(a) to be included in N Corporation's gross income. During 1979, A Corporation makes one distribution consisting of its $80,000 earnings and profits for 1978, all of which is excluded under section 959(a)(1) from N Corporation's gross income for 1979, and from which distribution foreign income taxes of $10,000 are withheld. For 1978 and 1979, N Corporation claims the foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2). The United States tax of N Corporation is determined as follows for such years, assuming a corporate tax rate of 22 percent, a surtax of 26 percent and a surtax exemption of $25,000:

| | | |
|---|---|---|
| 1978 | | |
| Taxable income of N Corporation: | | |
| U.S. sources | | $100,000 |
| Sources without the U.S.: | | |
| Amount required to be included in N Corporation's gross income under section 951(a) | $80,000 | |
| Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($20,000×$80,000/$80,000) | 20,000 | 100,000 |
| Total taxable income | | 200,000 |
| U.S. tax payable for 1978: | | |
| U.S. tax before credit ([$200,000×0.22]+[$175,000×0.26]) | | 89,500 |
| Credit: Foreign income taxes of $20,000, but not to exceed overall limitation of $44,750 ($89,500×$100,000/$200,000) | | 20,000 |
| U.S. tax payable | | 69,500 |
| 1979 | | |
| Taxable income of N Corporation, consisting of income from U.S. sources | | $25,000 |
| U.S. tax before credit ($25,000×0.22) | | 5,500 |
| Section 904(a)(2) overall limitation for 1979: | | |
| Limitation for 1979 before increase under section 960(b)(1) ($5,500×$0/$25,000) | | 0 |
| Plus: Increase in overall limitation for 1979 under section 960(b)(1): | | |
| Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($44,750 − [$41,500 × $0/$100,000]) | $44,750 | |
| Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($20,000 − $0) | 20,000 | |
| Balance | 24,750 | |

| | 1979 | |
|---|---|---|
| But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $80,000 distribution excluded under section 959(a)(1) ($10,000 tax withheld) | 10,000 | 10,000 |
| Overall limitation for 1979 | | 10,000 |
| U.S. tax payable for 1979: | | |
| U.S. tax before credit ($25,000×0.22) | | 5,500 |
| Credit: Foreign income taxes of $10,000, but not to exceed overall limitation of $10,000 for 1979 | | 10,000 |
| U.S. tax payable | | None |
| Overpayment of tax for 1979: | | |
| Increase in limitation under section 960(b)(1) for 1979 | | 10,000 |
| Less: Tax imposed for 1979 under chapter 1 of the Code | | 5,500 |
| Excess treated as overpayment | | 4,500 |

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

### § 1.960–7 Effective dates.

(a) *General rule.* Except as provided in paragraph (b), the rules contained in §§ 1.960–1—1.960–6 shall apply to taxable years of foreign corporations beginning after December 31, 1962, and taxable years of U.S. corporate shareholders within which or with which the taxable year of such foreign corporation ends.

(b) *Exception for less developed country corporations.* If for any taxable year beginning after December 31, 1962, and before January 1, 1976, a first-tier foreign corporation qualified as a less developed country corporation as defined in 26 CFR 1.902–2 revised as of April 1, 1978, the rules pertaining to less developed country corporations contained in 26 CFR 1.960–1—1.960–6 revised as of April 1, 1978, shall apply to any amounts required to be included in gross income under section 951 for such taxable year.

(c) *Third-tier credit.* The rules contained in §§ 1.960–1—1.960–6 shall apply to amounts included in the gross income of a domestic corporation under section 951 with respect to the earnings and profits of third-tier corporations (as defined in § 1.960–1) in taxable years beginning after December 31, 1976.

[T.D. 7649, 44 FR 60089, Oct. 18, 1979, as amended by T.D. 7843, 47 FR 50484, Nov. 8, 1982]

### § 1.961–1 Increase in basis of stock in controlled foreign corporations and of other property.

(a) *Increase in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the basis of a United States shareholder's—

(i) Stock in a controlled foreign corporation; or

(ii) Property (as defined in paragraph (b)(1) of this section) by reason of the ownership of which he is considered under section 958(a)(2) as owning stock in a controlled foreign corporation shall be increased under section 961(a), as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends. The increase in basis provided by the preceding sentence shall be made only to the extent to which such amount required to be included in gross income under section 951(a) was so included in gross income.

(2) *Limitation on amount of increase in case of election under section 962.* In the case of a United States shareholder who makes the election under section 962 for the taxable year, the amount of the increase in basis provided by subparagraph (1) of this paragraph shall not exceed the amount of United States tax paid in accordance with such election with respect to the amounts included in such shareholder's gross income under section 951(a) for such year (as determined under § 1.962–1).

(b) *Rules of application*—(1) *Property defined.* The property of a United States shareholder referred to in paragraph (a)(1)(ii) of this section shall consist of—

(i) Stock in a foreign corporation;

(ii) An interest in a foreign partnership; or

(iii) A beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share of stock.* Any increase under paragraph (a) of this section in the basis of a United States shareholder's stock in a foreign corporation shall be made in the amount included in gross income under section 951(a) or in the amount of United States tax paid in accordance with an election under section 962, as the case may be, with respect to each share of such stock.

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

*Example 1.* Domestic corporation M owns 800 of the 1,000 shares of the one class of stock in controlled foreign corporation R which owns all of the one class of stock in controlled foreign corporation S. Corporations M, R, and S use the calendar year as a taxable year. In 1964, S Corporation has $100,000 of earnings and profits after the payment of $11,250 of foreign income taxes, and $100,000 of subpart F income. Corporation R has no earnings and profits. With respect to S Corporation, M Corporation is required to include in gross income $80,000 (800/1,000×$100,000) under section 951(a), and $9,000 ($80,000/$100,000×$11,250) under section 78. On December 31, 1964, M Corporation must increase the basis of each share of its stock in R Corporation by $100 ($80,000/800).

*Example 2.* A, an individual United States shareholder, owns all of the 1,000 shares of the one class of stock in controlled foreign corporation T. Corporation T and A use the calendar year as a taxable year. In 1964, T Corporation has $80,000 of earnings and profits after the payment of $20,000 of foreign income taxes, and $80,000 of subpart F income. A makes the election under section 962 for 1964 and in accordance with such election pays a United States tax of $23,000 with respect to the $80,000 included in his gross income under section 951(a). On December 31, 1964, A must increase the basis of each share of his stock in T Corporation by $23 ($23,000/1,000).

[T.D. 6850, 30 FR 11854, Sept. 16, 1978]

### § 1.961–2 Reduction in basis of stock in foreign corporations and of other property.

(a) *Reduction in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the adjusted basis of a United States person's—

(i) Stock in a foreign corporation;

(ii) Interest in a foreign partnership; or

(iii) Beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)),

with respect to which such United States person receives an amount which is excluded from gross income under section 959(a), shall be reduced under section 961(b), as of the time such person receives such excluded amount, by the sum of the amount so excluded and any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(2) *Limitation on amount of reduction in case of election under section 962.* In the case of a distribution of earnings and profits attributable to amounts with respect to which an election under section 962 has been made, the amount of the reduction in basis provided by subparagraph (1) of this paragraph shall not exceed the sum of—

(i) The amount of such distribution which is excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962–3; and

(ii) Any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(b) *Reduction with respect to each share of stock.* Any reduction under paragraph (a) of this section in the adjusted basis of a United States person's stock in a foreign corporation shall be made with respect to each share of such stock in the sum of—

(1)(i) The amount excluded from gross income under section 959(a); or

(ii) The amount excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962–3; and

(2) The amount of any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

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

*Example 1.* (a) Domestic corporation M owns all of the 1,000 shares of the one class of stock in controlled foreign corporation R, which owns all of the 500 shares of the one class of stock in controlled foreign corporation S. Each share of M Corporation's stock in R Corporation has a basis of $200. Corporations M, R, and S use the calendar year as a taxable year. In 1963, S Corporation has $100,000 of earnings and profits after the payment of $50,000 of foreign income taxes and $100,000 of subpart F income. For 1963, M Corporation includes $100,000 in gross income under section 951(a) with respect to S Corporation. In accordance with the provisions of §1.961–1, M Corporation increases the basis of each of its 1,000 shares of stock in R Corporation to $300 ($200+$100,000/1,000) as of December 31, 1963.

(b) On July 31, 1964, M Corporation sells 250 of its shares of stock in R Corporation to domestic corporation N at a price of $350 per share. Corporation N satisfies the requirements of paragraph (d) of §1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, the earnings and profits attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963 are distributed to R Corporation which incurs a withholding tax of $10,000 on such distribution (10 percent of $100,000) and an additional foreign income tax of 33⅓ percent or $30,000 by reason of the inclusion of the net distribution of $90,000 ($100,000 minus $10,000) in its taxable income for 1964. On June 30, 1965, R Corporation distributes the remaining $60,000 of such earnings and profits to corporations M and N: Corporation M receives $45,000 (750/1,000×$60,000) and excludes such amount from gross income under section 959(a); Corporation N receives $15,000 (250/1,000×$60,000) and, as M Corporation's successor in interest, excludes such amount from gross income under section 959(a). As of June 30, 1965, M Corporation must reduce the adjusted basis of each of its 750 shares of stock in R Corporation to $200 ($300 minus ($45,000/750+$10,000/1,000+$30,000/1,000)); and N Corporation must reduce the basis of each of its 250 shares of stock in R Corporation to $250 ($350 minus ($15,000/250+$10,000/1,000+$30,000/1,000)).

*Example 2.* The facts are the same as in paragraph (a) of example 1, except that in addition, on July 31, 1964, R Corporation sells its 500 shares of stock in S Corporation to domestic corporation P at a price of $600 per share. Corporation P satisfies the requirements of paragraph (d) of §1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, S Corporation distributes $100,000 of earnings and profits to P Corporation, which earnings and profits are attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963. Corporation P incurs a withholding tax of $10,000 on the distribution from S Corporation (10 percent of $100,000). As M Corporation's successor in interest, P Corporation excludes the $90,000 it receives from gross income under section 959(a). As of September 30, 1964, P Corporation must reduce the basis of each of its 500 shares of stock in S Corporation to $400 ($600 minus ($90,000/500+$10,000/500)).

[T.D. 6850, 30 FR 11854, Sept. 16, 1965]

### § 1.962–1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

(a) *In general.* An individual United States shareholder may, in accordance with §1.962–2, elect to have the provisions of section 962 apply for his taxable year. In such case—

(1) The tax imposed under chapter 1 of the Internal Revenue Code on all amounts which are included in his gross income for such taxable year under section 951(a) shall (in lieu of the tax determined under section 1) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation (determined in accordance with paragraph (b)(1) of this section), and

(2) For purposes of applying section 960(a)(1) (relating to foreign tax credit) such amounts shall be treated as if received by a domestic corporation (as provided in paragraph (b)(2) of this section).

Thus, an individual United States shareholder may elect to be subject to

tax at corporate rates on amounts included in his gross income under section 951(a) and to have the benefit of a credit for certain foreign taxes paid with respect to the earnings and profits attributable to such amounts. Section 962 also provides rules for the treatment of an actual distribution of earnings and profits previously taxed in accordance with an election of the benefits of this section. See §1.962–3. For transitional rules for certain taxable years, see §1.962–4.

(b) *Rules of application.* For purposes of this section—

(1) *Application of section 11.* For purposes of applying section 11 for a taxable year as provided in paragraph (a)(1) of this section in the case of an electing United States shareholder—

(i) *Determination of taxable income.* The term ''taxable income'' as used in section 11 shall mean the sum of—

(*a*) All amounts required to be included in his gross income under section 951(a) for such taxable year; plus

(*b*) All amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in (*a*) of this subdivision if such shareholder were a domestic corporation.

For purposes of this section, such sum shall not be reduced by any deduction of the United States shareholder even if such shareholder's deductions exceed his gross income.

(ii) *Limitation on surtax exemption.* The surtax exemption provided by section 11(c) shall not exceed an amount which bears the same ratio to $25,000 ($50,000 in the case of a taxable year ending after December 31, 1974, and before January 1, 1976) as the amounts included in his gross income under section 951(a) for the taxable year bear to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which such United States shareholder includes any amount in his gross income under section 951(a) for the taxable year.

(2) *Allowance of foreign tax credit*—(i) *In general.* Subject to the applicable limitation of section 904 and to the provisions of this subparagraph, there shall be allowed as a credit against the United States tax on the amounts described in subparagraph (1)(i) of this paragraph the foreign income, war profits, and excess profits taxes deemed paid under section 960(a)(1) by the electing United States shareholder with respect to such amounts.

(ii) *Application of section 960(a)(1).* In applying section 960(a)(1) for purposes of this subparagraph in the case of an electing United States shareholder, the term ''domestic corporation'' as used in sections 960(a)(1) and 78, and the term ''corporation'' as used in section 901, shall be treated as referring to such shareholder with respect to the amounts described in subparagraph (1)(i) of this paragraph.

(iii) *Carryback and carryover of excess tax deemed paid.* For purposes of this subparagraph, any amount by which the foreign income, war profits, and excess profits taxes deemed paid by the electing United States shareholder for any taxable year under section 960(a)(1) exceed the limitation determined under subdivision (iv)(*a*) of this subparagraph shall be treated as a carryback and carryover of excess tax paid under section 904(d), except that in no case shall excess tax paid be deemed paid in a taxable year if an election under section 962 by such shareholder does not apply for such taxable year. Such carrybacks and carryovers shall be applied only against the United States tax on amounts described in subparagraph (1)(i) of this paragraph.

(iv) *Limitation on credit.* For purposes of determining the limitation under section 904 on the amount of the credit for foreign income, war profits, and excess profits taxes—

(*a*) Deemed paid with respect to amounts described in subparagraph (1)(i) of this paragraph, the electing United States shareholder's taxable income shall be considered to consist only of the amounts described in such subparagraph (1)(i), and

(*b*) Paid with respect to amounts other than amounts described in subparagraph (1)(i) of this paragraph, the electing United States shareholder's taxable income shall be considered to consist only of amounts other than the amounts described in such subparagraph (1)(i).

(v) *Effect of choosing benefits of sections 901 to 905.* The provisions of this subparagraph shall apply for a taxable year whether or not the electing United States shareholder chooses the benefits of subpart A of part III of subchapter N of chapter 1 (sections 901 to 905) of the Internal Revenue Code for such year.

(c) *Illustration.* The application of this section may be illustrated by the following example:

*Example.* Throughout his taxable year ending December 31, 1964, A, an unmarried individual who is not the head of a household, owns 60 of the 100 shares of the one class of stock in foreign corporation M and 80 of the 100 shares of the one class of stock in foreign corporation N. A and corporations M and N use the calendar year as a taxable year, corporations M and N are controlled foreign corporations throughout the period here involved, and neither corporation is a less developed country corporation. The earnings and profits and subpart F income of, and the foreign income taxes paid by, such corporations for 1964 are as follows:

| | M | N |
|---|---|---|
| Pretax earnings and profits | $500,000 | $1,200,000 |
| Foreign income taxes | 200,000 | 400,000 |
| Earnings and profits | 300,000 | 800,000 |
| Subpart F income | 150,000 | 750,000 |

Apart from his section 951(a) income, A has gross income of $200,600 and $100,000 of deductions attributable to such income. He is required to include $90,000 (0.60×$150,000) in gross income under section 951(a) with respect to M Corporation and $600,000 (0.80×$750,000) with respect to N Corporation. A elects to have the provisions of section 962 apply for 1964 and computes his tax as follows:

| | | | |
|---|---|---|---|
| Tax on amounts included under section 951(a): | | | |
| Income under section 951(a) from M Corporation | $90,000 | | |
| Gross-up under sections 960(a)(1) and 78 ($90,000/$300,000×$200,000) | 60,000 | | |
| Income under section 951(a) from N Corporation | 600,000 | | |
| Gross-up under sections 960(a)(1) and 78 ($600,000/$800,000×$400,000) | 300,000 | | |
| Taxable income under section 11 | 1,050,000 | | |
| Normal tax (0.22×$1,050,000) | | $231,000 | |
| Surtax exemption ([$90,000+$600,000]/[0.60×$300,000+(0.80×$800,000)]×$25,000) | 21,036 | | |
| Subject to surtax under section 11 ($1,050,000 − $21,036) | 1,028,964 | | |
| Surtax (0.28×$1,028,964) | | 288,110 | |
| Tentative U.S. tax | | 519,110 | |
| Foreign tax credit ($60,000+$300,000) | 360,000 | | |
| Total U.S. tax payable on amounts included under section 951(a) | | | $159,110 |
| Tax with respect to other income: | | | |
| Gross income | | 200,600 | |
| Less: | | | |
| Personal exemption | 600 | | |
| Deductions | 100,000 | | |
| | 100,600 | | |
| Taxable income | | 100,000 | |
| Tax with respect to such other taxable income | | 59,340 | |
| Total tax ($159,110+$59,340) | | | 218,450 |

[T.D. 6858, 30 FR 13695, Oct. 28, 1965, as amended by T.D. 7413, 41 FR 12640, Mar. 26, 1976]

## § 1.962–2 Election of limitation of tax for individuals.

(a) *Who may elect.* The election under section 962 may be made only by a United States shareholder who is an individual (including a trust or estate).

(b) *Time and manner of making election.* Except as provided in §1.962–4, a United States shareholder shall make an election under this section by filing a statement to such effect with his return for the taxable year with respect to which the election is made. The statement shall include the following information:

(1) The name, address, and taxable year of each controlled foreign corporation with respect to which the electing shareholder is a United States

shareholder and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The amounts, on a corporation-by-corporation basis, which are included in such shareholder's gross income for his taxable year under section 951(a);

(3) Such shareholder's pro rata share of the earnings and profits (determined under §1.964–1) of each such controlled foreign corporation with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and the foreign income, war profits, excess profits, and similar taxes paid on or with respect to such earnings and profits;

(4) The amount of distributions received by such shareholder during his taxable year from each controlled foreign corporation referred to in subparagraph (1) of this paragraph from excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of §1.962–3), from taxable section 962 earnings and profits (as defined in paragraph (b)(1)(ii) of §1.962–3), and from earnings and profits other than section 962 earnings and profits, showing the source of such amounts by taxable year; and

(5) Such further information as the Commissioner may prescribe by forms and accompanying instructions relating to such election.

(c) *Effect of election*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and §1.962–4, an election under this section by a United States shareholder for a taxable year shall be applicable to all controlled foreign corporations with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and shall be binding for the taxable year for which such election is made.

(2) *Revocation.* Upon application by the United States shareholder, an election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:R, Washington, DC 20224, containing a statement of the facts upon which such shareholder relies in requesting such consent.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

### §1.962–3 Treatment of actual distributions.

(a) *In general.* Section 962(d) provides that the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of an individual United States shareholder under section 951(a) by reason of such shareholder's ownership (within the meaning of section 958(a)) of stock in such corporation and with respect to which amounts an election under §1.962–2 applies or applied shall, when such earnings and profits are distributed to such shareholder with respect to such stock, notwithstanding the provisions of section 959(a)(1), be included in his gross income to the extent that such earnings and profits exceed the amount of income tax paid by such shareholder under this chapter on the amounts to which such election applies or applied. Thus, when such shareholder receives an actual distribution of section 962 earnings and profits (as defined in paragraph (b)(1) of this section) from a foreign corporation, only the excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of this section) may be excluded from his gross income.

(b) *Rules of application.* For purposes of this section—

(1) *Section 962 earnings and profits defined.* With respect to an individual United States shareholder, the term ''section 962 earnings and profits'' means the earnings and profits of a foreign corporation referred to in paragraph (a) of this section. Such earnings and profits include—

(i) *Excludable section 962 earnings and profits.* Excludable section 962 earnings and profits which are the amount of the section 962 earnings and profits equal to the amount of income tax paid under this chapter by such shareholder on the amounts included in his gross income under section 951(a); and

(ii) *Taxable section 962 earnings and profits.* Taxable section 962 earnings and profits which are the excess of section 962 earnings and profits over the amount described in subdivision (i) of this subparagraph.

(2) *Determinations made separately for each taxable year.* If section 962 earnings and profits attributable to more than one taxable year are distributed by a foreign corporation the determinations under this section shall be made separately with respect to each such taxable year.

(3) *Source of distributions*—(i) *In general.* Except as otherwise provided in this subparagraph, the provisions of paragraphs (a) through (d) of §1.959–3 shall apply in determining the source of distributions of earnings and profits by a foreign corporation.

(ii) *Treatment of section 962 earnings and profits under §1.959–3.* For purposes of a section 959(c) amount and year classification under paragraph (b) of §1.959–3, a distribution of earnings and profits by a foreign corporation shall be first allocated to earnings and profits other than section 962 earnings and profits (as defined in subparagraph (1) of this paragraph) and then to section 962 earnings and profits. Thus distributions shall be considered first attributable to amounts described in paragraph (b)(1) of §1.959–3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(1) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), secondly to amounts described in paragraph (b)(2) of §1.959–3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(2) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts described in paragraph (b)(3) of §1.959–3 (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year).

(iii) *Allocation to excludable section 962 earnings and profits.* A distribution of section 962 earnings and profits by a foreign corporation for any taxable year shall be considered first attributable to the excludable section 962 earnings and profits (as defined in subparagraph (1)(i) of this paragraph) and then to taxable section 962 earnings and profits.

(iv) *Allocation of deficits in earnings and profits.* A United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of §1.951–1) of a foreign corporation's deficit in earnings and profits (determined under §1.964–1) for any taxable year shall be applied in accordance with the provisions of paragraph (c) of §1.959–3 except that such deficit shall also be applied to taxable section 962 earnings and profits (as defined in subparagraph (1)(ii) of this paragraph).

(4) *Distribution in exchange for stock.* The provisions of this section shall not apply to a distribution of section 962 earnings and profits which is treated as in part or full payment in exchange for stock under subchapter C of chapter 1 of the Internal Revenue Code. The application of this subparagraph may be illustrated by the following example:

*Example.* Individual United States shareholder A owns 60 percent of the only class of stock in foreign corporation M, the basis of which is $10,000. Both A and M Corporation use the calendar year as a taxable year. In each of the taxable years 1964, 1965, and 1966, M Corporation has $1,000 of earnings and profits and $1,000 of subpart F income. With respect to each such amount, A includes $600 in gross income under section 951(a), makes the election under section 962, and pays a United States tax of $132 (22 percent of $600). Accordingly, A increases the basis of his stock in M corporation under section 961(a) by $132 in each of the years 1964, 1965, and 1966, and thus on December 31, 1966, the adjusted basis for A's stock in M Corporation is $10,396. In 1967, M Corporation is completely liquidated (in a transaction described in section 331) and A receives $13,800, consisting of $1,800 of earnings and profits attributable to the amounts which A included in gross income under section 951(a) in 1964, 1965, and 1966, and $12,000 attributable to the other assets of M Corporation. No amount of the $3,404 gain realized by A on such distribution ($13,800 minus $10,396) may be excluded from gross income under section 959(a)(1). However, section 962(d) will not prevent any part of such $3,404 from being treated as a capital gain under section 331.

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

*Example.* (a) M, a controlled foreign corporation is organized on January 1, 1963; A and B, individual United States shareholders, own 50 percent and 25 percent, respectively, of the only class of stock in M Corporation. Corporation M, A, and B use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. For the taxable years 1963, 1964, 1965, and 1966, A and B must include amounts in gross income under section 951(a) with respect to M Corporation. For the years 1963, 1965, and 1966, A makes the election under section 962. On January 1, 1967, B sells his 25-percent interest in M Corporation to A; A satisfies the requirements of paragraph (d) of §1.959–1 so as to qualify as B's successor in interest. As of December 31, 1967, M Corporation's accumulated earnings and profits of $675 (before taking into account distributions made in 1967) applicable to A's interest (including his interest as B's successor in interest) in such corporation are classified under §1.959–3 and this section for purposes of section 962(d) as follows:

CLASSIFICATION OF EARNINGS AND PROFITS FOR PURPOSES OF § 1.962–3

| Year | Section 959(c)(1) | | | Section 959(c)(2) | | | Section 959 (c)(3) |
|---|---|---|---|---|---|---|---|
| | Non-section 962 earnings and profits | Excludable section 962 earnings and profits | Taxable section 962, earnings and profits | Non-section 962 earnings and profits | Excludable section 962 earnings and profits | Taxable section 962 earnings and profits | |
| 1963 | $25 | $11 | $39 | | | | |
| 1964 | 75 | | | $60 | | | $15 |
| 1965 | | | | 75 | $33 | $117 | |
| 1966 | | | | 50 | 22 | 78 | |
| 1967 | | | | | | | 75 |

(b) During 1967, M Corporation makes three separate distributions to A of $200, $208, and $267. The source of such distributions under §1.959–3 and this section is as follows:

| Distribution | Amount | Year | Classification of distributions under sections 959 and 962(d) |
|---|---|---|---|
| No. 1 | $75 | 1964 | (c)(1) non-section 962. |
| | 25 | 1963 | Do. |
| | 11 | 1963 | (c)(1) excludable section 962. |
| | 39 | 1963 | (c)(1) taxable section 962. |
| | 50 | 1966 | (c)(2) non-section 962. |
| Total | 200 | | |
| No. 2 | 22 | 1966 | (c)(2) excludable section 962 |
| | 78 | 1966 | |
| | 75 | 1965 | (c)(2) taxable section 962. |
| | 33 | 1965 | (c)(2) non-section 962. |
| | | | (c)(2) excludable section 962. |
| Total | 208 | | |
| No. 3 | 117 | 1965 | (c)(2) taxable section 962. |
| | 60 | 1964 | (c)(2) non-section 962. |
| | 75 | 1967 | (c)(3). |
| | 15 | 1964 | Do. |
| Total | 267 | | |

(c) A must include $324 in his gross income for 1967. The source of these amounts is as follows:

| Distribution | Amount | Year | Classification |
|---|---|---|---|
| No. 1 | $39 | 1963 | (c)(1) taxable section 962. |
| No. 2 | 78 | 1966 | (c)(2) taxable section 962. |
| No. 3 | 117 | 1965 | Do. |
| | 75 | 1967 | (c)(3). |
| | 15 | 1964 | Do. |
| Total | 324 | | |

(c) *Treatment of shareholder's successor in interest*—(1) *In general.* If a United States person (as defined in §1.957–4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in this section, the rules of paragraphs (a) and (b) of this section shall apply to such acquiring person. However, no exclusion of section 962 earnings and profits under paragraph (a) of this section shall be allowed unless such acquiring person establishes to the satisfaction of the district director his right to such exclusion. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(i) The name, address, and taxable year of the foreign corporation from which a distribution of section 962 earnings and profits is received and of

all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(ii) The name and address of the person from whom the stock interest was acquired;

(iii) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(iv) The amount for which an exclusion under paragraph (a) of this section is claimed; and

(v) Evidence showing that the section 962 earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) subject to an election under §1.962–2, that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amount.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

(2) *Taxes previously deemed paid by an individual United States shareholder.* If a corporate successor in interest of an individual United States shareholder receives a distribution of section 962 earnings and profits, the income, war profits, and excess profits taxes paid to any foreign country or to any possession of the United States in connection with such earnings and profits shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such individual United States shareholder under paragraph (b)(2) of §1.962–1 and section 960(a)(1) for any prior taxable year.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

### § 1.962–4 Transitional rules for certain taxable years.

(a) *Extension of time for making or revoking election.* Paragraphs (b) and (c) of this section provide additional rules with respect to making or revoking an election under section 962 which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing his return (including any extensions of time under section 6081) occurs or occurred on or before January 31, 1966.

(b) *Manner of making election not previously made.* If a United States shareholder who has not previously made an election under section 962 for any taxable year referred to in paragraph (a) of this section desires to make such an election, he may do so by filing his return or an amended return for such taxable year together with a statement setting forth the information required under paragraph (b) of §1.962–2. Such return or amended return and statement shall be filed on or before January 31, 1966.

(c) *Revocation of election previously made.* If a United States shareholder who has made an election under section 962 on or before November 1, 1965, for any taxable year referred to in paragraph (a) of this section desires to revoke such election, he may do so by filing an amended return to which is attached a statement that the election previously made is revoked. Such amended return and statement shall be filed on or before January 31, 1966.

[T.D. 6858, 30 FR 13698, Oct. 28, 1965]

### § 1.963–0 Repeal of section 963; effective dates.

(a) *Repeal of section 963.* Except as provided in paragraphs (b) and (c) of this section, the provisions of section 963 and §§1.963–1 through 1.963–7 are repealed for taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (within the meaning of section 951(b), within which or with which such taxable years of such foreign corporations end.

(b) *Transitional rules for chain or group election*—(1) *In general.* If a United States shareholder (within the meaning of section 951(b) makes either a chain election pursuant to §1.963–1(e) or a group election pursuant to §1.963–1(f) for a taxable year of such shareholder beginning after December 31, 1975, then a foreign corporation shall be includible in such election only if—

(i) It has a taxable year beginning before January 1, 1976, which ends within such taxable year of the United States shareholder, and

(ii) It is either—

(A) A controlled foreign corporation or

(B) A foreign corporation by reason of ownership of stock in which such shareholder indirectly owns (within the meaning of section 958(a)(2)) stock in a controlled foreign corporation to which this subparagraph applies.

(2) *Series rule.* If any foreign corporation in a series of foreign corporations is excluded by subparagraph (i) of this paragraph from a chain or group election of a United States shareholder for its taxable year, then any foreign corporation in which the United States shareholder owns stock indirectly by reason of ownership of stock in such excluded corporation shall also be excluded from such election to the extent of such indirect ownership regardless of when its taxable year begins.

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

*Example.* (a) M is a domestic corporation, A, B, D, and E are controlled foreign corporations, and C is a foreign corporation other than a controlled foreign corporation. All five foreign corporations, each have only one class of stock outstanding. M owns directly all of the stock of A, which in turn owns directly all of the stock of B, which in turn owns directly 60 percent of the stock of D, which in turn owns directly all of the stock of E. M also owns directly 40 percent of the stock of C, which in turn owns directly the remaining 40 percent of the stock of D. M is a United States shareholder with respect to no other foreign corporation. M and B each use the calendar year as the taxable year. A, C, D, and E each use a fiscal year ending on November 30 as the taxable year. For calendar year 1976, M may make either a first-tier election with respect to A, a chain election with respect to C and D (to the extent of M's indirect 16-percent stock interest in D by reason of its direct ownership of 40 percent of the stock of C) or a group election with respect to A, C, D (to the extent of such 16-percent stock interest) and E (to the extent of M's indirect 16-percent stock interest in E).

(b) M's indirect 100 percent stock interest in B will be excluded from any chain or group election made by M for calendar year 1976 since B is a controlled foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(c) M's indirect 60 percent stock interest through A and B in D and E will be excluded from any chain or group election made by M for calendar year 1976 since such 60 percent interests are indirectly owned by M by reason of its indirect ownership of stock in B, which is a foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(d) If C used the calendar year as its taxable year and was therefore excluded from a chain election made with respect to it and D, then D would also be excluded from such an election, since D would then be a foreign corporation in which M owns stock indirectly by reason of ownership of stock in C, which is excluded from such election.

(c) *Deficiency distributions.* The rules relating to deficiency distributions under section 963(e)(2) and §1.963–6 shall continue to apply to a taxable year beginning after the effective date of the repeal of section 963 in which it is determined that a deficiency distribution must be made for an earlier taxable year for which a United States shareholder made an election to secure the exclusion under section 963 but failed to receive a minimum distribution.

(d) *Special adjustments pursuant to section 963 to be taken into account for taxable years subsequent to the repeal of section 963.* If a United States shareholder of a controlled foreign corporation elects to receive a minimum distribution under section 963 for a taxable year, section 963 and the regulations thereunder may require certain elections and adjustments to be made in subsequent taxable years. These elections and adjustments shall be taken into account for subsequent taxable years as if section 963 were still in effect and no election to receive a minimum distribution were made after the effective date of the repeal of section 963. Examples of these elections and special adjustments include, but are not limited to, the election which may be made pursuant to §1.963–3(g)(2), relating to the special extended distribution period, and the special adjustments to be made pursuant to §1.963–4, relating to the minimum overall tax burden test.

[T.D. 7545, 43 FR 19652, May 8, 1978]

### § 1.963–1 Exclusion of subpart F income upon receipt of minimum distribution.

(a) *In general*—(1) *Purpose of section 963.* Section 963 sets forth an exception to section 951(a)(1)(A)(i) by providing that a United States corporate shareholder may exclude from its gross income the subpart F income of a controlled foreign corporation if for the taxable year such shareholder elects such exclusion and, where necessary, receives a distribution of the earnings and profits of such foreign corporation sufficient to bring the aggregate U.S. and foreign income taxes on the pretax earnings and profits of that corporation to a percentage level approaching the U.S. tax rate for such year on the income of a domestic corporation. The election to secure an exclusion under section 963 may be made with respect to a ''single first-tier corporation'' or a ''chain'' or ''group'' of controlled foreign corporations. This section defines the terms ''single first-tier corporations,'' ''chains,'' ''group,'' and certain other terms and prescribes the manner in which such an election is to be made. Section 1.963–2 describes the manner in which the amount of the minimum distribution for any taxable year is to be determined. Section 1.963–3 specifies the distributions counting toward a minimum distribution. Section 1.963–4 sets forth the requirement with respect to a minimum distribution from a chain or group that the overall U.S. and foreign income tax must equal either 90 percent of the U.S. corporate tax rate applied against consolidated pretax and predistribution earnings and profits or, with the application of the special rules set forth in that section, the total U.S. and foreign income taxes which would have been incurred in respect of a pro rata minimum distribution from the chain or group. Section 1.963–5 provides special rules for applying section 963 in certain cases in which the rate of foreign income tax incurred by a foreign corporation varies with the amount of distributions it makes for the taxable year. Section 1.963–6 outlines the deficiency distribution procedure that may be followed if for reasonable cause a U.S. corporate shareholder fails to receive a complete minimum distribution for a taxable year for which it elects the exclusion under section 963. Section 1.963–7 provides transitional rules for the application of section 963 for certain taxable years of U.S. shareholders ending on or before the 90th day after September 30, 1964. Section 1.963–8 provides rules for the determination of the required minimum distribution during the period the §surcharge imposed by section 51 is in effect.

(2) *Conditions for exclusion of subpart F income.* To qualify for an exclusion under section 963 for any taxable year with respect to the subpart F income of a controlled foreign corporation, a corporate United States shareholder must—

(i) Elect such exclusion on or before the last day (including any extensions of time under section 6081) prescribed by law for filing its return of the tax imposed by chapter 1 of the Code for the taxable year;

(ii) Receive, if and to the extent necessary, distributions of the type described in paragraph (a) of §1.963–3 sufficient in amount to constitute a minimum distribution;

(iii) Incur, in the case of a chain or group election, income tax with respect to such minimum distribution sufficient to satisfy the requirements of paragraph (a) of §1.963–4, relating to the minimum overall tax burden; and

(iv) Consent, on or before such last day for making the election, to the regulations under section 963 applicable to such taxable year and to any amendments thereof duly prescribed before such last day.

The making of the election under section 963 by filing the return on or before such last day shall constitute the consent to the regulations under such section prescribed before such last day. For an extension of the time for receiving a minimum distribution and making the consent for certain taxable years ending on or before the 90th day after September 30, 1964, see §1.963–7.

(3) *Subpart F income excluded.* An exclusion under section 963 for a taxable year of a United States shareholder for which the election is made under such section shall apply only to the subpart F income for the taxable year of the single first-tier corporation to which

the election applies or of each controlled foreign corporation in the chain or group to which the election applies. Only those amounts attributable to the stock interest to which the election relates may be excluded. Thus, in case of a first-tier election with respect to stock of a controlled foreign corporation owned directly within the meaning of section 958(a)(1)(A), the corporate United States shareholder may not exclude any subpart F income of such foreign corporation which is includible in its gross income under section 951(a)(1)(A)(i) by virtue of its indirect ownership of stock in such foreign corporation through the operation of section 958(a)(2). Subpart F income of a controlled foreign corporation which is excluded from the gross income of a United States shareholder by reason of the receipt of a minimum distribution to which section 963 applies shall not be considered to be excluded under section 954(b)(1) or section 970(a).

(4) *Affiliated group of corporations.* An affiliated group of domestic corporations which makes a consolidated return under section 1501 for the taxable year shall be treated as a single United States shareholder for purposes of applying section 963 for such year if the common parent corporation in its return for such affiliated group makes any first-tier election, chain election, or group election under section 963 for such affiliated group; in such case, no member of such affiliated group may separately make any first-tier election, chain election, or group election under section 963 for the taxable year. If the common parent of such an affiliated group so making a consolidated return makes no first-tier election, chain election, or group election for such affiliated group, then any member may make a first-tier election, chain election, or group election to the same extent that it could so elect if such affiliated group had not filed a consolidated return; in such case, the affiliated group will not be treated as a single United States shareholder.

(b) *Definitions.* For purposes of section 963 and §§1.963–1 through 1.963–8—

(1) *Controlled foreign corporation.* The term ''Controlled foreign corporation'' shall have the meaning accorded to it by section 957 and the regulations thereunder but shall not include any foreign corporation for a taxable year beginning before January 1, 1963.

(2) *Single first-tier corporation.* The term ''single first-tier corporation'' means a controlled foreign corporation described in paragraph (d) of this section with respect to which a first-tier election has been made for the taxable year.

(3) *Chain.* The term ''chain'' means collectively the foreign corporations described in paragraph (e) of this section with respect to which a chain election has been made for the taxable year.

(4) *Group.* The term ''group'' means collectively the foreign corporations described in paragraph (f) of this section with respect to which a group election has been made for the taxable year.

(5) *First-tier election, etc.* The term ''first-tier election'' means an election described in paragraph (c)(1)(i)(a) of this section; the term ''chain election'' means an election described in paragraph (c)(1)(i)(b) of this section; and the term ''group election'' means an election described in paragraph (c)(1)(ii) of this section.

(6) *Taxable year.* (i) The term ''taxable year of a single first-tier corporation,'' ''taxable year of a corporation in a chain,'' or ''taxable year of a corporation in a group,'' means, respectively, the taxable year of such corporation ending with or within the taxable year of the electing United States shareholder for which is made under paragraph (c)(1) of this section the election establishing it as a single first-tier corporation, a corporation in a chain, or corporation in a group, as the case may be.

(ii) The term ''taxable year'' when used in reference to a chain or group refers collectively to the respective taxable years of the foreign corporations in such chain or group to which applies the election establishing such chain or group status, such taxable year being, in the case of each respective corporation in the chain or group, such corporation's taxable year ending with or within the taxable year of the electing United States shareholder, whether or not such taxable year of the corporation is the same as that of any

other foreign corporation in the chain or group.

(7) *Foreign income tax.* The term ''foreign income tax'' 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, paid or accrued to a foreign country or possession of the United States and taken into account for purposes of sections 901 through 905. Except in determining the foreign tax credit under section 901, the term shall not include any tax which is deemed paid by a foreign corporation under section 902(b).

(c) *Election to exclude subpart F income*—(1) *Foreign corporations included in election.* A corporate United States shareholder may for any taxable year exercise the election to secure an exclusion under section 963 either—

(i)(*a*) Separately with respect to any foreign corporation which as to such shareholder is described in paragraph (d) of this section, and/or

(*b*) Separately with respect to the foreign corporation or corporations which as to such shareholder are in a series described in paragraph (e) of this section, except to the extent of any interest (of such shareholder in any such corporation) with respect to which an election has otherwise been made under this subdivision (i); or

(ii) With respect to all foreign corporations which as to such shareholder are described in paragraph (f) of this section.

(2) *Manner of making election.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 and the consent to the regulations under such section shall be made for a taxable year by filing with the return for such taxable year—

(i) A written statement stating that such election is made for such taxable year,

(ii) The names of the foreign corporations to which the election applies, the taxable year, country or incorporation, earnings and profits (as determined under paragraph (d) of §1.963–2), foreign income tax taken into account under paragraph (e) of §1.963–2, and outstanding capital stock, of each such corporation,

(iii) In case of a group election, the names of all foreign corporations excluded from such group under paragraph (f)(2) and (3) of this section and identifying characterizations for all foreign branches included in, and excluded from, such group under paragraph (f)(4) of this section, together with the authority for such exclusion or inclusion, and

(iv) Such other information relating to the election made as the Commissioner may prescribe by instructions or schedules to support such return.

(3) *Duration of election*—(i) *Year-by-year requirement.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 may be made for each taxable year of the United States shareholder but shall be effective only with respect to the taxable year for which made. An election made for any taxable year shall be irrevocable with respect to that taxable year once the period for the making of such election has expired, except to the extent provided by subdivision (ii) of this subparagraph.

(ii) *Revocation or modification of election for reasonable cause—(a) Conditions under which allowed.* If, after the making of an election under subparagraph (1) of this paragraph, the United States shareholder establishes to the satisfaction of the Commissioner that reasonable cause exists for revocation or modification of such election, it may withdraw that election; change from a group election to first-tier elections and/or chain elections or from a chain election to a first-tier election: change from a first-tier election to a chain election or from first-tier elections and/or chain elections to a group election; or, in the case of a chain or group election, alter the composition of the chain or group by adding or eliminating corporations. The United States shareholder shall be allowed to revoke or modify elections pursuant to this subdivision only once for any taxable year of such shareholder and then only at a time prior to the expiration of the period prescribed by law for making an assessment of the tax imposed by chapter 1 of the Code for such taxable year and for any subsequent taxable year for

which the tax liability of such shareholder would be affected by such revocation or modification of election. The Commissioner may, as a condition to such revocation or modification of the election, require a consent by the United States shareholder under section 6501 to extend, for the taxable year and such subsequent years affected by the revocation or modification, the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties.

(*b*) *Nature of reasonable cause.* Reasonable cause shall be deemed to exist for the revocation or modification of an election only if, after the making of such election, a material and substantial change in circumstances affecting the election occurs which reasonably could not have been anticipated when the election was made and which, to a significant degree, was beyond the control of the electing United States shareholder. For example, reasonable cause would exist if the minimum distribution were computed on the basis of a contested foreign income tax asserted by a foreign tax authority which, as a consequence of litigation occurring after the filing of the United States shareholder's return, is refunded, with the result that the United States shareholder is not entitled under the election which was made to an exclusion under section 963.

(*c*) *Request for revocation or modification.* A United States shareholder desiring to revoke or modify the election shall mail to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224, a letter requesting such revocation or modification; such letter shall set forth the information required by subparagraph (2) of this paragraph with respect to any new election and the facts and circumstances which the shareholder considers reasonable cause for such revocation or modification. The shareholder shall also consent, if required, to the extension of assessment period referred to in (*a*) of this subdivision and shall furnish such other information as may be required by the Commissioner in support of such request. If the Commissioner is satisfied that reasonable cause exists for the revocation or modification, the United States shareholder shall file an amended return consistent with any new election which is made.

(d) *Corporations to which a first-tier election may apply*—(1) *Includible interest.* A corporate United States shareholder may make a first-tier election for the taxable year only with respect to a single controlled foreign corporation in which it owns stock directly within the meaning of section 958(a)(1)(A) and only with respect to the stock so owned. The election must apply to all of the stock so owned by such shareholder and shall relate only to the subpart F income of such corporation which would otherwise be required to be included in gross income by reason of owning such stock. The shareholder may for the same taxable year make a first-tier election with respect to one or more controlled foreign corporations in which it directly owns stock and not with respect to other controlled foreign corporations in which it directly owns stock.

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

*Example 1.* Domestic corporation M directly owns all the one class of stock in each of the controlled foreign corporations A, B, and C. Corporation M may make a first-tier election for a taxable year with respect to any one of corporations A, B, and C; with respect to corporations A and B, respectively; with respect to corporations A and C, respectively; with respect to corporations B and C, respectively; or with respect to corporations A, B, and C, respectively.

*Example 2.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 20 percent of the one class of stock of controlled foreign corporation B. Corporation A directly owns 80 percent of the stock of B Corporation. All such corporations use the calendar year as the taxable year. For 1964, M Corporation makes a first-tier election with respect to corporations A and B, respectively, and receives a minimum distribution from each. An exclusion under section 963 for 1964 will be allowed for all of A Corporation's subpart F income for such year but only for the amount of B Corporation's subpart F income which M Corporation would (without regard to section 963) be required to include in gross income for such year under section 951(a)(1)(A)(i) by reason of directly owning 20

percent of the stock of B Corporation. Corporation M may not exclude any amount which it would be required (without regard to section 963) to include in gross income under section 951(a)(1)(A)(i) for such year with respect to the subpart F income of B Corporation by reason of its indirect ownership (through the operation of section 958(a)(2)) of 80 percent of the stock of B Corporation, unless M Corporation separately elects such exclusion and receives a minimum distribution with respect to such interest. See paragraph (e) of this section relating to chain elections.

(e) *Corporations to which a chain election may apply*—(1) *Includible interests.* A Corporate United States shareholder may make a chain election for the taxable year with respect to one or more controlled foreign corporations in any series which includes only one foreign corporation described in subdivision (i), any one or more controlled foreign corporations described in subdivision (ii), and all foreign corporations described in subdivision (iii) of this subparagraph:

(i) A foreign corporation, whether or not a controlled foreign corporation, to the extent of stock owned by such shareholder—

(*a*) Directly (within the meaning of section 958(a)(1)(A)) in such corporation, or

(*b*) Indirectly (through the operation of section 958(a)(2)) by virtue of the direct ownership (within the meaning of section 958(a)(1)(A)) of stock in such corporation by a foreign trust, foreign estate, or foreign partnership, in which such shareholder is a beneficiary or partner;

(ii) To the extent that such shareholder so elects, any controlled foreign corporation to the extent that, by reason of its ownership of stock described in subdivision (i) of this subparagraph, such shareholder indirectly owns within the meaning of section 958(a)(2) stock in such controlled foreign corporation; and

(iii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation included in the series by reason of subdivision (ii) of this subparagraph.

Notwithstanding the preceding sentence, a corporate United States shareholder may make a chain election for the taxable year with respect to a single foreign corporation, but only if such foreign corporation is a controlled foreign corporation described in subdivision (i)(*b*) of this subparagraph. The shareholder may for the same taxable year make a chain election with respect to one or more series, and not with respect to other series, to which this subparagraph applies.

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

*Example 1.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B. Corporation M may make a chain election with respect to corporations A and B.

*Example 2.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns all the one class of stock of controlled foreign corporation C. Corporation M also directly owns 20 percent of the stock of B Corporation. Corporation M may make a chain election either with respect to corporations A and B or with respect to corporations A, B, and C. In either case corporations B and C can be included in the chain only to the extent of M Corporation's indirect 80-percent stock interest in such corporations by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may also make a chain election with respect to corporations B and C, in which case the chain would include corporations B and C to the extent of the 20-percent stock interest which M Corporation owns directly in B Corporation, and indirectly owns in C Corporation by reason of its direct ownership of such stock interest in B Corporation.

*Example 3.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporations B and C. Corporation M may make a chain election either with respect to corporations A, B, and C; or with respect to corporations A and B; or with respect to corporations A and C.

*Example 4.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 40 percent of the one class of stock of foreign corporation B, not a controlled foreign corporation. Corporation A directly owns 30 percent of

the one class of stock of controlled foreign corporation C, and B Corporation directly owns the remaining 70 percent of the stock of C Corporation. Corporation M may make a chain election with respect to corporations A and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 30-percent stock interest in such corporation by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may instead make a chain election with respect to corporations B and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 28-percent stock interest in such corporation by reason of its direct ownership of 40 percent of the stock of B Corporation. In the latter case, B Corporation must be included in the chain even though it is not a controlled foreign corporation. Corporation M may also make two chain elections, one with respect to corporations A and C, and the other with respect to corporations B and C, as described above.

*Example 5.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporation B and 40 percent of the one class of stock of foreign corporation C, not a controlled foreign corporation. Corporation M may make a chain election with respect to corporations A and B. Corporation C may not be included in the chain since M Corporation does not, by reason of its indirect ownership of stock in C Corporation, own stock in any controlled foreign corporation.

*Example 6.* Domestic corporation M directly owns a 60-percent partnership interest in foreign partnership D and by reason of such interest owns indirectly, within the meaning of section 958(a)(2), 60 percent of the one class of stock of controlled foreign corporation E (all of the stock of which is directly owned by D Partnership) and 60 percent of the one class of stock of controlled foreign corporation F (all the stock of which is also directly owned by D Partnership). By virtue of its direct interest in D Partnership, M Corporation may make a chain election with respect to E Corporation alone or with respect to F Corporation alone. Corporation M may also make two chain elections, one with respect to E Corporation, the other with respect to F Corporation.

(f) *Corporations to which a group election may apply*—(1) *Includible interests.* A corporate United States shareholder may make a group election for the taxable year with respect to a group of foreign corporations which includes, except as provided in subparagraphs (2) and (3) of this paragraph, all of the following corporations:

(i) All controlled foreign corporations in which such shareholder owns stock either directly within the meaning of section 958(a)(1)(A) or indirectly within the meaning of section 958(a)(2), and

(ii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder, indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation described in subdivision (i) of this subparagraph.

A first-tier election or chain election may not be made for any taxable year with respect to any foreign corporation which for such taxable year has been excluded under subparagraph (2) or (3) of this paragraph from a group with respect to which a group election has been made for such year. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B and is a United States shareholder with respect to no other foreign corporation. M Corporation may make a group election with respect to corporations A and B.

*Example 2.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, and B Corporation directly owns 80 percent of the one class of stock of controlled foreign corporation C. Corporation M is a United States shareholder only with respect to corporations A, B, and C. If M Corporation makes a group election, it must make the election with respect to corporations A, B, and C.

*Example 3.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. Corporation A directly owns 70 percent of the one class of stock of controlled foreign corporation C. Corporation B directly owns 40 percent of the one class of stock of foreign corporation D, not a controlled foreign corporation, and D Corporation directly owns 30 percent of the stock of C Corporation. Corporation M is a United States shareholder with respect to no other foreign corporation. If M Corporation makes a group election, it must make the election with respect to corporations A, B, C, and D. Corporation D must be included in the group even though it is not a controlled foreign corporation.

(2) *Less developed country corporations.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a group election every controlled foreign corporation which is a less developed country corporation as defined in section 955(c) and §1.955–5 for the taxable year of such foreign corporation ending with or within such taxable year of the shareholder but only if, by reason of ownership of stock in such foreign corporation, the shareholder does not indirectly own within the meaning of section 958(a)(2) stock in any other controlled foreign corporation which is not a less developed country corporation for its taxable year ending with or within such taxable year of the shareholder. The election under this subparagraph to exclude a less developed country corporation is required to be made with respect to all less developed country corporations of which the electing shareholder is a United States shareholder and which, under the preceding sentence, are eligible to be excluded.

*Example.* Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, not less developed country corporations. Corporation A directly owns all of the one class of stock of controlled foreign corporation C, B Corporation directly owns all the one class of stock of controlled foreign corporation D, and D Corporation directly owns all the one class of stock of controlled foreign corporation E. Corporations C, D, and E are less developed country corporations under section 955(c). Corporation M may make a group election with respect to corporations A, B, C, D, and E; it may also exclude the less developed country corporations and make a group election with respect to corporations A and B only. If E Corporation were not a less developed country corporation, however, neither D Corporation nor E Corporation could be excluded since, by reason of ownership of stock in D Corporation, M Corporation would indirectly own stock in E Corporation, a controlled foreign corporation which is not a less developed country corporation.

(3) *Foreign corporations with blocked foreign income.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a group election any foreign corporation with respect to which it is established to the satisfaction of the Commissioner that an amount of earnings and profits of such corporation sufficient to constitute its share of a pro rata minimum distribution (as defined in paragraph (a)(2)(i) of §1.963–4) by the group cannot be distributed to such United States shareholder because of currency or other restrictions or limitations imposed under the laws of any foreign country. If, by reason of ownership of stock in a foreign corporation which is excluded from the group under the preceding sentence, a United States shareholder owns stock in another foreign corporation an amount of whose earnings and profits sufficient to constitute its share of a pro rata minimum distribution by the group cannot be distributed to such United States shareholder through such excluded foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country, such other foreign corporation must also be excluded from the group for purposes of the group election. For purposes of this subparagraph, the determination as to whether earnings and profits cannot be distributed because of currency or other restrictions or limitations imposed under the laws of a foreign country shall be made in accordance with the regulations under section 964(b), except that such restrictions or limitations shall be considered to exist notwithstanding that distributions are made by the foreign corporation in a foreign currency if, assuming the distributee to be the United States shareholder, the distributed amounts would be excludable from the distributee's gross income for the taxable year of receipt under a method of accounting in which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Treatment of foreign branches of domestic corporation as foreign subsidiary corporations*—(i) *In general.* If the United States shareholder so elects, all branches (other than a branch excluded under subdivision (iii) of this subparagraph) maintained by such shareholder in foreign countries and possessions of the United States shall be treated, for purposes of applying subparagraph (1) of this paragraph, as wholly owned foreign subsidiary corporations of such shareholder organized under the laws

of such respective foreign countries or possessions of the United States. Each branch treated as such a foreign subsidiary corporation shall be included in the group by the United States shareholder making the group election and shall be regarded, for purposes of section 963, as having distributed to such shareholder all of its earnings and profits for the taxable year, irrespective of the statutory percentage applied for the taxable year under paragraph (b) of §1.963–2. As used in this subparagraph, the term ''branch'' shall mean a permanent organization maintained in a foreign country or a possession of the United States to engage in the active conduct of a trade or business. Whether a permanent organization is maintained in a foreign country or possession of the United States shall depend upon the facts and circumstances of the particular case. As a general rule, a permanent organization shall be considered to be maintained in such country or possession if the United States shareholder maintains therein a significant work force or significant manufacturing, mining, warehousing, sales, office, or similar business facilities of a fixed or permanent nature. If a United States shareholder so operates that it satisfies the branch test with respect to each of several foreign countries or possessions, each such branch shall be treated as a separate wholly owned foreign subsidiary corporation organized under the laws of such country or possession in respect of which it satisfies such test. In no event shall a branch which is treated as a wholly owned foreign subsidiary corporation under this subparagraph be also treated as a less developed country corporation. The term ''possession of the United States,'' as used in this subparagraph, shall be construed to have the same meaning as that contained in paragraph (b)(2) of §1.957–3.

(ii) *Earnings and profits and taxes of a foreign branch.* The earnings and profits (or deficit in earnings and profits) for a taxable year of a branch treated as a wholly owned foreign subsidiary corporation under this subparagraph shall be determined by applying against the gross income (as defined in section 61) of the branch its allowable deductions other than any net operating loss deduction. Any excess of gross income over such deductions shall constitute earnings and profits. Any excess of such deductions over gross income shall constitute a deficit in earnings and profits. For purposes of this subparagraph, the gross income of a branch is that which is produced by the trade or business activities separately conducted by it outside the United States and which is derived from sources without the United States under the provisions of sections 861 through 864 and the regulations thereunder; the allowable deductions of a branch are those which are properly allocable to or chargeable against its gross income and which are allowable under chapter 1 of the Code to the corporation of which it is a branch. Only the foreign income tax allocable to the gross income of the branch shall be considered paid or accrued by such branch. Solely for the purpose of determining under paragraph (c)(2) of §1.963–2 the effective foreign tax rate of a group which includes a branch treated as a wholly owned foreign subsidiary corporation, the foreign income tax considered paid or accrued by the branch shall be treated as an allowable deduction of such branch even though the United States shareholder chooses to take the benefits of section 901 for the taxable year.

(iii) *Excluded branches.* For purposes of subdivision (i) of this subparagraph, a branch maintained by the United States shareholder in a possession of the United States shall not be treated as a wholly owned foreign subsidiary corporation of the United States shareholder for the taxable year unless such branch would be a controlled foreign corporation (as defined in section 957 and the regulations thereunder) for such taxable year if it were incorporated under the laws of such possession and unless the gross income of such shareholder for such taxable year includes for purposes of the tax imposed by Chapter 1 of the Code the income, if any, derived by such shareholder from sources within possessions of the United States, as determined under the provisions of sections 861 through 864 and the regulations thereunder.

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

*Example 1.* Throughout 1964, domestic corporation M directly owns all of the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation engages in foreign country X in the manufacture and sale of steel tubing and rods, maintaining therein a significant work force and significant manufacturing and sales facilities for such purpose. Corporation M also engages in foreign country Y in the mining and sale of iron ore, maintaining therein a significant work force and substantial mining and sales facilities for such purpose. For 1964, M Corporation may make a group election with respect to corporations A and B and the branches operated in country X and country Y, treating such branches as wholly owned foreign subsidiary corporations. If corporation M elects to include one such branch in the group election, it must include both.

*Example 2.* Throughout 1964, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation exports tractors to foreign country Z, in which country its sole activities consist of arranging for title to the tractors to pass to the purchasers in that country. Corporation M's only facility in country Z in 1964 is a small rented office, and its work force therein consists only of a few clerical employees. The activities of M Corporation in country Z do not constitute the maintenance of a branch therein for purposes of this subparagraph. Corporation M may make a group election, only with respect to corporations A and B.

[T.D. 6759, 29 FR 13325, Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

### § 1.963–2 Determination of the amount of the minimum distribution.

(a) *Application of statutory percentage to earnings and profits.* The amount of the minimum distribution required to be received by a United States shareholder with respect to stock to which the election under paragraph (c) of § 1.963–1 applies for the taxable year in order to qualify for a section 963 exclusion for such year shall be the amount, if any, determined by the multiplication of the statutory percentage applicable for the taxable year by—

(1) In the case of a first-tier election, such shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits for the taxable year of the single first-tier corporation to which the election relates,

(2) In the case of a chain election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the chain to which the election relates, or

(3) In the case of a group election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the group to which the election relates.

For the requirement that the overall United States and foreign income tax incurred in respect of a minimum distribution from a chain or group must equal or exceed either 90 percent of the United States corporate tax rate applied against pretax and predistribution consolidated earnings and profits or, with the application of the special rules set forth therein, must equal or exceed the overall United States and foreign income tax which would have resulted from a pro rata minimum distribution, see paragraph (a)(1) of § 1.963–4.

(b) *Statutory percentage.* The statutory percentage (referred to in paragraph (a) of this section) for the taxable year shall be determined by applying the effective foreign tax rate (as defined in paragraph (c) of this section) for such year with respect to the single first-tier corporation, chain, or group, as the case may be, against—

(1) The table set forth in section 963(b)(1) in the case of an election to secure an exclusion under section 963 for a taxable year of the United States shareholder beginning in 1963 and a taxable year entirely within the surcharge period ending before January 1, 1970.

(2) The table set forth in section 963(b)(2) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning in 1964 or for a taxable year of such shareholder beginning in 1969

and ending in 1970 to the extent subparagraph (B) of section 963(b)(3) applies,

(3) The table set forth in section 963(b)(3) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning after December 31, 1964 except a taxable year which includes any part of the surcharge period, or

(4) The table set forth in paragraph (b) of §1.963–8 in the case of an election to secure an exclusion under section 963 for the calendar year 1970.

*Example.* Domestic corporation M owns all the one class of stock in controlled foreign corporation A. Corporation M uses the calendar year as its taxable year, and A Corporation uses a fiscal year ending August 31. For 1964, M Corporation makes a first-tier election in order to exclude from gross income for such year the subpart F income of A Corporation for its taxable year ending on August 31, 1964. Although, such election applies to the taxable year of A Corporation beginning on September 1, 1963, the applicable table, for purposes of determining the statutory percentages to be used under paragraph (a) of this section for the taxable year, is that set forth in section 963(b)(2), which relates to taxable years of United States shareholders beginning in 1964. Thus, if for the taxable year of A Corporation ending August 31, 1964, the effective foreign tax rate is 30 percent, A Corporation would have to distribute 72 percent of its earnings and profits for such year in order for M Corporation to be entitled to an exclusion under section 963 for 1964.

(c) *Effective foreign tax rate*—(1) *Single first-tier corporation.* For purposes of section 963 the term ''effective foreign tax rate'' for a taxable year means, with respect to a single first-tier corporation, the percentage which—

(i) The United States shareholder's proportionate share (as determined under paragraph (e)(1) of this section) of the foreign income tax of such corporation for such taxable year is of—

(ii) The sum of—

(*a*) The United States shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits of such corporation for such taxable year, and

(*b*) The amount referred to in subdivision (i) of this subparagraph.

(2) *Chain or group of corporations.* For purposes of section 963, the term ''effective foreign tax rate'' for a taxable year means, with respect to a chain or group, the percentage which—

(i) The consolidated foreign income taxes (as determined under paragraph (e)(2) of this section) of such chain or group with respect to the United States shareholder for such taxable year is of—

(ii) The sum of—

(*a*) The consolidated earnings and profits (as determined under paragraph (d)(3) of this section) of such chain or group with respect to such United States shareholder for such taxable year, and

(*b*) The amount referred to in subdivision (i) of this subparagraph.

(3) *Treatment of United States tax as foreign tax.* For the purpose solely of determining the effective foreign tax rate under this paragraph, if a foreign corporation has pretax earnings and profits attributable to income from sources within the United States for the taxable year upon which it pays United States income tax and if distributions from the earnings and profits of such corporation for such year to the electing United States shareholder with respect to stock to which the election to secure an exclusion under section 963 relates do not entitled such shareholder to the dividends-received deduction under section 245, the amount of the United States income tax shall be taken into account as though such tax were foreign income tax. The amount so treated as foreign income tax shall not exceed 90 percent of an amount determined by multiplying such pretax earnings and profits attributable to income from sources within the United States by a percentage which is the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the United States shareholder.

(d) *Determination of proportionate share of earnings and profits and consolidated earnings and profits*—(1) *Earnings and profits of foreign corporations.* For purposes of §§1.963–1 through 1.963–8, the earnings and profits, or deficit in earnings and profits, for the taxable year, of a single first-tier corporation or of a foreign corporation in a chain or group shall be the amount of its

earnings and profits for such year, determined under section 964(a) and §1.964–1 but without reduction for foreign income tax or for distributions made by such corporation, less—

(i) In the case of a foreign corporation included in a chain or group, the amount of any distributions received (computed without reduction for any income tax paid or accrued by such corporation with respect to such distributions) by such corporation during its taxable year from the earnings and profits (whether or not from earnings and profits of the taxable year to which the election under section 963 applies) of another foreign corporation in the chain or group.

(ii) In the case of every foreign corporation, the amount of foreign income tax paid or accrued by such corporation during its taxable year other than foreign income tax referred to in subdivision (i) and (iii) of this subparagraph, and

(iii) In the case of a foreign corporation included in a chain or group, the foreign income tax paid or accrued by such corporation with respect to distributions from the earnings and profits of any other foreign corporation in the chain or group for the taxable year of such other corporation to which the election under section 963 applies, but only if the U.S. shareholder chooses under this subdivision to take such tax into account in determining the effective foreign tax rate rather than count it toward the amount of the minimum distribution as provided in paragraph (b)(2) of §1.963–3.

In the event that the foreign income tax of a corporation included in a chain or group depends upon the extent to which distributions are made by such corporation, the amount of foreign income tax referred to in subdivision (ii) of this subparagraph shall, only for purposes of determining the effective foreign tax rate, be the amount which would have been paid or accrued if no distributions had been made. For the rules in other cases involving corporations whose foreign income tax varies with distributions, see §1.963–5. For the manner of computing the earnings and profits of a foreign branch treated as a wholly owned foreign subsidiary corporation see paragraph (f)(4)(ii) of §1.963–1.

(2) *Shareholder's proportionate share of earnings and profits*—(i) *Corporation with earnings and profits*—(*a*) *In general.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of the earnings and profits of a foreign corporation (not including a foreign branch described in (*b*) of this subdivision) for its taxable year shall be the share which such shareholder would receive if the total amount of such corporation's earnings and profits, as determined under subparagraph (1) of this paragraph, for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation.

(*b*) *Foreign branch treated as a foreign subsidiary corporation.* A United States shareholder's proportionate share of the earnings and profits, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of §1.963–1 shall be the total earnings and profits of such branch for the taxable year, as determined under paragraph (f)(4)(ii) of such section.

(*c*) *Indirectly held foreign corporations.* If the proportionate share to be determined is of earnings and profits of a foreign corporation the stock of which is owned by the United States shareholder by reason of its ownership of stock (with respect to which the election relates) in another corporation, such shareholder's proportionate share of such earnings and profits for the taxable year shall be determined on the basis of the amount such shareholder would receive from such foreign corporation with respect to stock in such foreign corporation if there were distributed for the taxable year all such earnings and profits, as determined under subparagraph (1) of this paragraph, and of all the earnings and profits of all other corporations through

which such earnings and profits must pass in order to be received by such shareholder with respect to the stock to which the election relates. For purposes of the preceding sentence, the amount received by the shareholder from the earnings and profits of a foreign corporation shall be determined without taking into account deductions (whether or not allowable under chapter 1 of the Code) of other foreign corporations through which such earnings and profits are distributed.

(*d*) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, the earnings and profits of such corporation for such year which shall be taken into account with respect to any one class of such stock shall be the earnings and profits which would be distributed with respect to such class if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year, on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation. If an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. For example, if a controlled foreign corporation, using the calendar year as its taxable year, has earnings and profits for 1963 of $100 accumulated at December 31, 1963, and an arrearage of $150 for such year in respect of preferred stock, the earnings and profits for 1964 attributable to such arrearage may not exceed $50 ($150 − $100).

(*e*) *Discretionary power to allocate earnings to different classes of stock.* If the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the power ordinarily exercised by the board of directors of a domestic corporation, the allocation of such earnings and profits to such classes shall be made for purposes of this subdivision as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share, unless a different method of allocation of such earnings and profits is made by such body not later than 90 days after the close of such taxable year.

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

*Example 1.* Domestic corporation M directly owns 80 percent of the one class of stock of controlled foreign corporation A, which directly owns 60 percent of the one class of stock of controlled foreign corporation B. Each such corporation has earnings and profits of $70 for the taxable year, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of the earnings and profits is $56 (0.80×$70) as to A Corporation and $33.60 (0.80×0.60×$70) as to B Corporation.

*Example 2.* Throughout 1964 controlled foreign corporation A, which uses the calendar year as the taxable year, has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, noncumulative preferred stock with a par value of $100 per share. Corporation A has earnings and profits of $1,000, for 1964, as determined under subparagraph (1) of this paragraph. In such case, $360 (0.06×$100×60) of earnings and profits would be taken into account with respect to the preferred stock and $640 ($1,000 − $360), with respect to the common stock. Thus, if a United States shareholder owns 10 shares of common stock and 30 shares of preferred stock for 1964, its proportionate share of the earnings and profits for such year is $340 ([10/40×$640]+[30/60×$360]).

(ii) *Deficit in earnings and profits of a corporation in a chain or group.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of a deficit in earnings and profits of a foreign corporation in a chain or group for a taxable year shall be the portion of such deficit which, if such corporation had earnings and profits for such year as determined under subparagraph (1) of this paragraph and all of such earnings and profits were distributed on the date described in subdivision (i)(*a*) of this subparagraph, the share of such

earnings and profits such shareholder would receive bears to the total of the earnings and profits which would be so distributed on such date. For the determination of the deficit of a foreign branch treated as a wholly owned foreign subsidiary corporation and included in a group, see paragraph (f)(4)(ii) of §1.963–1. A United States shareholder's proportionate share of the deficit of such a branch shall be the total deficit of such branch for the taxable year.

(iii) *Controlled foreign corporation for part of year.* If—

(*a*) Stock in a foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation for which such corporation is a controlled foreign corporation to which applies an election by such shareholder to secure an exclusion under section 963 with respect to such stock, or

(*b*) Stock in a foreign corporation which is not a controlled foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation on which another foreign corporation (which, by reason of the stock so owned, is owned by such shareholder within the meaning of section 958(a)) is a controlled foreign corporation to which applies an election by such shareholder to secure an exclusion under section 963 with respect to such stock,

the earnings and profits of such foreign corporation for the taxable year which are taken into account in determining such shareholder's proportionate share thereof shall be an amount of such earnings and profits, determined as provided in subparagraph (1) of this paragraph, which bears to the total of such earnings and profits the same ratio which the part (computed on a daily basis) of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation) bears to the total taxable year. If the United States shareholder by sufficient records and accounts establishes to the satisfaction of the district director the gross income received or accrued, and the deductions paid or accrued, for the part of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation), the amount of earnings and profits based on such records and accounts may be used in lieu of the amount determined under the preceding sentence. The application of this subdivision may be illustrated by the following examples:

*Example 1.* Domestic corporation M on June 30, 1963, purchases 60 percent of the one class of stock of A Corporation which on July 1 becomes a controlled foreign corporation and remains such throughout the remainder of 1963. Both corporations use the calendar year as the taxable year. Corporation M makes a first-tier election with respect to A Corporation. For 1963, A Corporation has $100 of earnings and profits, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of such earnings and profits for 1963 is $30.25 (0.60×[184/365×$100]).

*Example 2.* (a) Throughout 1963 domestic corporation M directly owns 20 percent of the one class of stock of foreign corporation A, not a controlled foreign corporation at any time, which directly owns 50 percent of the one class of stock of foreign corporation B, which becomes a controlled foreign corporation on July 1, 1963, and remains such throughout the remainder of 1963. All such corporations use the calendar year as the taxable year. Each of corporations A and B has earnings and profits for 1963 of $100, as determined under subparagraph (1) of this paragraph. Corporation M makes a chain election for 1963 with respect to corporations A and B. Corporation M's proportionate share of the earnings and profits of A Corporation for 1963 is $10.08 (0.20×[184/365×$100]). Corporation M's proportionate share of the earnings and profits of B Corporation for 1963 is $5.04 (0.20×0.50×[184/365×$100]).

(b) If B Corporation had been a controlled foreign corporation throughout 1963, M Corporation's proportionate share of the earnings and profits of corporations A and B for 1963 would have been $20 (0.20×$100) and $10 (0.20×0.50×$100), respectively.

(c) If corporations A and B had each been a controlled foreign corporation only for the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $9.92 (0.20×[181/365×$100]) and $4.98 (0.20×0.50×[181/365× $100]), respectively.

(d) If A Corporation had been a controlled foreign corporation throughout 1963 or during the period of July 1, 1963, through December 31, 1963, but B Corporation had been a controlled foreign corporation only during the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $20 (0.20×$100) and $4.96 (0.20×0.50×[181/365×$100]), respectively.

(3) *Consolidated earnings and profits with respect to United States shareholder.* The consolidated earnings and profits of a chain or group with respect to any United States shareholder for the taxable year shall be the sum of such shareholder's proportionate shares of the earnings and profits, and of the deficit in earnings and profits, determined under subparagraph (2) of this paragraph, for such year of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(e) *Foreign income taxes used in determining effective foreign tax rate.* For purposes of determining the effective foreign tax rate under paragraph (c) of this section—

(1) *Shareholder's proportionate share of taxes of a foreign corporation.* The foreign income tax of a foreign corporation for a taxable year shall consist of the foreign income tax referred to in paragraph (d)(1)(ii) of this section with respect to such year and, if the United States shareholder chooses to take the foreign income tax described in paragraph (d)(1)(iii) of this section into account in determining the effective foreign tax rate of a chain or group which includes such foreign corporation, the foreign income tax referred to in such paragraph with respect to such year. A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 applies, of the foreign income tax of such foreign corporation for a taxable year shall be the same proportion of such foreign income tax that such shareholder's proportionate share (as determined under paragraph (d)(2)(i) of this section) of the earnings and profits of such corporation for such year bears to the total earnings and profits of such corporation for such year. A United States shareholder's proportionate share of the foreign income tax, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of § 1.963–1 shall be the total foreign income tax of such branch for the taxable year.

(2) *Consolidated foreign income taxes with respect to United States shareholder.* The consolidated foreign income taxes of a chain or group with respect to a United States shareholder for the taxable year of such chain or group shall be the sum of such shareholder's proportionate shares (as determined under subparagraph (1) of this paragraph) of the foreign income tax of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* If a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of § 1.963–3, then any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

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

*Example 1.* For 1966, domestic corporation M makes a first-tier election with respect to controlled foreign corporation A, 80 percent of the one class of stock of which M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for foreign income tax) of $100 with respect to which it pays foreign income tax of $30. Its earnings and profits are $70 ($100 − $30). Corporation M's proportionate share of such earnings and profits is $56 (0.80×$70), and its proportionate share of the foreign income tax is $24 ($56/$70×$30). The effective foreign tax rate is 30 percent ($24/[$56+$24]). Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $38.64 (0.69×$56).

*Example 2.* For 1966, domestic corporation M makes a first-tier election with respect to

controlled foreign corporation A, all of whose one class of stock M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for income tax) of $100, of which $40 is attributable to income from sources within the United States on which $12 United States income tax is paid. The foreign country in which A Corporation is incorporated imposes an income tax at 30 percent on the $100 but allows a credit against its tax for the $12 of United States income tax, so that it imposes a net foreign income tax of $18 for 1966. In determining the effective foreign tax rate of A Corporation for 1966, such $12 of United States income tax may be treated as foreign income tax to the extent it does not exceed $17.28 ($40×0.90×0.48). Corporation A has earnings and profits of $70 for 1966. Although A Corporation's effective foreign tax rate for 1966 is 30 percent, determined by dividing $30 by the sum of $70 plus $30, none of the United States tax which is taken into account in determining such rate shall be treated as foreign income tax for purposes of determining the foreign tax credit of M Corporation under section 902. Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $48.30 (0.69×$70).

*Example 3.* Domestic corporation M directly owns throughout 1966, 60 percent of the one class of stock of controlled foreign corporation A, not a less developed country corporation under section 902(d), which has for 1966 earnings and profits of $70 (all of which is attributable to subpart F income) after having paid foreign income tax of $30. Both corporations use the calendar year as the taxable year. Corporation A is created under the laws of a foreign country which imposes a 6-percent dividend withholding tax. Corporation M would be required, but for section 963, to include $42 (0.60×$70) of A Corporation's subpart F income in gross income under section 951(a)(1)(A)(i). For 1966, however, M Corporation makes a first-tier election with respect to A Corporation. Since the tax withheld on distributions made by A Corporation is considered to have been paid by M Corporation, the effective foreign tax rate applicable to A Corporation for 1966 is only 30 percent, the percentage which such $30 of foreign income tax is of $100 (the sum of $30 plus $70). Thus, the statutory percentage under section 963(b) for 1966 is 69 percent. The amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is the distribution M Corporation will receive if A Corporation distributes 69 percent of its earnings and profits for 1966. Thus, if M Corporation receives a distribution of 69 percent of its proportionate share of such earnings and profits or $28.98 (0.69×0.60×$70), it may exclude from gross income for 1966 $42 otherwise required to be included in gross income under section 951(a)(1)(A)(i) and will determine its income tax, assuming no other income and no surtax exemption under section 11(c), as follows:

| | |
|---|---|
| Dividend | $28.98 |
| Gross-up under section 78 ($28.98/ $70×$30) | 12.42 |
| Taxable income | 41.40 |
| U.S. tax before foreign tax credit ($41.40×0.48) | 19.87 |
| Foreign tax credit ($12.42+[0.06 ×$28.98]) | 14.16 |
| U.S. tax payable | 5.71 |

*Example 4.* (a) For 1966 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock it directly owns, and controlled foreign corporation B, all of whose one class of stock is directly owned by A Corporation. Both foreign corporations are subject to a foreign income tax at a flat rate of 30 percent, and all corporations use the calendar year as a taxable year. For 1966, B Corporation has pretax earnings and profits of $100 and distributes $51.50. For 1966, A Corporation has pretax earnings and profits of $151.50, consisting of $100 from selling activities and $51.50 received as a distribution from B Corporation, upon which it pays a foreign income tax of $45.45 (i.e., 30 percent of $151.50).

(b) Corporation M chooses under paragraph (d)(1)(iii) of this section to take the foreign tax paid by A Corporation on the dividend received from B Corporation into account in determining the effective foreign tax rate of the chain rather than count it toward the amount of the minimum distribution. Thus, to determine consolidated earnings and profits of the chain for 1966, A Corporation's pretax earnings and profits of $151.50 are first reduced by the intercorporate dividend of $51.50 received from B Corporation so that A Corporation has pretax and predistribution earnings and profits of $100 ($151.50 less $51.50). Corporation A's pretax and predistribution earnings and profits of $100 are then reduced by the foreign income tax of $30 (30 percent of $100) paid on such earnings and profits, resulting in predistribution earnings and profits of $70 ($100 less $30). Since M Corporation chooses to count toward the effective foreign tax rate, rather than toward the minimum distribution, A Corporation's foreign income tax of $15.45 (0.30×51.50) imposed on the dividend received from B Corporation, such predistribution earnings and profits of $70 of A Corporation are further reduced by such $15.45 of tax to $54.55 ($70 − $15.45). Corporation B, having received no dividends from any other corporation in the chain, has predistribution earnings and profits of $70 ($100 less foreign income tax of $30).

(c) The consolidated earnings and profits of the chain for 1966 are $124.55 ($54.55+$70). The

consolidated foreign income taxes for such year are $75.45 ($30+$15.45+$30). The effective foreign tax rate of the chain for 1966 is 37.73 percent ($75.45/[$124.55+$75.45]). The statutory percentage for 1966 under section 963(b)(3) is 51 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the chain is $63.52 (0.51×$124.55).

*Example 5.* The facts are the same as in example 4 except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax of $15.45 paid by A Corporation on the distribution of $51.50 received from B Corporation. In such case, the consolidated earnings and profits of the chain are $140 ($70+$70) and the consolidated foreign income taxes are $60 ($30+$30), the latter amount being determined without taking into account A Corporation's foreign income tax of $15.45 on the distribution of $51.50 received from B Corporation. The effective foreign tax rate for 1966 is 30 percent ($60/[$140+$60]), and the statutory percentage under section 963(b) is 69 percent. Thus, the amount of the minimum distribution which must be made from the 1966 consolidated earnings and profits of the chain is $96.60 (0.69×$140). For the counting of such $15.45 of A Corporation's tax toward the $96.60 amount of the minimum distribution, see paragraph (b)(2) of § 1.963–3.

*Example 6.* For 1966 domestic corporation M directly owns the following percentages of the one class of stock of the following controlled foreign corporations in respect of which it makes a group election: 80 percent of A Corporation, 60 percent of B Corporation, and 70 percent of C Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). Each foreign corporation makes distributions during 1966. The consolidated earnings and profits, and the consolidated foreign income taxes, of the group for 1966 with respect to M Corporation, and the amount of the minimum distribution which M Corporation must receive, are determined as follows, based on the earnings and profits and foreign income tax shown in the following table:

| | Controlled foreign corporations | | |
|---|---|---|---|
| | A | B | C |
| Predistribution and pretax earnings and profits | $100 | $100 | $100.00 |
| Foreign income tax | 15 | 25 | 35.00 |
| Predistribution earnings and profits | 85 | 75 | 65.00 |
| M Corporation's proportionate share of earnings and profits: | | | |
| (0.80×$85) | 68 | ..... | ..... |
| (0.60×$75) | ..... | 45 | ..... |
| (0.70×$65) | ..... | ..... | 45.50 |
| Consolidated earnings and profits with respect to M Corporation ($68+$45+$45.50) | ..... | ..... | 158.50 |
| M Corporation's proportionate share of foreign income tax: | | | |
| ($15×[$68/$85]) | 12 | ..... | ..... |
| ($25×[$45/$75]) | ..... | 15 | ..... |
| ($35×[$45.50/$65]) | ..... | ..... | 24.50 |
| Consolidated foreign income taxes with respect to M Corporation ($12+$15+$24.50) | ..... | ..... | 51.50 |

The effective foreign tax rate for 1966 is 24.5 percent ($51.50/[$158.50+$51.50]) and the statutory percentage under section 963(b)(3) for such year is 76 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the group is $120.46 (0.76×$158.50).

*Example 7.* (a) For 1966 domestic corporation M makes a chain election with respect to the following controlled foreign corporations: A Corporation, 80 percent of whose one class of stock M Corporation owns directly; B Corporation, 60 percent of whose one class of stock is directly owned by A Corporation; and C Corporation, 70 percent of whose one class of stock is directly owned by B Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). The predistribution and pretax earnings and profits of each foreign corporation are $100. Each foreign corporation pays a flat rate of foreign income tax on all income computed without reduction for dividends paid and determined by including dividends received. Such rate is 15 percent for A Corporation, 25 percent for B Corporation, and 35 percent for C Corporation. Corporation C distributes $65, and B Corporation distributes $100, for 1966. Corporation M chooses under paragraph (d)(1)(iii) of this section to count toward the effective foreign tax rate, rather than toward the amount of the minimum distribution, the foreign income tax paid by corporations A and B, respectively, on distributions received from corporations B and C, respectively.

(b) The consolidated earnings and profits, and the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution for 1966, with respect to M Corporation are determined as follows:

| | Controlled foreign corporations | | | |
|---|---|---|---|---|
| | A | B | C | Total |
| Pretax earnings and profits | $160.00 | $145.50 | $100.00 | ..... |
| Reduction for intercorporate dividends: | | | | |
| (0.60×$100) | 60.00 | ..... | ..... | ..... |
| (0.70×$65) | ..... | 45.50 | ..... | ..... |
| Pretax and predistribution earnings and profits | 100.00 | 100.00 | 100.00 | ..... |
| Reduction for foreign income tax on such pretax and predistribution earnings and profits: | | | | |
| (0.15×$100) | 15.00 | ..... | ..... | ..... |
| (0.25×$100) | ..... | 25.00 | ..... | ..... |
| (0.35×$100) | ..... | ..... | 35.00 | ..... |
| Predistribution earnings and profits | 85.00 | 75.00 | 65.00 | ..... |
| Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits: | | | | |
| (0.15×$60) | 9.00 | ..... | ..... | ..... |
| (0.25×$45.50) | ..... | 11.38 | ..... | ..... |
| | 76.00 | 63.62 | 65.00 | |
| Consolidated earnings and profits with respect to M Corporation: | | | | |
| (0.80×$76) | 60.80 | ..... | ..... | ..... |
| (0.80×0.60×$63.62) | ..... | 30.54 | ..... | ..... |
| (0.80×0.60×0.70×$65) | ..... | ..... | 21.84 | $113.18 |
| Consolidated foreign income taxes with respect to M Corporation: | | | | |
| ($60.80/$76×[$15+$9]) | 19.20 | ..... | ..... | ..... |
| ($30.54/$63.62×[$25+$11.38]) | ..... | 17.46 | ..... | ..... |
| ($21.84/$65×$35) | ..... | ..... | 11.76 | $48.42 |
| Effective foreign tax rate ($48.42/[$113.18+$48.42]) | ..... | ..... | ..... | 29.96% |
| Statutory percentage under section 963(b) | | | | 69% |
| Amount of minimum distribution which M Corporation must receive from 1966 consolidated earnings and profits (0.69×$113.18), no amount of the tax on intercorporate distributions being counted toward the minimum distribution | ..... | ..... | ..... | $78.0 |

*Example 8.* The facts are the same as in example 7 except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax paid by the recipient corporations on the intercorporate distributions. The consolidated earnings and profits, the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution which M Corporation must receive, for 1966 are determined as follows:

| | Controlled foreign corporations | | | |
|---|---|---|---|---|
| | A | B | C | Total |
| Pretax earnings and profits | $160.00 | $145.50 | $100.00 | ..... |
| Reduction for intercorporate dividends: | | | | |
| (0.60×$100) | 60.00 | ..... | ..... | ..... |
| (0.70×$65) | ..... | 45.50 | ..... | ..... |
| Pretax and predistribution earnings and profits | 100.00 | 100.00 | 100.00 | ..... |
| Reduction for foreign income tax on such pretax and predistribution earnings and profits: | | | | |
| (0.15×$100) | 15.00 | ..... | ..... | ..... |
| (0.25×$100) | ..... | 25.00 | ..... | ..... |
| (0.35×$100) | ..... | ..... | 35.00 | ..... |
| Predistribution earnings and profits | 85.00 | 75.00 | 65.00 | ..... |
| Consolidated earnings and profits with respect to M Corporation: | | | | |
| (0.80×$85) | 68.00 | ..... | ..... | ..... |
| (0.80×0.60×$75) | ..... | 36.00 | ..... | ..... |
| (0.80×0.60×0.70×$65) | ..... | ..... | 21.84 | $125.84 |
| Consolidated foreign income taxes with respect to M Corporation: | | | | |
| ($68/$85×$15) | 12.00 | ..... | ..... | ..... |
| ($36/$75×$25) | ..... | 12.00 | ..... | ..... |
| ($21.84/$65×$35) | ..... | ..... | 11.76 | $35.76 |
| Effective foreign tax rate ($35.76/[$125.84+$35.76]) | ..... | ..... | ..... | 22.13% |
| Statutory percentage under section 963(b) | ..... | ..... | ..... | 76% |
| Amount of minimum distribution to be made from 1966 consolidated earnings and profits with respect to M Corporation: (0.76×$125.84) | ..... | ..... | ..... | $95.64 |

| | Controlled foreign corporations | | | |
|---|---|---|---|---|
| | A | B | C | Total |
| Foreign income tax on intercorporate distributions of 1966 earnings and profits which is counted toward the minimum distribution (see § 1.963–3(b)(2)): | | | | |
| ($68/$85×[0.15×$60]) | 7.20 | ..... | ..... | ..... |
| ($36/$75×[0.25×$45.50]) | ..... | 5.46 | ..... | $12.66 |
| Amount of minimum distribution which M Corporation must actually receive from the chain ($95.64 – $12.66) | ..... | ..... | ..... | $82.98 |

[T.D. 6759, 29 FR 13329, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

### § 1.963–3 Distributions counting toward a minimum distribution.

(a) *Conditions under which earnings and profits are counted toward a minimum distribution*—(1) *In general.* A distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation included in a chain or group shall count toward a minimum distribution for the taxable year of such shareholder to which the election under section 963 relates only to the extent that—

(i) It is received by such shareholder during such year or within 180 days thereafter,

(ii) It is a distribution of the type described in paragraph (b) of this section,

(iii) Under paragraph (c) of this section, it is deemed to be distributed from the earnings and profits of the foreign corporations for the taxable year of such corporation to which the election relates, and

(iv) Such shareholder chooses to include it in gross income for the taxable year of such shareholder to which the election relates notwithstanding that such distribution, by reason of its receipt after the close of such year, would ordinarily be includible in the gross income of a subsequent year.

Amounts taken into account under this subparagraph as gross income of the United States shareholder for the taxable year to which the election relates shall not be considered to be includible in the gross income of such shareholder for a subsequent taxable year. For purposes of determining the foreign tax credit under sections 901 through 905, foreign income tax paid or accrued by such shareholder on or with respect to such amounts shall be treated as paid or accrued during the taxable year of such election.

(2) *Distributions made prior to acquisition of stock.* A United States shareholder which owns within the meaning of section 958(a) stock in a foreign corporation with respect to which such shareholder elects to secure an exclusion under section 963 for the taxable year may count toward the minimum distribution any distribution made with respect to such stock, and before its acquisition by the United States shareholder, to any other domestic corporation not exempt from income tax under chapter 1 of the Code, to the extent that such distribution is made out of the United States shareholder's proportionate share, as determined under paragraph (d)(2) of § 1.963–2, of such corporation's earnings and profits for the taxable year and would have counted toward a minimum distribution if it had been distributed to such United States shareholder. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, which uses the calendar year as the taxable year, has for 1963 $100 of earnings and profits and 100 shares of only one class of stock outstanding. Domestic corporation M, not exempt from income tax under chapter 1 of the Code, directly owns all of such shares during the period from January 1, 1963, through June 30, 1963. On June 30, 1963, M Corporation transfers all of such shares to domestic corporation N, which owns them throughout the remainder of 1963 and elects to secure an exclusion under section 963 for such year with respect to the subpart F income of A Corporation. During June 1963, M Corporation receives a dividend of $75 from A Corporation, which would count toward a minimum distribution if it had been distributed to N Corporation for such year. Corporation N's proportionate share of the earnings and profits of A Corporation for 1963 is

$100; N Corporation may count toward a minimum distribution for 1963 the entire dividend of $75 paid to M Corporation.

*Example 2.* The facts are the same as in example 1 except that M is a nonresident alien individual. Since A Corporation is not a controlled foreign corporation from January 1, 1963, through June 30, 1963, N Corporation's proportionate share of the earnings and profits of A Corporation for 1963 is $50.41 ($100×184/365), as determined under paragraph (d)(2)(iii) of §1.963–2. Although $25.41 ($75 − $49.59) of the $75 distribution to M is paid from N Corporation's proportionate share of A Corporation's 1963 earnings and profits, N Corporation may not count toward a minimum distribution any part of the $75 dividend distributed to M, since M is not a domestic corporation.

(b) *Qualifying distributions*—(1) *Amounts not counted toward a minimum distribution.* No distribution received by a United States shareholder shall count toward a minimum distribution for the taxable year with respect to such shareholder to the extent the distribution is excludable from gross income to the extent gain on the distribution is not recognized, or to the extent the distribution is treated as a distribution in part or full payment in exchange for stock. Undistributed amounts required to be included in gross income under section 551 as undistributed foreign personal holding company income or under section 951 as undistributed amounts of a controlled foreign corporation shall not count toward a minimum distribution under section 963. An amount received by a United States shareholder as a distribution which under section 302 or section 331 is treated as a distribution in part or full payment in exchange for stock shall not count toward a minimum distribution even though such amount is includible in gross income under section 1248 as a dividend. For purposes of this subparagraph, any portion of a distribution of earnings and profits which is attributable to an increase in current earnings, invested in United States property which, but for paragraph (e) of this section, would be included in the gross income of the United States shareholder under section 951(a)(1)(B) shall not be treated as an amount excludable from gross income.

(2) *Inclusion of tax on intercorporate distributions.* In the case of a chain or group election, the United States shareholder's proportionate share of the amount of the foreign income tax paid or accrued for the taxable year by a foreign corporation in the chain or group with respect to distributions received by such corporation from the earnings and profits, of another foreign corporation in such chain or group, for the taxable year of such other corporation to which the election relates shall count toward a minimum distribution from such chain or group for the taxable year, but only if the United States shareholder does not choose under paragraph (d)(1)(iii) of §1.963–2 to take such tax into account in determining the effective foreign tax rate of such chain or group for the taxable year. To the extent that foreign income tax counts toward a minimum distribution under this subparagraph, it shall be applied against and reduce the amount of the minimum distribution required to be received by the United States shareholder, determined without regard to this paragraph.

(c) *Rules for allocation of distributions to earnings and profits for a taxable year.* To determine whether a distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation in a chain or group is made from the earnings and profits of such corporation for the taxable year to which the election under section 963 relates, the following subparagraphs shall apply:

(1) *Exception to section 316.* Section 316 shall apply except that a distribution of earnings and profits made by a foreign corporation either to another foreign corporation or to the United States shareholder shall be treated as having been paid from the earnings and profits of the distributing corporation for the taxable year of such corporation to which the election relates only if it is made during its distribution period (described in paragraph (g) of this section) for such year.

(2) *Distributions from other corporations.* The earnings and profits of a foreign corporation shall be determined in accordance with paragraph (d)(1) of §1.963–2 (applied as though the United States shareholder had chosen under subparagraph (1)(iii) of such paragraph to take the tax described therein into

account in determining the effective foreign tax rate) except that, in the case of a chain or group election, a distribution received by a foreign corporation in the chain or group from another foreign corporation in such chain or group shall be taken into account as earnings and profits of the recipient corporation for the taxable year of such recipient corporation to which the election relates but only to the extent that—

(i) The distribution is received by the recipient corporation during the distribution period for the taxable year of such recipient corporation to which the election relates,

(ii) If the distribution had been received by the United States shareholder, it would have constituted a distribution of the type described in paragraph (b) of this section, and

(iii) The distribution is made from the earnings and profits of the distributing corporation for the taxable year of such distributing corporation to which the election relates.

(d) *Year of inclusion in income of foreign corporation and effect upon subpart F income.* To the extent that a distribution to the United States shareholder counting toward a minimum distribution from a chain or group consists of earnings and profits distributed to a foreign corporation in the chain or group after the close of the recipient corporation's taxable year but during its distribution period for such year by another foreign corporation in such chain or group, such amount shall be treated as received by the recipient corporation on the last day of such taxable year and shall not be regarded as foreign personal holding company income (within the meaning of section 553(a) or 954(c)) of such corporation for the taxable year in which such amount is actually received. The extent to which a distribution counting toward a minimum distribution consists of earnings and profits distributed to a foreign corporation in a chain or group shall be determined under the ordering rules of paragraph (b)(3) of §1.963–4 (applied in each instance as though the United States shareholder had not chosen under paragraph (d)(1)(iii) of §1.963–2 to take the tax described therein into account in determining the effective foreign tax rate). However, for such purpose, the amount of foreign income tax, if any, which counts toward the minimum distribution shall be determined without regard to paragraph (b)(2) of this section but in accordance with paragraph (b)(3)(iii) of §1.963–4.

(e) *Distribution of current earnings invested in United States property.* A distribution made by a foreign corporation during its distribution period for a taxable year shall, notwithstanding section 959(c), first be attributed to earnings and profits for such year described in section 959(c)(3) and then to other earnings and profits. For such purposes, earnings and profits of such foreign corporation for such year attributable to amounts which would otherwise be included in gross income of the United States shareholder under section 951(a)(1)(B) for such year shall be treated as earnings and profits to which section 959(c)(3) applies, shall not be excluded from gross income under section 959 (a) or (b), and shall count toward a minimum distribution for such year. See paragraph (c)(1)(v) of §1.960–1 and paragraph (a) of §1.960–2.

(f) *Cumulative dividends in arrears.* A distribution in satisfaction of arrearages shall be treated as being made out of earnings and profits of the foreign corporation for the taxable year to which the election under section 963 applies only to the extent the dividend is not attributed, under paragraph (d)(2)(i)(*d*) of §1.963–2, to the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. The application of this paragraph may be illustrated by the following example:

*Example.* For 1963, single first-tier corporation A, which uses the calendar year as the taxable year, has earnings and profits of $50; for 1964, a deficit in earnings and profits of $20; for 1965, earnings and profits of $100; and for 1966, earnings and profits of $240. For each of such years preferred dividends accumulate at the rate of $60; but no dividend is paid until 1966 during which year the current dividend is paid and $180 is distributed toward the arrearages. Of this $180, only $50 ($180 − $130) shall be treated as paid from 1966 earnings and profits.

(g) *Distribution period of a foreign corporation*—(1) *General distribution period.* Except as provided by subparagraph (2)

of this paragraph, the distribution period with respect to a foreign corporation for its taxable year shall begin immediately after the close of the distribution period for the preceding taxable year and shall end with the close of the 60th day of the next succeeding taxable year. If no election to secure an exclusion under section 963 applied to the preceding taxable year, the distribution period for the taxable year shall begin with the 61st day of the taxable year.

(2) *Special extended distribution period.* If the United States shareholder of the foreign corporation so elects in statement filed with its return for the taxable year for which the election to secure the exclusion under section 963 is made, the distribution period with respect to such foreign corporation for its taxable year to which the election to secure the exclusion applies shall end with any day which occurs no earlier than the last day of such taxable year of such foreign corporation and no later than the 180th day after the close of such taxable year. The statement shall designate the day so elected as the end of the distribution period.

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

*Example 1.* For 1963 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock M Corporation directly owns, and controlled foreign corporation B, all of whose one class of stock is directly owned by A Corporation. All such corporations use the calendar year as the taxable year, and the distribution periods of corporations A and B for 1963 coincide. Corporations A and B each have earnings and profits (before distributions) of $100 for 1963. On June 1, 1963, B Corporation distributes earnings and profits of $120, of which $100 is from its earnings and profits for 1963 and $20 is from prior earnings. For 1963, A Corporation pays no income tax and distributes earnings and profits of $150 to M Corporation. Under paragraph (c) of this section, such $150 is allocated to A Corporation's earnings and profits of $200 for 1963, consisting of its total earnings and profits for that year of $220 less the $20 received as a distribution from B Corporation's prior earnings.

*Example 2.* Domestic corporation M directly owns all of the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year, and A Corporation's taxable year and its distribution period for 1963 coincide. For 1963, $50 is included in the gross income of M Corporation under section 951(a)(1)(B) as A Corporation's increase in earnings invested for such year in United States property. For 1964, M Corporation makes a first-tier election with respect to A Corporation. For 1964, A Corporation has earnings and profits of $100, including $10 attributable to an increase in earnings invested for such year in United States property. During 1964, A Corporation distributes earnings and profits of $80 to M Corporation. Without regard to paragraph (e) of this section, $10 of this distribution is attributable under section 959(c)(1) to A Corporation's 1964 earnings and profits required to be included in M Corporation's gross income under section 951(a)(1)(D). Pursuant to paragraph (e) of this section, however, the entire distribution of $80 counts toward a minimum distribution for 1964 and is considered to be from earnings and profits of A Corporation for 1964 described in section 959(c)(3). Thus the entire distribution of $80 is included in M Corporation's gross income as a dividend and the foreign tax credit in respect of such amount is determined in accordance with section 902 as modified by the regulations under section 963. On the other hand, if A Corporation made no distributions for 1964, no part of the $10 of A Corporation's increase in earnings invested in United States property for such year would count toward a minimum distribution for any other year but would be included in the gross income for M Corporation for 1964 under section 951(a)(1)(B), and the foreign tax credit in respect of such amount would be determined in accordance with § 1.960–1.

*Example 3.* For 1964 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is owned directly by M Corporation, and controlled foreign corporation B, all the one class of stock of which is owned directly by A Corporation. Corporation M makes no election under section 963 for 1963 or 1965. Corporations M and B use the calendar year as the taxable year, and A Corporation uses for its taxable year a fiscal year ending on September 30. Corporation M elects to have the distribution period for each controlled foreign corporation end on March 29, 1965, such date being the 180th day after the close of A Corporation's taxable year ending on September 30, 1964. Corporation A's distribution period for its taxable year ending on September 30, 1964, begins on November 30, 1963, the 61st day of such taxable year. The distribution period of B Corporation for 1964 begins on March 1, 1964, the 61st day of such taxable year. A distribution counting toward a minimum distribution for 1964 may be made from the earnings and profits of B Corporation only if

the amount thereof is distributed by B Corporation to A Corporation, and in turn by A Corporation to M Corporation, during the period of March 1, 1964, through March 29, 1965.

*Example 4.* The facts are the same as in example 3, except that for their taxable years ending in 1964, corporations A and B each have earnings and profits (before distributions) of $100. On March 10, 1965, B Corporation distributes to A Corporation a dividend of $80 upon which A Corporation incurs foreign income tax at the rate of 10 percent. On March 15, 1965, A Corporation distributes to M Corporation a dividend of $50. Corporation M chooses to take into account as gross income for 1964 from such distribution only $40. For purposes of applying this section, the distribution counting toward a minimum distribution is $44.44, consisting of the $40 of earnings and profits actually received by M Corporation plus the $4.44 ($40/$72×$8) of foreign income tax incurred by A Corporation attributable thereto; A Corporation is deemed to have received $44.44 ($40÷0.90) of the distribution from B Corporation on September 30, 1964, the last day of the taxable year of A Corporation to which the election relates; and the foreign personal holding company income derived by A Corporation for its taxable year ending in 1965 from the distribution from B is only $35.56 ($80 − $44.44). Assuming that no exceptions, exclusions, or exemptions were applicable, subpart F income would be realized by A Corporation for its taxable year ending on September 30, 1965, upon the distribution by B Corporation to A Corporation, but only in the amount of $32 ($35.56 less a deduction under section 954(b)(5) for taxes of $3.56).

[T.D. 7100, 36 FR 10860, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44214, Dec. 23, 1974]

### § 1.963–4 Limitations on minimum distribution from a chain or group.

(a) *Minimum overall tax burden*—(1) *In general.* Notwithstanding the fact that distributions of the type described in paragraph (a) of § 1.963–3 are made by a chain or group to the United States shareholder in an amount sufficient to constitute a minimum distribution for the taxable year of such shareholder to which the chain or group election relates, no exclusion shall be allowable under section 963 to such shareholder with respect to such chain or group for such year unless—

(i) Without applying the special rules set forth in paragraphs (b) and (c) of this section, the overall United States and foreign income tax (as defined in subparagraph (2)(ii) of this paragraph) for the taxable year with respect to the distribution which is made equals or exceeds 90 percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (d)(3) of § 1.963–2) and the consolidated foreign income taxes (as determined under paragraph (e)(2) of § 1.963–2) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder, or

(ii) With the application of the special rules set forth in paragraphs (b) and (c) of this section—

(*a*) Such shareholder receives a pro rata minimum distribution (as defined in subparagraph (2)(i) of this paragraph) from such chain or group for such taxable year, or

(*b*) To the extent necessary, the amount of the foreign income tax allowable as a credit for such year under section 901 with respect to the distribution which is made is reduced and credit for the reduction is deferred, as provided in paragraph (c)(3) of this section, so that the overall United States and foreign income tax for the taxable year with respect to such distribution equals or exceeds the lesser of—

(*1*) The overall United States and foreign income tax which would be paid or accrued for such year with respect to a pro rata minimum distribution received by such shareholder from such chain or group for such year, and

(*2*) Ninety percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (b)(1) of this section) and the consolidated foreign income taxes (as determined under paragraph (b)(1) of this section) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder.

(2) *Definitions.* For purposes of §§ 1.963–1 through 1.963.8—

(i) *Pro rata minimum distribution.* A pro rata minimum distribution from a chain or group for the taxable year is a distribution of earnings and profits to the United States shareholder, with respect to stock to which the chain or group election relates, which is the statutory percentage (applicable with respect to such chain or group as determined under paragraph (b) of §1.963–2) of the United States shareholder's proportionate share of the taxable year's earnings and profits of each foreign corporation in such chain or group (determined in accordance with paragraph (d)(2) of §1.963–2 but without making any deduction under paragraph (d)(1)(iii) of such section).

(ii) *Overall United States and foreign income tax.* The overall United States and foreign income tax for any taxable year of a chain or group with respect to a minimum distribution is the sum of—

(*a*) The consolidated foreign income taxes of the chain or group for such year with respect to the United States shareholder making the chain or group election,

(*b*) Any other foreign income tax paid or accrued by a foreign corporation in the chain or group by reason of the receipt of any distributions counting toward such minimum distribution from such chain or group for that year, and

(*c*) The foreign income tax, if any, and United States income tax paid or accrued by such shareholder upon amounts counting toward such minimum distribution from such chain or group for such year.

Such overall United States and foreign income tax shall be determined with respect to such minimum distribution without taking into account any foreign income tax which is deemed paid for such year under section 904(d), relating to carryback and carryover of excess tax paid. For purposes of this subdivision, the consolidated foreign income taxes of the chain or group shall be determined under paragraph (e)(2) of §1.963–2, applied without regard to the second sentence of paragraph (d)(1) of that section.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* For purposes of determining foreign income tax deemed paid by the United States shareholder for the taxable year under section 902, if a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of §1.963–3, any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

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

*Example.* (a) Domestic corporation M directly owns all of the one class of stock of foreign corporation A, which in turn directly owns all of the one class of stock of foreign corporation B. Corporation M makes a chain election with respect to A Corporation and B Corporation. All such corporations use the calendar year as the taxable year. Assuming that A Corporation does not incur foreign tax on amounts distributed by B Corporation, the foreign income tax and earnings and profits of corporations A and B, the effective foreign tax rate, and the statutory percentage for 1966, are as follows:

| | A | B | Consolidated |
|---|---|---|---|
| Pretax and predistribution earnings and profits | $100 | $100 | $200 |
| Foreign income tax | 20 | 40 | 60 |
| Earnings and profits | 80 | 60 | 140 |
| Effective foreign tax rate ($60/[$140+$60]) | ..... | ..... | 30% |
| Statutory percentage under section 963(b) | ..... | ..... | 69% |

(b) Corporation M is entitled for 1966 to exclude its pro rata share of the subpart F income of corporations A and B for such year if it receives from the 1966 consolidated earnings and profits of the chain distributions totaling at least $96.60 (0.69×$140) and if—

(1) The sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 without regard to paragraph (c) of this section) imposed on such distributions equals at least $86.40 (0.90×0.48×$200);

(2) Under the special rules of paragraphs (b) and (c) of this section, the distributions received consist of a distribution from each of corporations A and B which is 69 percent of the earnings and profits for 1966 of such corporation, that is, a distribution of $55.20

(0.69×$80) from A Corporation and of $41.40 (0.69×$60) from B Corporation; or

(3) Under the special rules of paragraphs (b) and (c) of this section, the foreign tax credit is reduced and deferred to such an extent that the sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 as modified by paragraph (c) of this section) imposed on such distributions equals the lesser of $86.40 (0.90×0.48×$200) and the amount which the sum of such taxes would be if M Corporation were to receive a distribution of $55.20 (0.69×$80) from the 1966 earnings and profits of A Corporation and $41.40 (0.69×$60) from the 1966 earnings and profits of B Corporation.

(b) *Special rules for determining earnings and profits and foreign income taxes.* For purposes of determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, §§ 1.963–2 and 1.963–3 shall apply as modified by the following subparagraphs:

(1) *Exclusion of tax on intercorporate distributions.* The consolidated earnings and profits and consolidated foreign income taxes of a chain or group for the taxable year shall be determined in accordance with § 1.963–2, except that foreign income tax referred to in paragraph (d)(1)(iii) of such section may be taken into account in determining the effective foreign tax rate only—

(i) To the extent that such tax is not deemed paid by the United States shareholder under section 902 (as modified by paragraph (c) of this section) for its taxable year to which the chain or group election relates, or

(ii) If, by taking the tax into account, the effective foreign tax rate with respect to such chain or group, as determined under paragraph (c)(2) of § 1.963–2, exceeds the highest effective foreign tax rate requiring a distribution under section 963(b) for such year of the shareholder.

(2) *Allocation of deficits.* For purposes of determining the amount of each foreign corporation's share of a pro rata minimum distribution from a chain or group for the taxable year and for purposes of determining the foreign tax credit under paragraph (c) of this section of the United States shareholder with respect to any minimum distribution from a chain or group for the taxable year—

(i) *Deficits of foreign corporations.* The total of the United States shareholder's proportionate shares, as determined under paragraph (d)(2)(ii) of § 1.963–2, of the deficit of every foreign corporation in the chain or group having a deficit for the taxable year shall be allocated against and shall reduce such shareholder's proportionate share, as determined under paragraph (d)(2)(i) of § 1.963–2, of the earnings and profits for the taxable year of each other foreign corporation in the chain or group having earnings and profits for such year in an amount which bears to such total of shares of deficit the same ratio which such share of earnings and profits bears to the total of such shareholder's proportionate shares, as so determined, of the earnings and profits of all foreign corporations in the chain or group having earnings and profits for the taxable year.

(ii) *Deficits of foreign branches.* If for the taxable year a group includes under paragraph (f)(4) of § 1.963–1 foreign branches the aggregate of whose allowable deductions (other than any net operating loss deduction) exceeds the aggregate of their gross incomes for the taxable year, determined as provided in paragraph (f)(4)(ii) of such section, the amount of such excess shall be allocated as provided by subdivision (i) of this subparagraph.

(3) *Distributions through a chain or group.* In determining whether and to what extent a distribution for any taxable year has been made out of the earnings and profits of a foreign corporation included in a chain of ownership described in section 958(a) consisting of two or more corporations in a chain or group for the taxable year, the following subdivisions shall apply:

(i) *Allocation first to income received as a distribution.* If any foreign corporation included in the chain or group for the taxable year receives a distribution for such year from another foreign corporation in the chain or group and in turn makes a distribution for the taxable year, the distribution so made shall first be allocated to the earnings and profits, to the extent thereof, attributable to the distribution so received; if distributions are received from more than one other corporation in the chain or group, the distribution

made by the recipient corporation shall be apportioned among all such amounts. For purposes of determining whether a distribution is made or received for the taxable year, see paragraph (c) of §1.963–3.

(ii) *Successive distributions through a chain or group.* If any foreign corporation included in the chain or group for the taxable year distributes an amount from its earnings and profits of such year, the amount so distributed shall be considered to be received from such earnings and profits by the United States shareholder to the extent the amount is distributed by successive distributions made by each other foreign corporation in the chain or group for the taxable year through the chain of ownership described in section 958(a) into the hands of such shareholder.

(iii) *Distribution determined without reduction by taxes of intervening corporations.* If, for the taxable year to which the election to secure an exclusion under section 963 applies, the United States shareholder receives a distribution to which subdivision (ii) of this subparagraph applies, the entire amount distributed by the foreign corporation from such shareholder's proportionate share of its earnings and profits for the taxable year shall, except where taxes referred to in paragraph (d)(1)(iii) of §1.963–2 are taken into account as provided by subparagraph (1) of this paragraph, count toward a minimum distribution and shall not be reduced for such purpose by a foreign income tax paid or accrued on such amount by another foreign corporation in the chain or group through which such amount is distributed by successive distributions into the hands of such shareholder. The application of this subdivision may be illustrated by the following examples:

*Example 1.* For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is directly owned by M Corporation, and controlled foreign corporation B, all the one class of stock of which is directly owned by A Corporation. All corporations use the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. Corporation A's only income for 1966 is a dividend of $52.50 distributed in such year by B Corporation, on which A Corporation is subject to an income tax of $10.50. The remaining $42 ($52.50 less $10.50) is distributed by A Corporation for 1966 to M Corporation. The full $52.50 distributed by B Corporation counts toward a minimum distribution by the chain for 1966.

*Example 2.* For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which it owns directly, and controlled foreign corporation B, all the one class of stock of which A Corporation own directly. All corporations use the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. The predistribution and pretax earnings and profits for 1966 of B Corporation are $100, and of A Corporation, $0. Corporation B pays foreign income tax of $30 and during the year distributes $70. On such $70, A Corporation pays foreign income tax of $14. By applying paragraph (d)(1)(iii) of §1.963–2, the consolidated foreign income taxes of the chain for 1966 are $44 ($30+$14) and the consolidated earnings and profits of the chain are $56 ($70 − $14); in such case, the effective foreign tax rate of the chain for 1966 is 44 percent ($44/[$56+$44]) and thus in excess of the highest effective foreign tax rate requiring a distribution for such year under section 963(b). Since M Corporation may thus take A Corporation's tax of $14 into account, the statutory percentage under section 963(b) for 1966 is zero percent and the amount of the minimum distribution required to be made by the chain is $0.

(c) *Special foreign tax credit rules*—(1) *In general.* In determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, the foreign tax credit of the United States shareholder with respect to a minimum distribution received for the taxable year from the chain or group shall be determined under the provisions of sections 901 through 905 as modified by §1.963–3 except that—

(i) Under subparagraph (2) of this paragraph—

(*a*) Taxes of a second-tier corporation making a distribution through a first-tier corporation shall not be averaged with taxes of such first-tier corporation,

(*b*) Taxes of a first-tier corporation or a second-tier corporation on a distribution made through such corporation shall not be averaged with such corporation's taxes on its other income; and

(*c*) Taxes of a first-tier corporation or a second-tier corporation shall not be deemed paid with respect to distributions from the earnings and profits of such corporation which are offset by a deficit allocated under paragraph (b)(2) of this section to the United States shareholder's proportionate share of the earnings and profits of such corporation; and

(ii) The foreign tax credit may be reduced and the reduction deferred under subparagraph (3) of this paragraph to another taxable year of the United States shareholder.

(2) *Nonaveraging of tax*—(i) *Year of minimum distribution—(a) Taxes deemed paid by a first-tier corporation and taxes actually paid by such corporation.* If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, and if both section 902(a) and section 902(b) apply with respect to such distribution, all the taxes deemed paid under section 902(b) by the first-tier corporation described in section 902(a) with respect to such distribution of such earnings and profits shall be deemed paid by the United States shareholder for such taxable year under section 902(a) with respect to the earnings and profits so distributed and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so deemed paid by such first-tier corporation shall be attributed to other earnings and profits of such first-tier corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(*b*) *Taxes of a foreign corporation paid on intercorporate distributions and on other income.* If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, then in applying section 902(a) with respect to such distribution through a first-tier corporation described in section 902(a), or in applying section 902(b) with respect to such distribution through a second-tier corporation described in section 902(b), as the case may be, the taxes of such corporation which shall be taken into account in determining taxes deemed paid under such section shall be the foreign income tax actually paid or accrued for the taxable year by such first-tier or second-tier corporation, as the case may be, with respect to such distribution; and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so paid by such first-tier or second-tier corporation shall be attributed to other earnings and profits of such corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(*c*) *Corporation with earnings and profits reduced by allocated deficits.* In the application of section 902, a United States shareholder's proportionate share of the earnings and profits for the taxable year of a foreign corporation to which the chain or group election applies shall reflect the reduction of such earnings and profits by deficits allocated thereto under paragraph (b)(2) of this section. No taxes paid or accrued by such corporation shall be deemed paid under section 902 with respect to a distribution to such shareholder from the earnings and profits of such corporation for such year to the extent that such distribution exceeds the shareholder's proportionate share as so reduced.

(ii) *Year of distribution of remaining earnings and profits.* If for a taxable year in respect of which a United States shareholder receives a minimum distribution pursuant to an election under section 963 and in respect of which the provisions of this subparagraph are applied—

(*a*) The foreign income tax which is paid or accrued by a foreign corporation for such year, by reason of the receipt and payment of earnings and profits counting toward such minimum distribution, is deemed paid under subdivision (i) (*a*) or (*b*) of this subparagraph,

(*b*) The pretax and predistribution earnings and profits for such year of a foreign corporation in a chain or group

with respect to stock on which such minimum distribution is received are reduced by reason of the deduction under paragraph (d)(1)(i) of §1.963–2 of distributions received from other corporations in such chain or group, or

(*c*) Such shareholder's proportionate share of the earnings and profits for such year of a foreign corporation in a chain or group making a distribution counting toward such minimum distribution is reduced by the allocation thereto under paragraph (b)(2) of this section of a portion of the deficits of foreign branches or other foreign corporations in such chain or group,

the pretax and predistribution earnings and profits of such foreign corporation for such year to which such minimum distribution is attributable and the foreign income tax which is taken into account in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder. For the purpose of applying the preceding sentence to a case in which (*c*) of this subdivision applies, the pretax and predistribution earnings and profits of the foreign corporation for such year to which the minimum distributed is attributable shall be the amount of such corporation's earnings and profits which are distributed and count toward the minimum distribution plus the foreign income tax of such foreign corporation allocated thereto in determining the taxes deemed paid under section 902 for the taxable year of the minimum distribution.

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

*Example 1.* Domestic corporation M makes a chain election for 1966 with respect to controlled foreign corporation A, which is wholly owned directly by M Corporation, and controlled foreign corporation B, which is wholly owned directly by A Corporation. Each corporation uses the calendar year as the taxable year. In 1966, corporations A and B are subject to foreign income tax at the rates of 20 percent and 30 percent, respectively, with no deduction being allowed for dividends received or paid; each such corporation has pretax and predistribution earnings and profits of $100. Corporation M receives from the chain a pro rata minimum distribution for such year and applies thereto the special rules of this paragraph and paragraph (b) of this section. Corporation A is not a less developed country corporation under section 902(d). The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

| | A | B | Total |
|---|---|---|---|
| Pretax and predistribution earnings and profits | $100.00 | $100.00 | $200.00 |
| Foreign income tax | 20.00 | 30.00 | 50.00 |
| Consolidated earnings and profits | 80.00 | 70.00 | 150.00 |
| Effective foreign tax rate ($50/[$150+$50]) | | | 25% |
| Statutory percentage under section 963(b) | | | 76% |
| Amount distributed as pro rata minimum distribution for 1966: | | | |
| (0.76×$80) | 60.80 | | |
| (0.76×$70) | | 53.20 | 114.00 |
| Amount received by M Corporation as pro rata minimum distribution: | | | |
| A Corporation's distribution | $60.80 | | |
| B Corporation's distribution ($53.20 − [0.20 × $53.20]), or ($53.20 − $10.64) | | $42.56 | $103.36 |
| Amount of tax counted toward minimum distribution | | | 10.64 |
| Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit: | | | |
| ($60.80/$80×$20) | 15.20 | | |
| ([$42.56/$42.56×$10.64] +[$53.20/$70×$30]) or ($10.64+$22.80) | | 33.44 | 48.64 |
| Remaining 1966 earnings and profits for future distribution to M Corporation: | | | |
| ($80 − $60.80) | 19.20 | | |
| ($70 − $53.20) | | 16.80 | 36.00 |
| Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation: | | | |
| ($19.20/$80×$20) | 4.80 | | |
| ($16.80/$70×$30) | | 7.20 | 12.00 |

*Example 2.* The facts are the same as in example 1 except that A Corporation pays foreign income tax at the rate of 30 percent and B Corporation, at the rate of 20 percent; and A Corporation is allowed a deduction, in computing its income subject to tax, for the full amount of dividends received. The determination of tax deemed paid for 1966 is as follows:

| | A | B | Total |
|---|---|---|---|
| Pretax and predistribution earnings and profits | $100.00 | $100.00 | $200.00 |
| Foreign income tax | 30.00 | 20.00 | 50.00 |
| Consolidated earnings and profits | 70.00 | 80.00 | 50.00 |
| Effective foreign tax rate ($50/[$150+$50]) | | | 25% |
| Statutory percentage under section 963(b) | | | 76% |
| Amount distributed by foreign corporations as a pro rata minimum distribution for 1966 and amount received by M Corporation: | | | |
| (0.76×$70) | $53.20 | | |
| (0.76×$80) | | $60.80 | $114.00 |
| Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit: | | | |
| ($53.20/$70×$30) | 22.80 | | |
| ($60.80/$80×$20) | | 15.20 | 38.00 |
| Remaining 1966 earnings and profits for future distribution to M Corporation: | | | |
| ($70 − $53.20) | 16.80 | | |
| ($80 − $60.80) | | 19.20 | 36.00 |
| Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation: | | | |
| ($16.80/$70×$30) | 7.20 | | |
| ($19.20/$80×$20) | | 4.80 | 12.00 |

*Example 3.* For 1966, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which are wholly owned directly by M Corporation, and foreign branch C of M Corporation. All such corporations use the calendar year as the taxable year. Corporation M receives a pro rata minimum distribution from the group for 1966 and applies thereto the special rules of this paragraph and paragraph (b) of this section. Neither foreign corporation is a less developed country corporation under section 902(d). Corporations A and B pay foreign income tax at a flat rate of 20 percent and 30 percent, respectively. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

| | A | B | Branch C | Total |
|---|---|---|---|---|
| Pretax and predistribution earnings and profits (and deficit) of the group | $60.00 | $60.00 | ($20) | $100.00 |
| Foreign income tax | 12.00 | 18.00 | | 30.00 |
| Earnings and profits (and deficit) | 48.00 | 42.00 | (20) | 70.00 |
| Allocation of deficit of Branch C: | | | | |
| ($48/[$48+$42]×$20) | (10.67) | | | |
| ($42/[$48+$42]×$20) | | (9.33) | | |
| Consolidated earnings and profits of the group | 37.33 | 32.67 | | 70.00 |
| Effective foreign tax rate ($30/$100) | | | | 30% |
| Statutory percentage under section 963(b) | | | | 69% |
| Amount received by M Corporation as pro rata minimum distribution for 1966: | | | | |
| (0.69×$37.33) | 25.76 | | | |
| (0.69×$32.67) | | 22.54 | | $48.30 |
| Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit: | | | | |
| ($25.76/$37.33×$12) | 8.28 | | | |
| ($22.54/$32.67×$18) | | 12.42 | | 20.70 |
| Remaining 1966 earnings and profits for future distribution to M Corporation: | | | | |
| ($48 − $25.76) | 22.24 | | | |
| ($42 − $22.54) | | 19.46 | | 41.70 |
| Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation: | | | | |
| ($12 − $8.28) | 3.72 | | | |
| ($18 − $12.42) | | 5.58 | | 9.30 |

*Example 4.* The facts are the same as in example 3 except that the group does not make a pro rata minimum distribution but distributes $48.30, consisting of $40 distributed by A Corporation and $8.30 distributed by B Corporation. Corporation M complies with the special rules of this paragraph and paragraph (b) of this section. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a)

for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows, the minimum overall tax burden for 1966 being such as to satisfy the requirement of paragraph (a)(1)(ii)(*b*) of this section:

| | A | B | Branch C | Total |
|---|---|---|---|---|
| Amount received by M Corporation | $40.00 | $8.30 | ..... | $48.30 |
| Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit: | | | | |
| ($37.33/$37.33×$12) | 12.00 | ..... | ..... | ..... |
| ($8.30/$32.67×$18) | ..... | 4.57 | ..... | 16.57 |
| Remaining 1966 earnings and profits for future distribution to M Corporation: | | | | |
| ($48 − $40) | 8.00 | ..... | ..... | ..... |
| ($42 − $8.30) | ..... | 33.70 | ..... | 41.70 |

| | A | B | Branch C | Total |
|---|---|---|---|---|
| Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation: | | | | |
| ($12 − $12) | 0 | ..... | ..... | ..... |
| ($18 − $4.57) | ..... | 13.43 | ..... | 13.43 |

(3) *Reduction and deferral of the foreign tax credit*—(i) *In general.* To the extent specified in paragraph (a)(1)(ii)(*b*) of this section a reduction shall be made in the foreign tax credit allowable under section 901 for the taxable year with respect to distributions counting toward a minimum distribution for such year from the chain or group; and such reduction in credit shall be allocated, as provided in subdivision (ii) of this subparagraph, to foreign corporations in such chain or group and deferred, as provided in subdivision (iii) of this subparagraph, to subsequent taxable years of the United States shareholder.

(ii) *Allocation of reduction in foreign tax credit.* The amount of any reduction in foreign tax credit for the taxable year which is made under subdivision (i) of this subparagraph with respect to a minimum distribution for any taxable year from the chain or group shall be allocated among any first-tier and second-tier corporations described in section 902 (a) and (b), respectively, which are in such chain or group. The amount of any such reduction in foreign tax credit shall be allocated among such first-tier and second-tier corporations in the ratio which the United States shareholder's proportionate share of undistributed earnings and profits of each such corporation for the taxable year bears to the total of such shareholder's proportionate shares of the undistributed earnings and profits of all such corporations for such year. None of such reduction shall be allocated to any other corporations in the chain or group or to any foreign branches included under paragraph (f)(4) of § 1.963–1 in the group as wholly owned foreign subsidiary corporations.

(iii) *Deferral of allocated credit*—(*a*) *Allowance of credit in subsequent years.* The reduction in foreign tax credit allocated to a first-tier or second-tier corporation in the chain or group for a taxable year under subdivision (ii) of this subparagraph shall be deemed paid under the principles of section 902 (applicable to foreign corporations which are not less developed country corporations) with respect to distributions, to the extent made by such corporation to the United States shareholder referred to in subdivision (ii) of this subparagraph, in a subsequent taxable year from the undistributed earnings and profits of such corporation for such year of allocation. Thus, for example, in the case of a distribution in the subsequent year from such earnings and profits by a first-tier corporation, the tax deemed paid shall be an amount which bears to the total of such reduction in foreign tax credit the same ratio that the distribution to the shareholder in the subsequent year bears to such shareholder's proportionate share of such undistributed earnings and profits for the year of allocation.

(*b*) *Limitations on use of deferred credit.* The deferred tax so deemed paid shall be deemed paid for such subsequent

taxable year and shall be allowed under section 901 (without regard to the limitations under section 904) as a credit against the income tax imposed for such year by chapter 1 of the Code, but the amount of such credit shall not exceed the excess of the tax so imposed for such year over the credit (determined without regard to this subdivision (iii) allowed under sections 901 through 905 for such year. Any amount by which the deferred tax so deemed paid in such subsequent taxable year exceeds the limitation under the preceding sentence shall not be carried back or carried over under section 904(d) to another taxable year of the United States shareholder. No credit shall be allowed under this subdivision for the subsequent taxable year to the extent that the credit would reduce the tax of the United States shareholder under chapter 1 of the Code on any minimum distribution for such year to which section 963 applies.

(*c*) *Gross-up not applicable.* Any amount allowed as a credit for a subsequent taxable year under this subdivision shall not be included in the gross income of the United States shareholder for such year under section 78.

(*d*) *Illustrations.* The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(c) is disregarded:

*Example 1.* (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is not a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, M Corporation complies with the special rules of paragraphs (b) and (c) of this section. Corporation A has pretax and predistribution earnings and profits for 1966 of $40 and is subject to foreign income tax at a flat rate of 36 percent, with no deduction being allowed for dividends received or paid. B Corporation has pretax and predistribution earnings and profits of $60 for 1966 and is subject to a foreign income tax at a flat rate of 20 percent, with no deduction being allowed for dividends received or paid. For 1967, B Corporation has no earnings and profits, A Corporation has no earnings and profits other than a dividend of $21.22 from B Corporation, and M Corporation has taxable income of $20.98 from United States sources. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1966, the overall United States and foreign income tax for such year with respect to such distribution would be $41.30, determined as follows:

| | A | B | Total |
|---|---|---|---|
| Pretax and predistribution earnings and profits | $40.00 | $60.00 | $100.00 |
| Foreign income tax: | | | |
| (0.36×$40) | 14.40 | | |
| (0.20×$60) | | 12.00 | $26.40 |
| Consolidated earnings and profits | 25.60 | 48.00 | 73.60 |
| Effective foreign tax rate ($26.40/[$73.60+$26.40]) | | | 26.4% |
| Statutory percentage under section 963(b) | | | 69% |
| Amount distributed as pro rata minimum distribution: | | | |
| (0.69×$25.60) | 17.66 | | |
| (0.69×$48) | | 33.12 | $50.78 |
| Amount received by M Corporation as pro rata minimum distribution: | | | |
| Corporation's distribution | 17.66 | | |
| B Corporation's distribution ($33.12−[0.36×$33.12]), or | | | |
| ($33.12−$11.92) | | 21.20 | 38.86 |
| Gross-up under section 78: | | | |
| ($17.66/$25.60×$14.40) | 9.94 | | |
| ($21.20/$21.20×[$11.92+($33.12/$48×$12)]), or | | | |
| ($11.92+$8.28) | | 20.20 | 30.14 |
| Taxable income of M Corporation | | | 69.00 |
| U.S. tax before foreign tax credit ($69×0.48) | | | 33.12 |
| Foreign tax credit (as determined under gross-up above) | | | 30.14 |
| U.S. tax payable | | | 2.98 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($26.40+$11.92+$2.98) | | | 41.30 |

(c) The chain, however, does not make a pro rata distribution for 1966, but distributes $24 from A Corporation's earnings and profits and $26.78 from B Corporation's earnings and profits, the total distribution of $50.78 being equal to the statutory percentage of the consolidated earnings and profits (0.69×$73.60) of the chain with respect to M Corporation. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1966 with respect to the distribution equals the lesser of $41.30 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum

distribution) and $43.20 (90 percent of 48 percent of pretax and predistribution consolidated earnings and profits of $100). The remaining 1956 earnings and profits of the chain are distributed late in 1967. Corporation M determines its tax as follows for such years:

*1966*

| | A | B | Total |
|---|---|---|---|
| Distributions made | $24.00 | $26.78 | $50.78 |
| Amount received by M Corporation: | | | |
| A Corporation's distribution | 24.00 | ..... | ..... |
| B Corporation's distribution ($26.78 − [0.36× 26.78]), or ($26.78 − $9.64) | ..... | 17.14 | 41.14 |
| Gross-up under section 78: | | | |
| ($24/$25.60×$14.40) | 13.50 | ..... | ..... |
| ($17.14/$17.14×[$9.64+ ($26.78/$48×$12)]), or ($9.64+$6.70) | ..... | 16.34 | 29.84 |
| Taxable income of M Corporation | ..... | ..... | $70.98 |
| Tentative U.S. tax before foreign tax credit ($70.98×.48) | ..... | ..... | 34.07 |
| Less: Tentative foreign tax credit (as computed under gross-up above) | ..... | ..... | 29.84 |
| Tentative U.S. tax payable | ..... | ..... | 4.23 |
| Tentative overall U.S. and foreign income tax ($26.40+$9.64+$4.23) | ..... | ..... | 40.27 |
| Overall U.S. and foreign tax which would be paid with respect to a pro rata minimum distribution (part (b) of this example) | ..... | ..... | 41.30 |
| Insufficient overall U.S. and foreign income tax ($41.30 − $40.27) | ..... | ..... | 1.03 |
| Reduced foreign tax credit ($29.84 − $1.03) | ..... | ..... | 28.81 |
| U.S. tax payable ($34.07 − $28.81) | ..... | ..... | 5.26 |
| Overall U.S. and foreign income tax ($26.40+$9.64+$5.26) | ..... | ..... | 41.30 |
| Reduction in foreign tax credit to be deferred ($29.84 − $28.81) | ..... | ..... | 1.03 |
| Remaining 1966 earnings and profits of: | | | |
| A Corporation ($25.60 − $24) | $1.60 | ..... | ..... |
| B Corporation ($48 − $26.78) | ..... | $21.22 | 22.82 |
| Allocation of reduction in foreign tax credit to remaining 1966 earnings and profits of: | | | |
| A Corporation ($1.60/22.82×$1.03) | .07 | ..... | ..... |
| B Corporation ($21.22/$22.82×$1.03) | ..... | .96 | 1.03 |
| Foreign income tax attributable to remaining 1966 earnings and profits of: | | | |
| A Corporation ($1.60/$25.60×$14.40) | .90 | ..... | ..... |
| B Corporation ($21.22/$48×$12) | ..... | 5.30 | 6.20 |

*1967*

| | | | |
|---|---|---|---|
| Taxable income of M Corporation consisting of distributions from: | | | |
| A Corporation's remaining 1966 earnings and profits | 1.60 | ..... | ..... |
| B Corporation's remaining 1966 earnings and profits ($21.22 − [.36×21.22]), or ($21.22 − $7.64) | ..... | 13.58 | 15.18 |
| Gross-up under section 78: | | | |
| ($1.60/$1.60×$0.90) | .90 | ..... | ..... |
| ($13.58/$13.58× [$7.64+($21.22/ 21.22×$5.30)]) | ..... | 12.94 | 13.84 |
| Taxable income from sources without the U.S. | ..... | ..... | 29.02 |
| Taxable income from sources within the U.S. | ..... | ..... | 20.98 |
| Total taxable income of M Corporation | ..... | ..... | 50.00 |
| U.S. tax before foreign tax credit (0.48×$50) | ..... | ..... | 24.00 |
| Foreign tax credit: | | | |
| Tax deemed paid under section 902: | | | |
| $13.84, but not to exceed section 904 limitation of $13.93 ($29.02/$50×$24) (see gross-up above) | ..... | ..... | 13.84 |
| Tax deemed paid under the principles of section 902: | | | |
| ($1.60/$1.60×$0.07) | .07 | ..... | ..... |
| ($21.22/$21.22× 0.96) | ..... | .96 | 1.03 |
| U.S. tax payable ($24 − [$13.84+$1.03]) | ..... | ..... | 9.13 |

*Example 2.* (a) For 1963, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which M Corporation wholly owns directly. All such corporations use the calendar year as the taxable year. Corporation A is created under the laws of foreign country X, and B Corporation is created under the laws of foreign country Y; neither of such corporations is a less developed country corporation under section 902(d). Corporation

M complies with the special rules of paragraphs (b) and (c) of this section. Each foreign corporation has pretax earnings and profits of $100 for 1963. The income of A Corporation is subject to a foreign income tax rate of 20 percent, and the income of B Corporation is subject to a foreign income tax rate of 30 percent. Corporation M uses the per-country limitation under section 904(a)(1) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1963, the group would distribute $123 based upon an effective foreign tax rate of 25 percent ($50/[$50+$150]) and a statutory percentage of 82 percent under section 963(b); of this amount $57.40 (0.82×$70) would be distributed from B Corporation's earnings and profits and $65.60 (0.82×$80) would be distributed from A Corporation's earnings and profits. In such case, the overall United States and foreign income tax for 1963 with respect to the pro rata minimum distribution would be determined as follows, using the 52 percent United States corporate income tax rate applicable for such year:

| | | |
|---|---|---|
| Taxable income of M Corporation from sources in— | | |
| Y Country: | | |
| B Corporation dividend | $57.40 | |
| Gross-up under section 78 ($57.40/$70×$30) | 24.60 | $82.00 |
| X Country: | | |
| A Corporation dividend | 65.60 | |
| Gross-up under section 78 ($65.60/$80×$20) | 16.40 | 82.00 |
| Taxable income | | 164.00 |
| U.S. tax before tax credit (0.52×$164) | | 85.28 |
| Foreign tax credit: | | |
| Y Country tax | 24.60 | |
| X Country tax | 16.40 | 41.00 |
| U.S. tax payable | | 44.28 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($44.28+ $50) | | 94.28 |

(c) The group, however, does not make a pro rata minimum distribution for 1963 but distributes $123, consisting of $70 from B Corporation's earnings and profits and $53 from A Corporation's earnings and profits. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1963 with respect to the distribution equals the lesser of $94.28 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution) and $93.60 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $200). The remaining 1963 earnings and profits of the group are distributed late in 1964. Neither A Corporation nor B Corporation has earnings and profits for 1964. Corporation M determines its tax as follows for such years, assuming a 52 percent (instead of 50 percent) United States corporate income tax rate for 1964:

1963

| | | |
|---|---|---|
| Taxable income of M Corporation from sources in— | | |
| Y Country: | | |
| B Corporation dividend | $70.00 | |
| Gross-up under section 78 ($70/$70×$30) | 30.00 | $100.00 |
| X Country: | | |
| A Corporation dividend | 53.00 | |
| Gross-up under section 78 ($53/$80×$20) | 13.25 | 66.25 |
| Taxable income for 1963 | | 166.25 |
| U.S. tax before foreign tax credit (0.52×$166.25) | | 86.45 |
| Less: Tentative foreign tax credit: | | |
| Y Country tax ($30.00 but not to exceed ($100.00/$166.25×$86.45)) | 30.00 | |
| X Country tax ($13.25 but not to exceed ($66.25/$166.25×$86.45)) | 13.24 | 43.25 |
| Tentative U.S. tax payable | | 43.20 |
| Tentative overall U.S. and foreign income tax ($50+$43.20) | | 93.60 |
| Insufficient overall U.S. and foreign income tax ($93.60 − $93.20) | | .40 |
| Reduced foreign tax credit ($43.25 − $0.40) | | 42.85 |
| U.S. tax payable for 1963 ($86.45 − $42.85) | | 43.00 |
| Overall U.S. and foreign income tax ($50+$43.60) | | 93.60 |
| Reduction in foreign tax credit to be deferred ($43.25 − $42.85) | | .40 |
| Remaining 1963 earnings and profits of: | | |
| A Corporation ($80 − $53) | 27.00 | |
| B Corporation ($70 − $70) | 0 | 27.00 |
| Allocation of reduction in foreign tax credit to remaining 1963 earnings and profits of A Corporation ($27/$27× $0.40) | | .40 |
| Foreign income tax attributable to remaining 1963 earnings and profits of: | | |
| A Corporation ($20 − $13.25) | 6.75 | |
| B Corporation ($30 − $30) | 0 | 6.75 |

1964

| | | |
|---|---|---|
| Taxable income of M Corporation from sources in X Country: | | |
| A Corporation dividend | | 27.00 |
| Gross-up under section 78 ($27/$27× $6.75) | | 6.75 |
| Taxable income for 1964 | | 33.75 |
| U.S. tax before foreign tax credit ($33.75×0.52) | | 17.55 |
| Less: Foreign tax credit: | | |
| Tax deemed paid under section 902 (as computed under gross-up, but not to exceed $33.75/$33.75 × $17.55) | 6.75 | |
| Tax deemed paid under the principles of section 902 ($27/$27×$0.40) | .40 | 7.15 |
| U.S. tax payable for 1964 | | 10.40 |

*Example 3.* (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, each of the foreign corporations has pretax and predistribution earnings and profits of $100. The income of A Corporation is subject to a foreign income tax rate of 20 percent, with no deduction being allowed for dividends received or paid; and the income of B Corporation is subject to a foreign income tax rate of 30 percent on such basis. During 1966, B Corporation distributes $50 to A Corporation, and A Corporation distributes $104 to M Corporation. During 1967 the remaining 1966 earnings and profits of such corporations are distributed to M Corporation.

(b) If M Corporation were not to comply with the special rules of paragraphs (b) and (c) of this section and were to deduct foreign income tax on intercorporate distributions under paragraph (d)(1)(iii) of §1.963–2, the chain would not be considered to make a minimum distribution for 1966 because, although it makes a distribution which is sufficient in amount to constitute a minimum distribution, the overall United States and foreign income tax for such year with respect to such distribution would be insufficient under paragraph (a)(1)(i) of this section. The determination that M Corporation would not be entitled to the section 963 exclusion for 1966 by reason of such distribution in such circumstances is made as follows:

| | A | B | Total |
|---|---|---|---|
| Pretax earnings and profits | $150 | $100 | |
| Reduction for intercorporate dividends | 50 | | |
| Pretax and predistribution earnings and profits | 100 | 100 | $200.00 |
| Reduction for foreign income tax on such pretax and predistribution earnings and profits | 20 | 30 | 50.00 |
| Predistribution earnings and profits | 80 | 70 | 150.00 |
| Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits ($50×0.20) | 10 | | 10.00 |
| Consolidated earnings and profits of the chain | 70 | 70 | 140.00 |
| Consolidated foreign income taxes ($30+$20+$10) | | | 60.00 |
| Effective foreign tax rate ($60/[$140+$60]) | | | 30% |
| Statutory percentage under section 963(b) | | | 69% |
| Amount of a minimum distribution ($140×0.69) | | | 96.60 |
| Overall United States and foreign income tax required to be paid (part (a)(1)(i) of this section) (0.90× [0.22+0.26]×$200) | | | 86.40 |
| Tentative taxable income of M Corporation | | | $104.00 |
| Tentative U.S. tax before foreign tax credit (0.48×$104) | | | 49.92 |
| Tentative foreign tax credit ($104/ $120×[($120/ $150×$30)+($50/ $100×$30)] or ($104/$120×$39) | | | 33.80 |
| Tentative U.S. tax payable ($49.92 − $33.80) | | | 16.12 |
| Overall U.S. and foreign income tax ($60+$16.12) | | | 76.12 |
| Insufficient overall U.S. and foreign income tax ($86.40 − $76.12) | | | 10.28 |

(c) By complying with the special rules of paragraphs (b) and (c) of this section, however, M Corporation will receive a minimum distribution for 1966 if it receives the statutory percentage of consolidated earnings and profits and if the overall United States and foreign income tax with respect to the distribution which is made is at least the lesser of $86.40 (0.90×0.48×$200) and of the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution from the chain. If a pro rata minimum distribution were made for 1966, the chain would be required to distribute earnings and profits of $114, based upon an effective foreign tax rate of 25 percent ($50/[$50+$150]) and a statutory percentage of 76 percent under section 963(b); of this amount $53.20 (0.76×$70) would be distributed from B Corporation's earnings and profits and $60.80 (0.76×$80) would be distributed from A Corporation's earnings and profits. The overall United States and foreign income tax with respect to such a pro rata minimum distribution would be $73.62, determined as follows:

| | | |
|---|---|---|
| Taxable income of M Corporation ($60.80+[$53.20 − ($53.20×0.20)]) | | $103.36 |
| U.S. tax before foreign tax credit (0.48 ×$103.36) | | 49.61 |
| Foreign tax credit: | | |
| B Corporation's distribution ($53.20/[$70+$30]×$30)+ ($42.56+ $10.64]×$10.64) | $24.47 | |
| A Corporation's distribution ($60.80/[$80+20]×$20) | 12.16 | 36.63 |
| U.S. tax payable | | 12.98 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($50+ $10.64+$12.98) | | 73.62 |

(d) The United States income tax of M Corporation for 1966 and 1967 is determined as follows, assuming that the minimum overall tax burden is determined under paragraph (a)(1)(ii)(b) of this section:

| | | |
|---|---|---|
| *1966* | | |
| Dividend from earnings and profits of— | | |
| B Corporation ($50 minus tax of $10 on A Corporation at the rate of 20 percent) | | $40.00 |
| A Corporation | | 64.00 |
| Taxable income of M Corporation | | 104.00 |
| U.S. tax before foreign tax credit (0.48×$104) | | $49.92 |
| Less: Foreign tax credit: | | |
| B Corporation's distribution ($50/[$70+$30]×$30+($40/[$40+$10]×$10), or ($15+$8) | $23.00 | |
| A Corporation's distribution ($64/$80+$20]×$20) | 12.80 | 35.80 |
| U.S. tax payable | | $14.12 |
| Overall U.S. and foreign income tax with respect to actual distribution ($50+$10+$14.12) | | 74.12 |
| Overall U.S. and foreign income tax that would be paid with respect to a pro rata minimum distribution (part (c) of this example) | | 73.62 |
| Remaining 1966 earnings and profits for future distribution by: | | |
| B Corporation ($70 − $50) | | 20.00 |
| A Corporation ($80 − $64) | | 16.00 |
| Total | | 36.00 |
| Foreign income tax attributable to remaining 1966 earnings and profits of: | | |
| B Corporation ($20/$70×$30) | | 8.57 |
| A Corporation ($16/$80×$20) | | 4.00 |
| *1967* | | |
| Dividend from remaining 1966 earnings and profits of— | | |
| B Corporation ($20 minus tax of $4 on A Corporation at the rate of 20 percent) | | 16.00 |
| A Corporation | | 16.00 |
| Taxable income of M Corporation | | 32.00 |
| U.S. tax before foreign tax credit (0.48×$32) | | 15.36 |
| Less: Foreign tax credit: | | |
| B Corporation's distribution ($20/[$20+$8.57]×$8.57)+($16/[$16+$4] ×$4), or ($6+$3.20) | $9.20 | |
| A Corporation's distribution ($16/[$16+$4]×$4) | 3.20 | 12.40 |
| U.S. tax payable | | 2.96 |

*Example 4.* (a) Domestic corporation M directly owns 90 percent of the one class of stock of controlled foreign corporation A, which directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns 60 percent of the one class of stock of controlled foreign corporation C. None of the foreign corporations are less developed country corporations under section 902(d); all corporations use the calendar year as the taxable year. For 1963, M Corporation makes a chain election with respect to corporations A, B, and C and receives a distribution from the consolidated earnings and profits of the chain which does not constitute a pro rata minimum distribution. The remaining 1963 consolidated earnings and profits of the chain are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. No corporation in the chain has earnings and profits for 1964 other than from distributions received from remaining 1963 earnings and profits of another corporation in the chain. The foreign country under the laws of which A Corporation is created does not tax dividends which are received by such corporation from B Corporation, but B Corporation is taxed on dividends received from C Corporation. Corporation M complies with the special rules of paragraphs (b) and (c) of this section and determines the minimum overall tax burden under paragraph (a)(1)(ii)(b) of this section with respect to the distribution which is made. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit. The distribution received by M Corporation for 1963 from the consolidated earnings and profits of the chain is sufficient in amount to constitute a minimum distribution. The overall United States and foreign income tax for 1963 with respect to the distribution which is made must be at least equal to the lesser of $32.21 (the amount payable, as determined under paragraph (b) of this example, with respect to a pro rata minimum distribution) and $31.34 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $66.96).

(b) If the chain were to make a pro rata minimum distribution, the distributions and the overall United States and foreign income tax for 1963 with respect to the minimum distribution would be determined as follows, based upon the facts assumed:

| | A | B | C | Total |
|---|---|---|---|---|
| Pretax and predistribution earnings and profits | $20.00 | $50.00 | $30.00 | |
| Reduction for foreign income tax on such earnings and profits (10%, 40%, and 10%, respectively) | 2.00 | 20.00 | 3.00 | |
| Predistribution earnings and profits | 18.00 | 30.00 | 27.00 | |
| Consolidated earnings and profits with respect to M Corporation: | | | | |
| (0.90×$18) | 16.20 | | | |
| (0.90×0.80×$30) or (0.72×$30) | | 21.60 | | |
| (0.90×0.80×0.60×$27) or (0.432×$27) | | | 11.66 | $49.46 |

| | A | B | C | Total |
|---|---|---|---|---|
| Consolidated foreign income taxes with respect to M Corporation: | | | | |
| ($16.20/$18×$2) | 1.80 | | | |
| ($21.60/$30×$20) | | 14.40 | | |
| ($11.66/$27×$3) | | | 1.30 | 17.50 |
| Effective foreign tax rate of the chain for 1963 ($17.50/[$49.46+$17.50]), or ($17.50/ $66.96) | | | | 26.14% |
| Statutory percentage under section 963(b) | | | | 82% |
| Pro rata minimum distribution (before reduction of dividend from C Corporation's share by B Corporation tax paid on such amount): | | | | |
| (0.82×$16.20) | 13.28 | | | |
| (0.82×$21.60) | | 17.71 | | |
| (0.82×$11.66) | | | 9.56 | |
| (0.82×$49.46) | | | | 40.56 |
| Such amounts as reduced by further foreign income tax imposed on distributions through the chain: | | | | |
| No further foreign tax | 13.28 | | | |
| No further foreign tax | | 17.71 | | |
| B Corporation tax ($9.56 − [0.40×$9.56]), or ($9.56 − $3.82) | | | 5.74 | 36.73 |
| Gross-up under section 78: | | | | |
| ($13.28/$16.20×$1.80) | 1.48 | | | |
| ($17.71/$21.60×$14.40) | | 11.81 | | |
| ($5.74/$5.74×$3.82) | | 3.82 | | 17.11 |
| M Corporation's taxable income for 1963 attributable to minimum distribution ($36.73+$17.11) | | | | 53.84 |
| U.S. tax before foreign tax credit ($53.84×0.52) | | | | 28.00 |
| Foreign tax credit (as determined under gross-up above) | | | | 17.11 |
| U.S. tax payable for 1963 ($28 − $17.11) | | | | 10.89 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($17.50+$3.82+$10.89) | | | | 32.21 |

(c) Based upon the distributions which are made by corporations A, B, and C, M. Corporation pays United States tax as follows for 1963 and 1964:

1963

| | A | B | C | Total |
|---|---|---|---|---|
| Distribution made from consolidated earnings and profits of the chain | $9.36 | $21.60 | $9.60 | $40.56 |
| Excess of distribution over statutory percentage of consolidated earnings and profits for 1963 ($40.56 − [0.82×$49.46]) | | | | None |
| Determination of whether the overall U.S. and foreign income tax with respect to the actual distribution is equal to, or exceeds, the lesser of $32.21 (paragraph (b) of example) and $31.34 (paragraph (a) of example): | | | | |
| Amount received by M Corporation after reduction by further foreign income tax imposed on distributions through the chain: | | | | |
| No further foreign tax | 9.36 | | | |
| No further foreign tax | | 21.60 | | |
| B Corporation tax ($9.60 − [0.40×$9.60]), or ($9.60 − $3.84) | | | 5.76 | 36.72 |
| Gross-up under section 78: | | | | |
| ($9.36/$16.20×$1.80) | 1.04 | | | |
| ($21.60/$21.60×$14.40) | | 14.40 | | |
| ($5.76/$5.76×$3.84) | | 3.84 | | 19.28 |
| Taxable income of M Corporation for 1963 attributable to actual distribution ($36.72+$19.28) | | | | 56.00 |
| U.S. tax before foreign tax credit ($56×0.52) | | | | 29.12 |
| Tentative foreign tax credit (as determined under gross-up above) | | | | 19.28 |
| Tentative U.S. tax payable ($29.12 − $19.28) | | | | 9.84 |
| Overall U.S. and foreign income tax with respect to actual distribution ($17.50+ $3.84+$9.84) | | | | 31.18 |
| Insufficient overall U.S. and foreign income tax ($31.34 [i.e., 0.90×0.52×$66.96] − 31,18) | | | | .16 |
| Reduced foreign tax credit ($19.28 − $0.16) | | | | 19.12 |
| U.S. tax payable for 1963 ($29.12 − $19.12) | | | | 10.00 |
| Overall U.S. and foreign income tax with respect to actual distribution ($17.50+$3.84+$10) | | | | 31.34 |
| Allocation of reduction in foreign tax credit to undistributed consolidated 1963 earnings and profits of A and B Corporations to be deemed paid by M Corporation in future years: | | | | |
| Reduction in foreign tax credit ($19.28 − $19.12) | | | | .16 |
| Undistributed 1963 consolidated earnings and profits of the chain: | | | | |
| ($16.20 − $9.36) | 6.84 | | | |
| ($21.60 − $21.00) | | 0 | | |

1963

| | A | B | C | Total |
|---|---|---|---|---|
| ($11.66 − $9.60) | | | $2.06 | 8.90 |
| Allocation of reduction in credit: | | | | |
| ($6.84/$6.84×$0.16) | .16 | | | .16 |
| Foreign income tax attributable to undistributed 1963 earnings and profits of the chain to be taken into account in determining tax deemed paid under section 902: | | | | |
| ($1.80 − $1.04) | .76 | | | |
| ($14.40 − $14.40) | | | | .7 |

1964

| | | | | |
|---|---|---|---|---|
| Distribution from remaining 1963 consolidated earnings and profits of the chain: | | | | |
| ($16.20 − $9.36) | 6.84 | | | |
| ($21.60 − $21.60) | | 0 | | |
| ($11.66 − $9.60) | | | 2.06 | 8.90 |
| Such amounts as reduced by further foreign income tax imposed on distributions through the chain: | | | | |
| No further foreign tax | 6.84 | | | |
| B Corporation tax ($2.06 − [0.40×$2.06]), or ($2.06 − $0.82) | | 1.24 | | 8.08 |
| Gross-up under section 78: | | | | |
| ($6.84/$6.84×$0.76) | 0.76 | | | |
| ($1.24/$1.24×$0.82) | | 0.82 | | 1.58 |
| Taxable income of M Corporation for 1964 attributable to 1964 distribution ($8.08+$1.58) | | | | 9.66 |
| U.S. tax before foreign tax credit ($9.66×0.52) | | | | 5.02 |
| Foreign tax credit: | | | | |
| Deferred credit in accordance with principles of section 902 ($6.84/$6.84×$0.16) | 0.16 | | | 0.16 |
| Tax deemed paid under section 902 (computed under gross-up above) | | | | 1.58 |
| U.S. tax payable for 1964 ($5.02 − [$0.16+$1.58]) | | | | 3.28 |

*Example 5.* (a) Domestic corporation M directly owns all the one class of stock of each of controlled foreign corporations A, B, C, and D. All such corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d). For 1963, M Corporation makes a group election with respect to corporations A, B, C, and D and receives from the 1963 consolidated earnings and profits of the group a distribution which is not a pro rata minimum distribution. None of the foreign corporations has earnings and profits for 1964, but the remaining 1963 earnings and profits of the group are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. The overall limitation under section 904(a)(2) on the foreign tax credit applies for both years.

(b) Assume that M Corporation does not comply with the special rules of paragraphs (b) and (c) of this section and that for 1963 it draws a distribution of all of B Corporation's earnings and profits and enough of C Corporation's earnings and profits to receive the amount of a minimum distribution and to assure that the overall United States and foreign income tax for such year with respect to the distribution from the group satisfies the overall minimum tax requirement of paragraph (a)(1)(i) of this section. In such case, the overall United States and foreign income tax for 1963 with respect to the distribution which is made, determined by using the foreign tax credit under section 901 without applying the special credit rules of paragraph (c) of this section, must at least equal $37.44 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $80). Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows, based upon the facts assumed:

1963

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Pretax and predistribution earnings and profits (and deficits) of the group | $25.00 | $25.00 | $50.00 | ($20.00) | $80.00 |
| Consolidated foreign income taxes | 2.50 | 12.50 | 15.00 | | 30.00 |
| Consolidated earnings and profits | 22.50 | 12.50 | 35.00 | (20.00) | 50.00 |
| Effective foreign tax rate ($30/[$50+$30]) | | | | | 37.5% |
| Statutory percentage under section 963(b) | | | | | 68% |

1963

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Amount of a minimum distribution (0.68×$50) | | | | | 34.00 |
| Tentative distribution | | 12.50 | 21.50 | | 34.00 |
| Tentative gross-up under section 78: | | | | | |
| ($12.50/$12.50×$12.50) | | 12.50 | | | |
| ($21.50/$35×$15) | | | 9.21 | | 21.71 |
| Tentative taxable income of M Corporation ($34+$21.71) | | | | | 55.71 |
| Tentative U.S. tax before foreign tax credit (0.52×$55.71) | | | | | 28.97 |
| Tentative foreign tax credit (as computed under gross-up above) | | | | | 21.71 |
| Tentative U.S. tax payable ($28.97 − $21.71) | | | | | 7.26 |
| Tentative overall U.S. and foreign income tax ($30+$7.26) | | | | | 37.26 |
| Minimum overall U.S. and foreign income tax required to be paid (0.90× .52×$80) | | | | | 37.44 |
| Insufficient overall U.S. and foreign income tax ($37.44 − $37.26) | | | | | .18 |
| Revised distribution | | 12.50 | 22.07 | | 34.57 |
| Gross-up under section 78: | | | | | |
| ($12.50/$12.50×$12.50) | | 12.50 | | | |
| ($22.07/$35×$15) | | | 9.46 | | 21.96 |
| Taxable income of M Corporation ($34.57+$21.96) | | | | | 56.53 |
| U.S. tax before foreign tax credit (.52×$56.53) | | | | | 29.40 |
| Foreign tax credit (as computed under gross-up above) | | | | | 21.96 |
| U.S. tax payable ($29.40 − $21.96) | | | | | 7.44 |
| Overall U.S. and foreign income tax on actual distribution ($30+$7.44) | | | | | 37.44 |

1964

| | | | | | |
|---|---|---|---|---|---|
| Distribution of remaining 1963 consolidated earnings and profits: | | | | | |
| ($22.50 − $0) | 22.50 | | | | |
| ($12.50 − $12.50) | | | | | |
| ($35 − $22.07) | | | 12.93 | | 35.43 |
| Gross-up under section 78: | | | | | |
| ($22.50/$22.50×$2.50) | 2.50 | | | | |
| ($12.93/$35×$15) | | | 5.54 | | 8.04 |
| Taxable income of M Corporation ($35.43+$8.04) | | | | | 43.47 |
| U.S. tax before foreign tax credit ($43.47×0.52) | | | | | 22.60 |
| Foreign tax credit (as computed under gross-up above) | | | | | 8.04 |
| U.S. tax payable ($22.60 − $8.04) | | | | | 14.56 |

(c) Assume that M Corporation does comply with the special rules of paragraphs (b) and (c) of this section and for 1963 receives a minimum distribution consisting of $20 from A Corporation and $14 from C Corporation. In such case, the overall United States and foreign income tax for 1963 with respect to the minimum distribution must at least equal the lesser of $37.44 ($0.90 \times 0.52 \times \$80$) and the overall United States and foreign income tax of $37.89 that would be paid with respect to a pro rata minimum distribution from the group for such year. In such case, the determinations would be made pursuant to subparagraphs (1) and (2) of this paragraph.

(1) If a pro rata minimum distribution were made for 1963 by the group, the overall United States and foreign income tax for such year with respect to such distribution would be $37.89, determined as follows:

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Pretax and predistribution earnings and profits (and deficits) of the group | $25.00 | $25.00 | $50.00 | ($20) | $80.00 |
| Consolidated foreign income taxes | 2.50 | 12.50 | 15.00 | | 30.00 |
| Consolidated earnings and profits before allocation of deficits | 22.50 | 12.50 | 35.00 | | 70.00 |
| Allocation of deficit of D Corporation: | | | | | |
| ($22.50/$70×$20) | (6.43) | | | | |
| ($12.50/$70×$20) | | (3.57) | | | |
| ($35/$70×$20) | | | (10.00) | | (20.00) |
| Consolidated earnings and profits | 16.07 | 8.93 | 25.00 | | 50.00 |
| Effective foreign tax rate ($30/$80) | | | | | 37.50% |
| Statutory percentage under section 963(b) | | | | | 68% |
| Pro rata minimum distribution: | | | | | |
| (0.68×$16.07) | 10.93 | | | | |
| (0.68×$8.93) | | 6.07 | | | |
| (0.68×$25) | | | 17.00 | | 34.00 |
| Gross-up under section 78: | | | | | |
| ($10.93/$16.07×$2.50) | 1.70 | | | | |

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| ($6.07/$8.93×$12.50) | | 8.50 | | | |
| ($17/$25×$15) | | | 10.20 | | 20.40 |
| Taxable income of M Corporation ($34+$20.40) | | | | | 54.40 |
| U.S. tax before foreign tax credit (0.52×$54.40) | | | | | 28.29 |
| Foreign tax credit (as computed under the gross-up above) | | | | | 20.40 |
| U.S. tax payable ($28.29 − $20.40) | | | | | 7.89 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($30+$7.89) | | | | | 37.89 |

(2) Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows:

1963

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Distributions actually made | $20.00 | | $14.00 | | $34.00 |
| Gross-up under section 78: | | | | | |
| ($16.07/$16.07×$2.50) | 2.50 | | | | |
| ($14/$25×$15) | | | 8.40 | | 10.90 |
| Taxable income of M Corporation ($34+$10.90) | | | | | 44.90 |
| U.S. tax before foreign tax credit (0.52×$44.90) | | | | | 23.35 |
| Foreign tax credit (as computed under gross-up above) | | | | | 10.90 |
| U.S. tax payable ($23.35 − $10.90) | | | | | 12.45 |
| Overall U.S. and foreign income tax with respect to the distribution actually made ($30+$12.45), such amount being in excess of the minimum overall tax burden of $37.44 | | | | | 42.45 |

1964

| | | | | | |
|---|---|---|---|---|---|
| Earnings and profits for 1963 to which minimum distribution for such year was not attributable: | | | | | |
| ($22.50 − $20) | $2.50 | | | | |
| ($12.50 − $0) | | $12.50 | | | |
| ($35.00 − $14) | | | $21.00 | | $36.00 |
| Foreign income tax for 1963 not taken into account in determining tax deemed paid for such year on pretax earnings and profits to which the minimum distribution for such year was attributable: | | | | | |
| ([$16.07 − $16.07]/$16.07×$2.50) | 0 | | | | |
| ([$8.93 − $0]/$8.93×$12.50) | | 12.50 | | | |
| ([$25 − $14]/$25×$15) | | | 6.60 | | 19.10 |
| Distributions to M Corporation in 1964 | 2.50 | 12.50 | 21.00 | | 36.00 |
| Gross-up under section 78: | | | | | |
| ($2.50/$2.50×$0) | 0 | | | | |
| ($12.50/$12.50×$12.50) | | 12.50 | | | |
| ($21/$21×$6.60) | | | 6.60 | | 19.10 |
| Taxable income of M Corporation ($36+$19.10) | | | | | 55.10 |
| U.S. tax before foreign tax credit (0.52×$55.10) | | | | | 28.65 |
| Foreign tax credit (as computed under gross-up above) | | | | | 19.10 |
| U.S. tax payable ($28.65 − $19.10) | | | | | 9.55 |

*Example 6.* Throughout 1963, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A, B, and C, and maintains in a foreign country a branch which qualifies under paragraph (f)(4) of §1.963–1 for inclusion in a group as a wholly owned foreign subsidiary corporation. For 1963, a year for which the overall limitation under section 904(a)(2) on the foreign tax credit applies, M Corporation makes a group election with respect to A, B, and C Corporations and the foreign branch. All such corporations use the calendar year as the taxable year. The foreign branch has pretax and predistribution earnings and profits of $40 for 1963, as determined under paragraph (f)(4)(ii) of §1.963–1. None of the foreign corporations is a less developed country corporation under section 902(d). Corporation M complies with the special rules of paragraphs (b) and (c) of this section. The United States income tax of M Corporation for 1963 is as follows, based upon the facts assumed:

| | A | B | C | Branch | Total |
|---|---|---|---|---|---|
| Pretax and predistribution consolidated earnings and profits of the group | $20.00 | $30.00 | $10 | $40 | $100.00 |
| Consolidated income taxes | 2.00 | 15.00 | 5 | 20 | 42.00 |
| Effective foreign tax rate ($42/$100) | | | | | 42% |
| Statutory percentage under section 963(b) | | | | | 40% |
| Posttax and predistribution consolidated earnings and profits of the group | 18.00 | 15.00 | 5 | 20 | 58.00 |
| U.S. tax which would be paid on a pro rata minimum distribution from consolidated earnings and profits of the group: | | | | | |
| Pro rata minimum distribution (and amount which would be received by M Corporation): | | | | | |
| (0.40×$18) | 7.20 | | | | |
| (0.40×$15) | | 6.00 | | | |
| (0.40×$5) | | | 2 | | |
| (0.40×$40) | | | | 16 | 31.20 |
| Gross-up under section 78: | | | | | |
| ($7.20/$18×$2) | .80 | | | | |
| ($6/$15×$15) | | 6.00 | | | |
| ($2/$5×$5) | | | 2 | | 8.80 |
| Taxable income of M Corporation ($31.20+$8.80) | | | | | 40.00 |
| U.S. tax before foreign tax credit (0.52×$40) | | | | | 20.80 |
| Foreign tax credit ($8.80, as computed under the gross-up, plus 40 percent of $20) | | | | | 16.80 |
| U.S. tax payable ($20.80 − $16.80) | | | | | 4.00 |
| Overall U.S. and foreign income tax with respect to a pro rata minimum distribution for 1963 ($4+$42) | | | | | 46.00 |
| Tentative tax on distribution actually received by M Corporation: | | | | | |
| Actual distribution received | | | $5 | $40 | $45.00 |
| Gross-up under section 78 ($5/$5×$5) | | | 5 | | 5.00 |
| Taxable income of M Corporation ($45+$5) | | | | | 50.00 |
| U.S. tax before foreign tax credit (0.52×$50) | | | | | 26.00 |
| Tentative foreign tax credit ($5, as computed under the gross-up above, plus 100 percent of $20) | | | | | 25.00 |
| Tentative U.S. tax payable ($26 − $25) | | | | | 1.00 |
| Insufficient overall U.S. and foreign income tax (the lesser of $46 or $46.80 [0.90×0.52×$100] minus $43 [$1+$42]) | | | | | 3.00 |
| Reduced foreign tax credit ($25 − $3) | | | | | 22.00 |
| U.S. tax payable ($26 − $22) | | | | | 4.00 |
| Overall U.S. and foreign income tax with respect to actual distribution for 1963 ($4+$42) | | | | | 46.00 |
| Reduction in foreign tax credit for 1963 ($25 − $22) | | | | | 3.00 |
| Allocation of reduction in foreign tax credit to undistributed 1963 consolidated earnings and profits of the group: | | | | | |
| ($18/[$18+$15]×$3.00) | 1.64 | | | | |
| ($15/[$18+$15]×$3.00) | | 1.36 | | | 3.00 |

*Example 7.* Domestic group M, an affiliated group of domestic corporations filing a consolidated return under section 1501, makes a group election for 1963 with respect to a group consisting of two controlled foreign corporations C and D, all of whose one class of stock is directly owned by group M, and foreign branch B, a foreign branch of a Western Hemisphere trade corporation (as defined in section 921) included in group M. No distributions are received for the taxable year from corporations C and D, but the foreign group makes a minimum distribution by reason of the deemed distribution of all of branch B's earnings and profits. Group M complies with the special rules of paragraphs (b) and (c) of this section. For 1963, a year for which the United States corporate income tax rate is 52 percent, the overall limitation under section 904(a)(2) on the foreign tax credit applies. All corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d) for 1963. The income, and the United States and foreign income tax for 1963, are determined as follows, based upon the facts assumed:

| | Branch | C | D | Total |
|---|---|---|---|---|
| Pretax and predistribution consolidated earnings and profits of the foreign group (before Western Hemisphere trade corporation deduction) | $100.00 | $10.00 | $10.00 | $120.00 |
| Western Hemisphere trade corporation deduction ($100×0.14/0.52) | 26.92 | | | 26.92 |
| Pretax and predistribution consolidated earnings and profits of the foreign group (after Western Hemisphere trade corporation deduction) | 73.08 | 10.00 | 10.00 | 93.08 |

| | Branch | C | D | Total |
|---|---|---|---|---|
| Consolidated foreign income taxes (38%, 20%, and zero rate, respectively): | | | | |
| (0.38×$100) | 38.00 | | | |
| (0.20×$10) | | 2.00 | | 40.00 |
| Consolidated earnings and profits of the foreign group | 35.08 | 8.00 | 10.00 | 53.08 |
| Effective foreign tax rate ($40/$93.08) | | | | 43% |
| Statutory percentage under section 963(b) | | | | 40% |
| Tax which would be paid with respect to a pro rata minimum distribution from consolidated earnings and profits of the foreign group: | | | | |
| Pro rata minimum distribution: | | | | |
| (0.40×$73.08) | 29.23 | | | |
| (0.40×$8.00) | | 3.20 | | |
| (0.40×$10.00) | | | 4.00 | 36.43 |
| Gross-up under section 78: ($3.20/$8.00×$2) | | .80 | | .80 |
| Taxable income of group M | 29.23 | 4.00 | 4.00 | 37.23 |
| U.S. tax before foreign tax credit: | | | | |
| (0.52×$29.23) | 15.20 | | | |
| (0.54×$4.00) | | 2.16 | | |
| (0.54×$4.00) | | | 2.16 | 19.52 |
| Foreign tax credit ($0.80, as computed under the gross-up above, plus 40 percent of $38) | 15.20 | .80 | | 16.00 |
| U.S. tax payable | | 1.36 | 2.16 | 3.52 |
| Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($3.52+$40) | | | | 43.52 |
| Tentative tax on distribution actually received by group M: | | | | |
| Taxable income of branch | 73.08 | | | 73.08 |
| U.S. tax before foreign tax credit (0.52×$73.08) | 38.00 | | | 38.00 |
| Tentative foreign tax credit | 38.00 | | | 38.00 |
| Tentative U.S. tax payable | | | | 0 |
| Insufficient overall U.S. and foreign income tax (the lesser of $43.52 or $43.56 [0.90×0.52×$93.08] minus $40) | | | | 3.52 |
| Reduced foreign tax credit ($38 − $3.52) | | | | 34.48 |
| U.S. tax payable ($38 − $34.48) | | | | 3.52 |
| Overall U.S. and foreign income tax ($3.52+$40.00) | | | | 43.52 |
| Reduction in foreign tax credit for 1963 ($38 − $34.48) | | | | 3.52 |
| Allocation of reduction in foreign tax credit to 1963 undistributed consolidated earnings and profits of the foreign group: | | | | |
| ($8/[$8+$10]×$3.52) | | 1.56 | | |
| ($10/[$8+$10]×$3.52) | | | 1.96 | 3.52 |

[T.D. 6759, 29 FR 13335, Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14878, Nov. 3, 1964; T.D. 7100, 36 FR 5336, Mar. 20, 1971]

### § 1.963–5 Foreign corporations with variation in foreign tax rate because of distributions.

(a) *Limited application of section.* The rules of this section shall apply to a foreign corporation only if—

(1) Under the laws of a foreign country or possession of the United States the foreign income tax of the corporation for the taxable year depends upon the extent to which distributions are made by such corporation from its earnings and profits for the taxable year, so that the rate of such tax for the taxable year on income which is distributed differs from the rate of such tax for such year on the income which is not distributed, and

(2) The corporation—

(i) Is a single first-tier corporation, or

(ii) Is for the taxable year in a chain or group from which the United States shareholder receives a minimum distribution in respect of which the minimum overall tax burden is determined in accordance with paragraph (a)(1)(ii) of § 1.963–4.

(b) *Foreign income tax determined as though no distributions were made.* The foreign income tax on the pretax and predistribution earnings and profits of the foreign corporation for the taxable year shall (solely for the purpose of determining the effective foreign tax rate under paragraph (c) of § 1.963–2) be determined as if the foreign corporation made no distributions for the taxable year. However, notwithstanding the second sentence of paragraph (d)(1) of § 1.963–2, where the United States shareholder owns the stock (with respect to which the election under section 963 is

made) in such corporation by reason of stock owned through a chain of ownership described in section 958(a) and the foreign income tax of such corporation for the taxable year decreases as distributions are made from its earnings and profits, the rule in the preceding sentence shall not apply if the electing United States shareholder does not actually receive for the taxable year its proportionate share of the earnings and profits which are actually distributed. In such case, the foreign income tax on pretax and predistribution earnings and profits shall be the actual foreign income tax of such corporation, computed on the basis of the distributions which are made. For example, assume that a second-tier foreign corporation in a chain has pretax and predistribution earnings of $100 for the taxable year and that foreign law imposes on such corporation a foreign income tax of 50 percent of the pretax earnings and profits minus dividends for such year and of 20 percent of such dividends. If the second-tier foreign corporation distributes $20 of earnings and profits to a first-tier foreign corporation which is part of the same chain, and if the first-tier corporation retains the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be the tax actually paid for the taxable year, that is, $44 (50 percent of $80 plus 20 percent of $20). If the first-tier foreign corporation distributes the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be $50 (50 percent of $100). For purposes of this paragraph, the principles of paragraph (b)(3) of §1.963–4 shall apply.

(c) *Minimum distribution*—(1) *Single first-tier corporation.* A minimum distribution for a taxable year by a single first-tier corporation described in paragraph (a)(1) of this section shall be a distribution which is equal to—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for such year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(2)(i) of §1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(2) *Corporation in a chain or group making a pro rata minimum distribution.* In case of a corporation described in paragraph (a)(2)(ii) of this section in a chain or group, such corporation's share of a pro rata minimum distribution by the chain or group for the taxable year shall be—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for the taxable year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(3) of §1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(3) *A chain or group making a distribution other than a pro rata minimum distribution.* If a chain or group contains one or more foreign corporations described in paragraph (a)(2)(ii) of this section and such chain or group makes a minimum distribution other than a pro rata minimum distribution for the taxable year, the amount of such minimum distribution to the electing United States shareholder shall be at least—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for the taxable year by the consolidated earnings and profits of such chain or group with respect to such shareholder, as determined under paragraph (d)(3) of such section but without any deduction for foreign income tax provided by paragraph

(d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by the foreign corporations in the chain or group by reason of distributing such amount, less such tax, for such taxable year.

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

*Example 1.* Domestic corporation M directly owns 80 percent of the one class of stock of single first-tier corporation B, which for 1964 has $100 of pretax earnings and profits on which is imposed a foreign income tax of 40 percent of pretax earnings and profits minus dividends for the taxable year and of 20 percent of the amount of such dividends. Both corporations use the calendar year as the taxable year. The effective foreign tax rate applicable to B Corporation, as determined under paragraph (c) of §1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of §1.963–2 for 1964 is 38 percent. Corporation M receives a minimum distribution for 1964 if it receives from B Corporation's earnings and profits for such year $22.80, that is, 80 percent of $28.50, the distribution which would be made if there were distributed that amount of earnings and profits which, together with the foreign income tax at the rate effectively applicable to pretax earnings and profits to which such distribution is attributable, equals 38 percent of $100. Such distribution may be determined by solving for ''d'' in the following formula:

$$d=\$38-0.20d-0.40(\$38-d)$$
$$d=\$38-0.20d-\$15.20+0.40d$$
$$d=\$22.80+0.20d$$
$$0.80\ d=\$22.80$$
$$d=\$22.80/0.80$$
$$d=\$28.50$$

*Example 2.* Domestic corporation M directly owns 80 percent of the one class of stock of each of controlled foreign corporations A and B, which constitute a group and each of which for 1964 has pretax earnings and profits of $100. All corporations use the calendar year as the taxable year. Corporation A is subject to foreign income tax at a flat rate of 40 percent; and B Corporation is subject to a foreign income tax of 40 percent of $100 minus dividends for the taxable year and of 20 percent of the amount of such dividends. The effective foreign tax rate with respect to the group, as determined under paragraph (c) of §1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of §1.963–2 for 1964 is 38 percent. Corporation B distributes $25 for 1964 toward a minimum distribution from the group which is not a pro rata minimum distribution. The minimum distribution by the group for 1964 with respect to M Corporation is determined as follows:

| | |
|---|---|
| M Corporation's proportionate share of B Corporation's distribution (0.80×$25) | $20.00 |
| Pretax and predistribution consolidated earnings and profits of the group (0.80×$200) | 160.00 |
| Statutory percentage of pretax and predistribution consolidated earnings and profits (0.33×$160) | 60.80 |
| Less: portion of such statutory percentage to which the $20 dividend received from B Corporation is attributable: Total dividend paid by B Corporation | 25.00 |
| Plus: Foreign income tax on B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable, letting ''t'' represent such tax: t=0.20 ($25)+0.40t. t=$5+0.40t. 0.60t=$5. t=$5/0.60 | 8.33 |
| B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable | 33.33 |
| M Corporation's proportionate share of B Corporation's pretax and predistribution earnings and profits to which the dividend is attributable (0.80×$33.33) | 26.67 |
| The statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which A Corporation's distribution must be attributable | 34.13 |
| Dividend required to be received from A Corporation ($34.13−[0.40×$34.13]) | 20.48 |
| Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.48) | 40.48 |

*Example 3.* The facts are the same as in example 2 except that the $25 distribution of earnings and profits is made by A Corporation. The amount of the minimum distribution for 1964 is determined as follows:

| | |
|---|---|
| M Corporation's proportionate share of A Corporation's distribution (0.80×$25) | $20.00 |
| Pretax and predistribution consolidated earnings and profits of the group (0.80×$200) | 160.00 |
| Statutory percentage of pretax and predistribution consolidated earnings and profits (0.38×$160) | 60.80 |
| Less: Portion of such statutory percentage to which the $20 dividend received from A Corporation is attributable: Total dividend paid by A Corporation | 25.00 |
| Plus: Foreign income tax on A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable (0.40×[$25/0.60]) | 16.67 |
| A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable | 41.67 |
| M Corporation's proportionate share of A Corporation's pretax and predistribution earnings and profits to which dividend is attributable ($41.67×0.80) | 33.34 |

| | |
|---|---|
| Portion of the statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which B Corporation's distribution must be attributable | 27.46 |
| Dividend received from B Corporation, letting "d" represent the dividend:<br>d=$27.46 − 0.20d − 0.40 ($27.46 − d).<br>d=$27.46 − 0.20d − $10.98+0.40d.<br>d=$16.48+0.20d.<br>0.80d=$16.48.<br>d=$16.48/0.80 | 20.60 |
| Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.60) | 40.60 |

(d) *Distributions through a chain or group.* In the application of paragraph (b)(3)(i) of §1.963–4, relating to the allocation of dividend payments first to income received as a distribution from other foreign corporations in the chain or group, if one or more of such other foreign corporations is a corporation whose foreign income tax rate decreases as the distributions are made, the allocation under such paragraph shall be made first to such corporations' distributions.

(e) *Foreign tax credit*—(1) *Year of minimum distribution.* If a United States shareholder receives for a taxable year a distribution of the earnings and profits for the taxable year of a foreign corporation described in paragraph (a) of this section and if for such year such corporation is a first-tier corporation, or a second-tier corporation described in section 902 (a) or (b), as the case may be, then, in applying paragraph (c)(2)(i) of §1.963–4, only the foreign income tax which is effectively applicable to pretax earnings and profits to which are attributable the earnings and profits which are distributed shall be deemed paid for such year under section 902 (a) or (b), as the case may be, and the foreign income tax so paid or accrued by such corporation shall not be averaged, for purposes of such section, with its foreign income tax paid or accrued for such year on its pretax earnings and profits to which are attributable the earnings and profits which are not distributed.

(2) *Year of distribution of remaining earnings and profits.* If for a taxable year a United States shareholder receives a minimum distribution from a corporation described in paragraph (a) of this section, the pretax and predistribution earnings and profits of such corporation for the taxable year to which such minimum distribution is attributable and the foreign income tax which is taken into account, in accordance with paragraph (c)(2)(i) of §1.963–4, in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder.

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

*Example 1.* (a) All the income of controlled foreign corporation B, wholly owned directly by domestic corporation M, is taxed by foreign country Y, the tax laws of which impose at the local level a corporate income tax of 10 percent of earnings and profits (before reduction for income taxes) and, at the national level, an income tax of 30 percent of such earnings and profits reduced by the local tax and by any profits which are distributed. Also, at the national level, a tax of 20 percent is imposed on B Corporation on the dividends which are paid for the taxable year. Both corporations use the calendar year as the taxable year. For 1963, B Corporation has earnings and profits (before reduction by income taxes) of $100. B Corporation is not a less developed country corporation under section 902(d). For 1963, M Corporation makes a first-tier election with respect to B Corporation and receives a minimum distribution. Corporation B has no 1964 earnings and profits, and its remaining 1963 earnings and profits are distributed late in 1964. The amount of the minimum distribution required to be received by M Corporation for 1963 and the United States tax with respect to the 1963 earnings and profits of B Corporation are determined as follows, assuming a United States corporate income tax rate of 52 percent (instead of 50 percent) for 1964 and no surtax exemption under section 11(c) for either year:

1963

| | |
|---|---|
| Effective foreign tax rate which obtains if no earnings and profits of B Corporation are distributed [($100×0.10)+([$100 − ($100×0.10)]×0.30)]/$100 | 37% |
| Minimum percentage of earnings and profits required under section 963(b) to be distributed, given a 37 percent effective foreign tax rate | 68% |

| 1963 | |
|---|---|
| Amount of earnings and profits (before reduction by foreign income tax) to which minimum distribution would be attributable if the effective foreign tax rate of 37 percent obtained (0.68×$100) | $68.00 |
| Minimum distribution required to be received by M Corporation, i.e., such an amount that is $68 less the foreign income tax on such $68, determined by letting "d" equal the dividend in the algebraic equation: d=$68 − (0.10 × $68) − 0.30 ($68 − [0.10 × $68] − d) − 0.20d. d=$68 − $6.80 − ($20.40 − $2.04 − 0.30d) − 0.20d. d=$61.20 − $20.40 + $2.04 + 0.30d − 0.20d. d=$42.84 + 0.10d. 0.90d=$42.84. d=$42.84/0.90, or | $47.60 |
| Gross-up under section 78, using the actual foreign income tax imposed on pretax profits to which are attributable the earnings and profits distributed ($6.80+0.30 [$61.20−$47.60]+0.20 [$47.60]) | $20.40 |
| Taxable income of M Corporation for 1963 ($47.60+$20.40) | $68.00 |
| U.S. tax before foreign tax credit ($68×0.52) | $35.36 |
| Foreign tax credit ($47.60/$47.60× $20.40) | $20.40 |
| U.S. tax payable for 1963 ($35.36− $20.40) | $14.96 |
| Overall U.S. and foreign income tax rate [$14.96+$20.40+($32×0.37)]/ $100 | 47.20% |

| 1964 | |
|---|---|
| Dividend received by M Corporation ($32−[0.37×$32]) | $20.16 |
| Gross-up under section 78, using the foreign income tax paid or accrued on pretax earnings and profits to which are attributable 1963 earnings and profits distributed during 1964 ($20.16/$20.16×[$32× 0.37]) | $11.84 |
| Taxable income of M Corporation for 1964 ($20.16+$11.84) | $32.00 |
| U.S. tax before foreign tax credit ($32×0.52) | $16.64 |
| Foreign tax credit ($20.16/$20.16× $11.84) | $11.84 |
| U.S. tax payable ($16.64−$11.84) | $4.80 |

(b) If B Corporation were a less developed country corporation under section 902(d), there would be no gross-up under section 78 and the foreign tax credit of M Corporation would be $14.28 for 1963 ($47.60/[47.60+ $20.40]×$20.40), and $7.46 for 1964 ($20.16/ [$20.16+$11.84]×$11.84).

*Example 2.* For 1963, domestic corporation M receives a dividend of $21 from B Corporation which counts toward a minimum distribution from a group, determined by applying the special rules of paragraphs (b) and (c) of §1.963–4. Both corporations use the calendar year as the taxable year. Foreign law imposes on B Corporation an income tax of 40 percent of the year's pretax earnings and profits, less dividends paid for such year, and of 20 percent of such dividends. Corporation M directly owns 70 percent of the one class of stock of B Corporation, which for 1963 has pretax and predistribution earnings and profits of $100. Corporation B is not a less developed country corporation under section 902(d). In late 1964, M Corporation receives a distribution of all of B Corporation's 1964 earnings and profits and of $25.20 from its 1963 earnings and profits. The foreign income tax of B Corporation deemed paid for 1963 by M Corporation under section 902(a) is based on the foreign income tax actually paid by B Corporation on an amount of pretax earnings and profits which, when reduced by the tax so paid, equals the total dividend which is paid. The determination of tax deemed paid by M Corporation with respect to distributions from 1963 earnings and profits of B Corporation is as follows:

| 1963 | |
|---|---|
| Pretax and predistribution earnings and profits of B Corporation for 1963 | $100 |
| Total dividend paid by B Corporation in 1963 ($21/ 0.70) | 30 |
| Total foreign income tax paid by B Corporation for 1963 (0.40[$100− $30]+[0.20×$30]) or ($28+$6) | 34 |
| Foreign income tax, represented by "t" in the following equation, to be taken into account with respect to total dividend in determining tax deemed paid under section 902(a) by M Corporation: t=(0.20×$30)+0.40t. t=$6+0.40t. 0.60t=$6. t=$6/0.60, or | $10 |
| Foreign income tax deemed paid by M Corporation for 1963 ($21/$30×$10) | 7 |

| 1964 | |
|---|---|
| Remaining 1963 earnings and profits of B Corporation ([$100−$34]−$30) or ($66−$30) | 36 |
| Dividend received by M Corporation for 1964 (0.70×$36) | 25.20 |
| Foreign income tax deemed paid by M Corporation for 1964 ($25.20/$36× [$34−$10]) or ($25.20/ $36×$24) | 16.80 |

[T.D. 6759, 29 Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

## § 1.963–6 Deficiency distribution.

(a) *In general.* Section 963(e)(2) and this section provide a method under which, by virtue of a deficiency distribution, a United States shareholder may be relieved from the payment of a deficiency in tax for any taxable year arising by reason of failure to include subpart F income in gross income under section 951(a)(1)(A)(i), when it has been determined that such shareholder has failed to receive a minimum distribution for such year in respect of which it elected to secure the exclusion

under section 963. In addition, this section provides rules with respect to a credit or refund of part or all of any such deficiency which has been paid. Under the method provided, the benefit of the exclusion of subpart F income from gross income of the United States shareholder is allowed retroactively for the taxable year in respect of which the election under section 963 applied, but only if the subsequent deficiency distribution meets the requirements of this section. The benefits of the retroactive exclusion will not, however, prevent the assessment of interest, additional amounts, and assessable penalties.

(b) *Requirements for deficiency distribution*—(1) *Distribution made on or after date of determination.* If—

(i) A United States shareholder, in making its return of the tax imposed by chapter 1 of the Code for any taxable year, elects to secure an exclusion under section 963 for such year,

(ii) It is subsequently determined (within the meaning of paragraph (c) of this section) that an exclusion under section 963 of subpart F income with respect to stock to which such election relates does not apply for such taxable year because of the failure of such shareholder to receive a minimum distribution for such year with respect to such stock, and

(iii) Such failure is due to reasonable cause, a deficiency distribution which is received by such shareholder with respect to such stock from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if such deficiency distribution is received (except as provided by subparagraph (2) of this paragraph) on, or within 90 days after, the date of such determination and prior to the filing of a claim under paragraph (d)(1) of this section. Such claim must be filed within 120 days after the date of such determination, and the deficiency distribution must be a dividend of such a nature (except as otherwise provided in this section) as would have permitted it to count toward a minimum distribution for the taxable year of the election if it had been received by the United States shareholder during such year. No distribution shall count as a deficiency distribution under this subparagraph unless a claim therefor is filed under paragraph (d)(1) of this section.

(2) *Distribution made before date of determination.* A deficiency distribution may also be received by a United States shareholder at any time prior to the date on which the determination required by subparagraph (1) of this paragraph is made. A distribution will count as a deficiency distribution under this subparagraph—

(i) To the extent that such distribution otherwise satisfies the requirements of this section;

(ii) If the United States shareholder files within 90 days after such distribution but before the determination date an advance claim described in paragraph (d)(2) of this section for treatment of such distribution as a deficiency distribution;

(iii) If such shareholder consents in such claim to include such deficiency distribution in gross income for the taxable year of the election to the extent necessary to complete a minimum distribution for such year and under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for such taxable year;

(iv) If, when requested by the district director, such shareholder consents under section 6501 in such claim to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts and assessable penalties for the year of receipt of such distribution; and

(v) To the extent that such shareholder makes advance payment of tax which would result from the inclusion of such distribution in gross income as a minimum distribution for the year of such deficiency.

To the extent that such distribution is not necesasry under the determination (when made under paragraph (c) of this section) for a deficiency distribution, it

shall be included in the United States shareholder's gross income for the taxable year of receipt of such distribution and paragraph (g) of this section shall not apply.

(3) *Earnings and profits of year of election to be first distributed.* If—

(i) In the case of a first-tier election, the United States shareholder's proportionate share of the earnings and profits of the foreign corporation which was the single first-tier corporation, or

(ii) In the case of a chain or group election, any portion of the share of any corporation or corporations (which were in the chain or group) of the consolidated earnings and profits with respect to the United States shareholder, for the taxable year of the election has not been distributed on the stock with respect to which the election was made, then a distribution, in order to be counted toward a deficiency distribution, must be made by such corporation or corporations and from such earnings and profits to the extent thereof. Once all such earnings and profits of such corporation or corporations have been completely distributed, a deficiency distribution may be made from other earnings and profits of such foreign corporation which was a single first-tier corporation, or of such corporation or corporations which were in such chain or group, as the case may be.

(4) *Proof of reasonable cause.* Reasonable cause for failure to receive a minimum distribution shall be deemed to exist, in the absence of circumstances demonstrating bad faith, if the electing United States shareholder receives, within the period prescribed by paragraph (a)(1)(i) of §1.963–3 with respect to the year of election, at least 80 percent of the amount of a minimum distribution (from the earnings and profits to which the election for such year relates) which if received during such period would have satisfied the conditions for the section 963 exclusion to apply to such year. If less than 80 percent of the amount of a minimum distribution is received during such period, the existence of a reasonable cause for failure to receive a minimum distribution must be established by clear and convincing evidence; however, the preceding sentence shall not be taken as a limitation on the establishment of reasonable cause by any other proof of reasonable cause. For example, reasonable cause will exist if a single first-tier corporation for its taxable year makes a distribution which would be a minimum distribution but for a refund of foreign income tax which it has paid in good faith under foreign law but which is found not to be due after the United States income tax return of the United States shareholder has been filed.

(c) *Nature and details of determination.* (1) A determination that the section 963 exclusion does not apply to a United States shareholder for a taxable year due to its failure to receive a minimum distribution for such year shall, for the purposes of this section, be established by—

(i) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(ii) A closing agreement made under section 7121; or,

(iii) An agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated, and by, or on behalf of, such shareholder and which relates to the liability of such shareholder for the tax under chapter 1 of the Code for such year.

(2) The date of determination by a decision of the Tax Court shall be the date upon which such decision becomes final, as prescribed in section 7481.

(3) The date upon which a judgment of a court becomes final shall be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court shall become final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims shall become final upon the expiration of the time allowed for filing a petition for certiorari, if no such petition is duly filed within such time.

(4) The date of determination by a closing agreement made under section 7121 shall be the date such agreement is approved by the Commissioner.

(5) The date of a determination made by an agreement which is signed by the

district director, or such other official to whom authority to sign the agreement is delegated, shall be the date prescribed by this subparagraph. The agreement shall be sent to the United States shareholder at his 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 for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if the deficiency distribution is received by such shareholder before such registration or postmark date but on or after the date the agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be the date on which the agreement is so signed.

(6) The determination under this paragraph shall find that, due to the United States shareholder's failure to receive a minimum distribution, the section 963 exclusion does not apply for the taxable year with respect to stock to which the election under such section relates. A determination described in subdivision (ii) or (iii) of subparagraph (1) of this paragraph shall set forth the amount of the deficiency distribution and the amount of additional income tax for which the United States shareholder is liable under Chapter 1 of the Code by reason of not including in gross income for such year the amount of the deficiency distribution. If a determination described in subdivision (i) of subparagraph (1) of this paragraph does not establish the amount of the deficiency distribution and such amount of additional tax, such amounts may be established by an agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated.

(d) *Claim for treatment of distribution as a deficiency distribution*—(1) *Claim filed after date of determination.* A claim (including any amendments thereof) for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 120 days after the date of the determination described in paragraph (c) of this section, with the requisite declaration prescribed by the Commissioner on the appropriate claim form and shall be accompanied by—

(i) A copy of such determination and a description of how it became final;

(ii) If requested by the district director, or by such other official to whom authority to sign the agreement referred to in paragraph (c)(1) or (6) of this section is delegated, a consent by the United States shareholder under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for the taxable year of election; and

(iii) Such other information as may be required by the claim form or the district director, or other official, in support of the claim.

(2) *Advance claim.* An advance claim for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 90 days after such distribution but before the date of determination described in paragraph (c) of this section, and shall satisfy all requirements of subparagraph (1) of this paragraph other than subdivision (i) of such subparagraph. However, within 120 days after the date of the determination described in paragraph (c) of this section, the advance claim shall be completed so that it satisfies all requirements of subparagraph (1) of this paragraph.

(e) *Computation of interest on deficiencies in tax.* If a United States shareholder, for the taxable year of the election under section 963, completes a minimum distribution for such year by receiving a deficiency distribution to which this section applies, the interest on the deficiency in tax due by reason of the failure to include the amount of such deficiency distribution in such shareholder's gross income for such year shall be computed for the period from the last date prescribed for payment of the tax for such year to the date such deficiency in tax is paid. No

interest shall be due by reason of the failure to include Subpart F income in gross income for a taxable year in respect of which a minimum distribution under section 963 is completed by a deficiency distribution to which this section applies.

(f) *Claim for credit or refund.* If a deficiency in tax is asserted for any taxable year by reason of failure to include Subpart F income in gross income under section 951(a)(1)(A)(i) and the United States shareholder has paid any portion of such asserted deficiency, such shareholder is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment of tax as the result of the receipt of a deficiency distribution to which this section applies. To secure credit or refund of such overpayment of tax, the United States shareholder must file a claim for refund in accordance with §301.6402–3, in addition to the claim form required under paragraph (d) of this section. No interest shall be allowed on such credit or refund. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see section 6402 and the regulations thereunder. For the limitations applicable to the credit or refund for an overpayment of tax, see section 6511 and the regulations thereunder.

(g) *Effect of deficiency distribution*—(1) *Allocation of distributions.* The deficiency distribution shall be allocated, by applying the rules of §1.963–3 (and paragraph (b) of §1.963–4, if applicable for the year of election), as a distribution first from the earnings and profits (to the extent thereof) of the foreign corporation which was the single first-tier corporation, or of the distributing corporation or corporations which were in the chain or group, as the case may be, for the taxable year in respect of which the election was made, and then from earnings and profits (to the extent thereof) described in section 959(c)(3) and determined as provided in section 959 for the most recent taxable year and the first, second, etc., taxable years preceding such recent taxable years, in that order, of the distributing corporation or corporations. In applying the preceding sentence to taxable years other than the taxable year in respect of which the election was made, the deficiency distribution shall first be allocated, in the order of allocation prescribed by such sentence, first to taxable years in respect of which no election under section 963 was made with respect to the stock on which such distribution is received and then to taxable years in respect of which an election under such section was made.

(2) *Year of receipt.* Any deficiency distribution made with respect to a taxable year of the United States shareholder shall be treated, except as provided in paragraph (b)(2) of this section, as having been received by the shareholder in that year for which such shareholder elected to secure an exclusion under section 963; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a deficiency distribution for such year shall be treated as paid or accrued, or deemed paid, for such year.

(3) *Year of payment.* A distribution counting toward a deficiency distribution for a taxable year of election shall, except as provided in paragraph (b)(2) of this section, be treated for purposes of applying paragraph (a) of §1.963–3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of §1.963–4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of §1.963–3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of §1.963–4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

(4) *Allocation of reduction in tax credit.* If any portion of a deficiency distribution from a corporation which was in a chain or group is paid from earnings and profits of a taxable year other than that in respect of which the election was made, then the minimum distribution toward which such deficiency distribution counts may not be treated as a pro rata minimum distribution for purposes of §1.963–4. Moreover, the amount of the overall United States and foreign income tax with respect to such minimum distribution must satisfy the minimum tax requirements of paragraph (a)(1)(i), or paragraph (ii), of §1.963–4, but, if the latter applies, without any reduction and deferral under paragraph (c)(3) of such section of the foreign tax credit allowable under section 901 with respect to the deficiency distribution.

[T.D. 6759, 29 FR 13346, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964; T.D. 7410, 41 FR 11020, Mar. 16, 1976; T.D. 8939, 66 FR 2819, Jan. 12, 2001]

### § 1.963–7 Transitional rules for certain taxable years.

(a) *Extension of time for making, revoking, or changing election*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph provide additional rules which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing its return (including any extensions of time under section 6081) occurs on or before the 90th day after September 30, 1964.

(2) *Manner of making the election.* The election of the United States shareholder to secure the exclusion under section 963 and the consent to the regulations under such section may be made for the taxable year—

(i) By filing with the return (or with an amended return filed on or before such 90th day) for such taxable year—

(*a*) A written statement stating that such election is made for such taxable year, and

(*b*) The names of the foreign corporations to which such election applies, the taxable year, country of incorporation, pretax earnings and profits, foreign income taxes, earnings and profits, and outstanding capital stock, of each such corporation, and such other information relating to the election made as the Commissioner may prescribe, on or before the date of filing, by instructions or schedules to support such return; or

(ii) In case of any extension of time under section 6081 with respect to such taxable year where the last day prescribed by law for filing the return by the electing United States shareholder (not including any extensions thereof) occurs on or before September 30, 1964, by filing with the request for the first such extension of time a written statement stating that such election is made for such taxable year and setting forth the names of the foreign corporations to which each election applies.

(3) *Revocation or change of election.* An election made in the manner provided by subparagraph (2) of this paragraph may be revoked or changed—

(i) By filing with the return on or before the 90th day after September 30, 1964, a written statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)(*b*) of this paragraph, or

(ii) Where the return has been filed on or before such 90th day, by filing on or before such 90th day an amended return and an accompanying statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)(*b*) of this paragraph.

(b) *Extension of time for making a minimum distribution*—(1) *In general.* This paragraph applies only with respect to a taxable year of a United States shareholder ending on or before September 30, 1964, for which an election to secure an exclusion under section 963 is made where, in case of a first-tier election, the distribution period of such first-tier corporation with respect to its taxable year to which such election applies ends on or before the 90th day after such date, and where, in the case of a chain or group election, the distribution period ends on or before such 90th day with respect to the taxable year to which the election applies of any of the foreign corporations in such chain or group.

(2) *Conditions for obtaining extension of time.* A distribution on stock with respect to which the election under section 963 was made which is received by the United States shareholder from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if—

(i) The distribution is made on or before such 90th day,

(ii) The shareholder, in a statement attached to its return or amended return for such year (which is filed on or before such 90th day) indicates the foreign corporation or corporations from which the distribution is made and states that, and the extent to which, the distribution is to count toward such minimum distribution,

(iii) The distribution is of such a nature as would have permitted it to count toward a minimum distribution for such taxable year of the United States shareholder if it had been made on the last day of such year, and

(iv) The United States shareholder includes the distribution in gross income as if it were received on the last day of such taxable year of election.

The distribution shall be applied against the earnings and profits of the single first-tier corporation or the foreign corporations in the chain or group for the taxable year of such corporation or corporations to which the election applies.

(3) *Year of receipt.* To the extent that a distribution counts toward a minimum distribution under this paragraph with respect to a taxable year of the United States shareholder, it shall be treated as having been received by the shareholder in that year for the purpose of determining gross income and the assessment of interest, additional amounts, and assessable penalties; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a distribution for such year under this paragraph shall be treated as paid or accrued, or deemed paid, for such year.

(4) *Year of payment.* The distribution shall be treated for purposes of applying paragraph (a) of §1.963–3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of §1.963–4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of §1.963–3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of §1.963–4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

[T.D. 6759, 29 FR 13348, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

### § 1.963–8 Determination of minimum distribution during the surcharge period.

(a) *Taxable years not wholly within the surcharge period.* In the case of a taxable year beginning before the surcharge period and ending within the surcharge period, or beginning within the surcharge period and ending after the surcharge period, or beginning before January 1, 1970, and ending after December 31, 1969, section 963(b) provides the method for determining the required minimum distribution. Under the method prescribed in section 963(b) for such years, the required minimum distribution is an amount equal to the sums of:

(1) That portion of the minimum distribution which would be required if the provisions of section 963(b)(1) were applicable to the taxable year, which the number of days in such taxable year which are within the surcharge period and before January 1, 1970, bears to the total number of days in such taxable year.

(2) That portion of the minimum distribution which would be required if the provisions of section 963(b)(2) were applicable to such taxable year, which the number of days in such taxable year which are within the surcharge period and after December 31, 1969, bears to the total number of days in such taxable year, and

(3) That portion of the minimum distribution which would be required if the provisions of section 963(b)(3) were applicable to such taxable year, which the number of days in such taxable year which are not within the surcharge period bears to the total number of days in such taxable year.

(b) *Calendar year 1970.* For calendar year 1970, the required minimum distribution shall be an amount determined in accordance with the following table:

| If the effective foreign tax rate is (percentage)— | The required minimum distribution of earnings and profits is (percentage)— |
|---|---|
| Under 9 | 84.983562 |
| 9 or over but less than 10 | 82.967123 |
| 10 or over but less than 18 | 80.983562 |
| 18 or over but less than 19 | 79.471233 |
| 19 or over but less than 26 | 77.487671 |
| 26 or over but less than 27 | 73.958904 |
| 27 or over but less than 32 | 70.487671 |
| 32 or over but less than 33 | 67.463014 |
| 33 or over but less than 36 | 63.991781 |
| 36 or over but less than 37 | 57.942466 |
| 37 or over but less than 39 | 51.991781 |
| 39 or over but less than 40 | 44.934247 |
| 40 or over but less than 41 | 37.495890 |
| 41 or over but less than 42 | 31.446575 |
| 42 or over but less than 43 | 19.446575 |
| 43 or over but less than 44 | 12.893151 |
| 44 or over but less than 45 | 6.446575 |
| 45 or over | 0 |

(c) *Surcharge period.* For purposes of this section the term ''surcharge period'' means the period beginning January 1, 1968, and ending June 30, 1970.

(d) *Illustration of principles.* The application of the rules set forth in paragraphs (a), (b), and (c) of this section may be illustrated by the following example. It is assumed that all computations are carried to sufficient accuracy:

*Example.* (a) M, a domestic corporation, and A, its controlled corporation (the one class of stock of which is wholly owned by M), both have a taxable year beginning December 1, 1969, and ending November 30, 1970. For such taxable year M makes a first-tier election with respect to A corporation. The effective foreign tax rate for such year is 30 percent.

(b) Under section 963(b) and paragraph (b) of this section the surcharge period ends June 30, 1970. Therefore, of the 365 days in the taxable year, 153 days are not within the surcharge period. Of the remaining 212 days, 31 are within the surcharge period and before January 1, 1970 and 181 days are within the surcharge period and after December 31, 1969. If section 963(b)(1) were applicable to the entire taxable year, the required minimum distribution of earnings and profits would be 75 percent. If section 963(b)(2) were applicable to the entire taxable year, the required minimum distribution would be 72 percent. If section 963(b)(3) were applicable to the entire taxable year, the required minimum distribution would be 69 percent.

(c) Under section 963(b) and this section the required minimum distribution of earnings and profits is 71 percent, computed as follows:

(75%×31÷365)+(72%×181÷365)
+(69%×153÷365)=71%.

[T.D. 7100, 36 FR 5336, Mar. 20, 1971]

### § 1.964–1 Determination of the earnings and profits of a foreign corporation.

(a)(1) *In general.* For taxable years beginning after December 31, 1986, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall be computed substantially as if such corporation were a domestic corporation by—

(i) Preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders.

(ii) Making the adjustments necessary to conform such statement to the accounting principles described in paragraph (b) of this section; and

(iii) Making the further adjustments necessary to conform such statement to the tax accounting standards described in paragraph (c) of this section.

(2) *Required adjustments.* The computation described in paragraph (a)(1) of this section shall be made in the foreign corporation's functional currency (determined under section 985 and the regulations under that section) and may be made by following the procedures described in paragraphs (a)(1)(i) through (a)(1)(iii) of this section in an order other than the one listed, as long as the result so obtained would be the

same. In determining earnings and profits, or the deficit in earnings and profits, of a foreign corporation under section 964, the amount of an illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations issued pursuant to section 964) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease such earnings and profits or to increase such deficit. No adjustment shall be required under paragraph (a)(1)(ii) or (iii) of this section unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature. For the treatment of earnings and profits whose distribution is prevented by restrictions and limitations imposed by a foreign government, see section 964(b) and the regulations issued pursuant to section 964. For rules for determining the earnings and profits (or deficit in earnings and profits) of a foreign corporation for taxable years beginning before January 1, 1987, for purposes of sections 951 through 964, see 26 CFR 1.964–1(a) (revised as of April 1, 2006).

(b) *Accounting adjustments*—(1) *In general.* The accounting principles to be applied in making the adjustments required by paragraph (a)(1)(ii) of this section shall be those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates, including the following:

(i) *Clear reflection of income.* Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) *Physical assets, depreciation, etc.* All physical assets (as defined in paragraph (e)(5)(ii) of this section), including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost. For special rules for determining historical cost where assets are acquired during a taxable year beginning before January 1, 1950, or a majority interest in the foreign corporation is acquired after December 31, 1949, but before October 27, 1964, see subparagraph (2) of this paragraph.

(iii) *Valuation of assets and liabilities.* Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section. For example, an adjustment will be required where inventory is written down below market value. For the definition of market value, see paragraph (a) of §1.471–4.

(iv) *Income equalization.* Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section.

(v) *Foreign currency.* If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be

made in a manner substantially similar to that prescribed by paragraph (d) of this section for the translation of foreign currency amounts into United States dollars.

(2) *Historical cost.* For purposes of this section, the historical cost of an asset acquired by the foreign corporation during a taxable year beginning before January 1, 1963, shall be determined, if it is so elected by or on behalf of such corporation—

(i) In the event that the foreign corporation became a majority owned subsidiary of a United States person (within the meaning of section 7701(a)(30)) after December 31, 1949, but before October 27, 1964, and the asset was held by such foreign corporation at that time, as though the asset was purchased on the date during such period the foreign corporation first became a majority owned subsidiary at a price equal to its then fair market value, or

(ii) In the event that subdivision (i) of this subparagraph is inapplicable but the asset was acquired by the foreign corporation during a taxable year beginning before January 1, 1950, as though the asset were purchased on the first day of the first taxable year of the foreign corporation beginning after December 31, 1949, at a price equal to the undepreciated cost (cost or other basis minus book depreciation) of that asset as of that date as shown on the books of account of such corporation regularly maintained for the purpose of accounting to its shareholders.

For purposes of this subparagraph, a foreign corporation shall be considered a majority owned subsidiary of a United States person if, taking into account only stock acquired by purchase (as defined in section 334(b)(3)), the United States person owns (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. The election under this subparagraph shall be made for the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under §1.954–6(f). Once made, such an election shall be irrevocable. For the time and manner in which an election may be made on behalf of a foreign corporation, see paragraph (c)(3) of this section.

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

*Example 1.* Corporation M is a controlled foreign corporation which regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices prevalent in country X, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects an allocation to an arbitrary reserve out of current income and depreciation allowances based on replacement values which are greater than historical cost. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices, will have to be eliminated from the statement, an increase in the amount of profit (or a decrease in the amount of loss) thereby resulting.

*Example 2.* In 1973, Corporation N is a foreign corporation which is not a controlled foreign corporation but which is included in a chain, for minimum distribution purposes, under section 963(c)(2)(B). Corporation N regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices of country Y, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects the inclusion in income of stock dividends and of corporate distributions representing a return of capital. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices will have to be eliminated from the statement, a decrease in the amount of profit (or increase in the amount of loss) thereby resulting.

(c) *Tax adjustments*—(1) *In general.* The tax accounting standards to be applied in making the adjustments required by paragraph (a)(1)(iii) of this section shall be the following:

(i) *Accounting methods.* The method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

(ii) *Inventories.* Inventories shall be taken into account in accordance with the provisions of sections 471 and 472 and the regulations thereunder.

(iii) *Depreciation.* Depreciation shall be computed as follows:

(*a*) For any taxable year beginning before July 1, 1972; depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(*b*) If, for any taxable year beginning after June 30, 1972, 20 percent or more of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with the provisions of §1.312–15.

(*c*) If, for any taxable year beginning after June 30, 1972, less than 20 percent of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(iv) *Elections.* Effect shall be given to any election made in accordance with an applicable provision of the Code and the regulations thereunder and these regulations.

Except as provided in subparagraphs (2) and (3) of this paragraph, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method is to be taken into account in the computation of its earnings and profits.

(v) [Reserved]. For further guidance, see §1.964–1T(c)(1)(v).

(c)(2) through (c)(6) [Reserved]. For further guidance, see §1.964–1T(c)(2) through (c)(6).

(7) *Revocation of election.* Notwithstanding any other provision of this section, any election made by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) may be modified or revoked by or on behalf of such corporation for the taxable year for which made whenever the consent of the Commissioner is secured for such modification or revocation, even though such election would be irrevocable but for this subparagraph.

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

*Example 1.* X Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by taking inventoriable items into account under the ''first-in, first-out'' method. A, B, and C, the United States shareholders of X Corporation, own 45 percent, 30 percent, and 25 percent of its voting stock, respectively. For the first taxable year of X Corporation beginning after December 31, 1962, B and C adopt on its behalf the ''last-in, first-out'' inventory method, notifying A of the action taken. Even though A may object to such action, adjustments must be made to reflect the use of the LIFO method of inventorying in the computation of the earnings and profits of X Corporation with respect to him as well as with respect to B and C.

*Example 2.* Y Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by employing the straight-line method of depreciation. D and E, the United States shareholders of Y Corporation, own 51 percent and 10 percent of its voting stock, respectively. For the first taxable year of Y Corporation beginning after December 31, 1962, D adopts on its behalf the declining balance method of depreciation. However, not knowing that E is a United States shareholder of the company, D fails to provide him with notice of the action taken. Assuming that E has filed the return required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d), adjustments in the computation of earnings and profits will not be required with respect to him unless the Director of International Operations notifies him of the action taken within 240 days after the close of Y's taxable year. If notice is not provided to E within this period, he will not be compelled to make the adjustments. At his option, however, he may accept the action taken by assenting thereto not later than 90

days after he is first apprised of such action by the Director of International Operations.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56491, Dec. 17, 1982; T.D. 7893, 48 FR 22510, May 19, 1983; T.D. 9260, 71 FR 24540, Apr. 25, 2006; T.D. 9260, 71 FR 77265, Dec. 26, 2006]

### § 1.964–1T Determination of the earnings and profits of a foreign corporation (temporary).

(a) through (c)(1)(iv) [Reserved]. For further guidance, see §1.964–1(a) through (c)(1)(iv).

(v) *Taxable years.* The period for computation of taxable income and earnings and profits known as the taxable year shall reflect the provisions of section 441 and the regulations thereunder.

(2) *Adoption or change of method or taxable year.* For the first taxable year of a foreign corporation beginning after April 25, 2006, in which such foreign corporation first qualifies as a controlled foreign corporation (as defined in section 957 or 953) or a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)), any method of accounting or taxable year allowable under this section may be adopted, and any election allowable under this section may be made, by such foreign corporation or on its behalf notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Internal Revenue Code or regulations to be made in a prior taxable year. Any allowable methods adopted or elections made shall be reflected in the computation of the foreign corporation's earnings and profits for such taxable year, prior taxable years, and (unless the Commissioner consents to a change) subsequent taxable years. However, see section 898 for the rules regarding the taxable year of a specified foreign corporation as defined in section 898(b). Any allowable method of accounting or election that relates to events that first arise in a subsequent taxable year may be adopted or made by or on behalf of the foreign corporation for such year. See paragraph (a)(3) of this section for the manner in which a method of accounting or a taxable year may be adopted or changed on behalf of the foreign corporation. See paragraph (c)(4) and (g)(3) of this section for applicable rules if the amount of the foreign corporation's earnings and profits became significant for United States tax purposes before a method of accounting or taxable year was adopted by the foreign corporation or on its behalf in accordance with the rules of paragraph (c)(3) of this section. See paragraphs (c)(6) and (g)(2) of this section for special rules postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant for U.S. tax purposes.

(3) *Action on behalf of corporation*—(i) *In general.* An election shall be deemed made, or an adoption or change in method of accounting or taxable year deemed effectuated, on behalf of the foreign corporation only if its controlling domestic shareholders (as defined in paragraph (c)(5) of this section)—

(A) Satisfy for such corporation any requirements imposed by the Internal Revenue Code or applicable regulations with respect to such election or such adoption or change in method or taxable year (including the provisions of sections 442 and 446 and the regulations thereunder, as well as any operative provisions), such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner. For purposes of this paragraph (c)(3)(i)(A), the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling domestic shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner;

(B) File the statement described in paragraph (c)(3)(ii) of this section, at the time and in the manner prescribed therein; and

(C) Provide the written notice required by paragraph (c)(3)(iii) of this section at the time and in the manner prescribed therein.

(ii) *Statement required to be filed with a tax return.* The statement required by this paragraph (c)(3)(ii) shall set forth

the name, country of organization, and U.S. employer identification number (if applicable) of the foreign corporation, the name, address, stock interests, and U.S. employer identification number of each controlling domestic shareholder (or, if applicable, the shareholder's common parent) approving the action, and the names, addresses, U.S. employer identification numbers, and stock interests of all other domestic shareholders notified of the action taken. Such statement shall describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or its common parent). Each controlling domestic shareholder shall file the statement with its own tax return (or information return, if applicable) for its taxable year with or within which ends the taxable year of the foreign corporation for which the election is made or for which the method of accounting or taxable year is adopted or changed.

(iii) *Notice.* On or before the filing date described in paragraph (c)(3)(ii) of this section, the controlling domestic shareholders shall provide written notice of the election made or the adoption or change of method or taxable year effected to all other persons known by them to be domestic shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall set forth the name, country of organization and U.S. employer identification number (if applicable) of the foreign corporation, and the names, addresses, and stock interests of the controlling domestic shareholders. Such notice shall describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or its common parent). However, the failure of the controlling domestic shareholders to provide such notice to a person required to be notified shall not invalidate the election made or the adoption or change of method or taxable year effected.

(4) *Effect of action or inaction by controlling domestic shareholders.* Any action taken by the controlling domestic shareholders on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the tax liability of all domestic shareholders of the foreign corporation. See §1.964–1T(g)(5). In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in paragraph (c)(6) of this section and such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause, such action may be undertaken during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. The principles of §1.964–1T(g)(3) and (g)(4) shall apply in determining the effect of a failure of the controlling domestic shareholders to take action on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section. Accordingly, if the earnings and profits of a noncontrolled section 902 corporation became significant for United States income tax purposes in a taxable year beginning on or before April 25, 2006, the corporation's earnings and profits shall be computed as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the foreign corporation for purposes of accounting to its shareholders had been adopted. Any change in accounting method may be made by or on behalf of the foreign corporation only with the Commissioner's consent.

(5) *Controlling domestic shareholders—*(i) *Controlled foreign corporations.* For purposes of this paragraph, the controlling domestic shareholders of a controlled foreign corporation shall be its controlling United States shareholders.

The controlling United States shareholders of a controlled foreign corporation shall be those United States shareholders (as defined in section 951(b) or 953(c)) who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote and who undertake to act on its behalf. In the event that the United States shareholders of the controlled foreign corporation do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote, the controlling United States shareholders of the controlled foreign corporation shall be all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation.

(ii) *Noncontrolled section 902 corporations.* For purposes of this paragraph, the controlling domestic shareholders of a noncontrolled section 902 corporation that is not a controlled foreign corporation shall be its majority domestic corporate shareholders. The majority domestic corporate shareholders of a noncontrolled section 902 corporation shall be those domestic corporations that meet the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as defined in section 902(b)(2) as the noncontrolled section 902 corporation) that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all of the voting stock of the noncontrolled section 902 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation (or a relevant first-tier foreign corporation).

(6) *Action not required until significant.* Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) to make an election or to adopt a taxable year or method of accounting shall not be required until the due date (including extensions) of the return for a controlling domestic shareholder's first taxable year with or within which ends the foreign corporation's first taxable year in which the computation of its earnings and profits is significant for United States tax purposes with respect to its controlling domestic shareholders (as defined in §1.964–1T(c)(5)). The filing of the information return required by section 6038 shall not itself constitute a significant event. For taxable years beginning on or after April 25, 2006, events that cause a foreign corporation's earnings and profits to have United States tax significance include, without limitation,

(i) A distribution from the foreign corporation to its shareholders with respect to their stock;

(ii) An amount is includible in gross income with respect to such corporation under section 951(a);

(iii) An amount is excluded from subpart F income of the foreign corporation or another foreign corporation by reason of section 952(c);

(iv) Any event making the foreign corporation subject to tax under section 882;

(v) The use by the foreign corporation's controlling domestic shareholders of the tax book value (or alternative tax book value) method of allocating interest expense under section 864(e)(4); or

(vi) A sale or exchange of the foreign corporation's stock of the controlling domestic shareholders that results in the recharacterization of gain under section 1248.

(c)(7) and (8) [Reserved]. For further guidance, see §1.964–1(c)(7) and (c)(8) and §1.964–1T(g)(6).

(d)–(f) [Reserved]

(g)(1) *Earnings and profits computed in functional currency*—(i) *Rule.* For taxable years of a controlled foreign corporation (within the meaning of section 957) beginning after December 31, 1986, earnings and profits shall be computed in the controlled foreign corporation's functional currency (determined under section 985 and the regulations thereunder) in accordance with §1.964–1 as modified by this paragraph (g). Accordingly, §1.964–1 (d), (e), and (f) and (to the extent inconsistent with this

paragraph (g)) §1.964–1(c) do not apply for taxable years of a controlled foreign corporation beginning after December 31, 1986. For purposes of this section, the term ''earnings and profits'' includes a deficit in earnings and profits.

(ii) *Cross reference.* In the case of a controlled foreign corporation with a functional currency other than the United States dollar (dollar), see sections 986(b) and 989(b) for rules regarding the time and manner of translating distributions or inclusions of the controlled foreign corporation's earnings and profits into dollars.

(2) *Election required when first significant.* Tax accounting methods or elections may be adopted or made by, or on behalf of, a controlled foreign corporation in the manner prescribed by the Code and regulations no later than 180 days after the close of the first taxable year of the controlled foreign corporation in which the computation of its earnings and profits is significant for United States income tax purposes with respect to its controlling United States shareholders (as defined in §1.964–1(c)(5)). For taxable years of a controlled foreign corporation beginning before January 1, 1989, only the events listed in §1.964–1(c)(6) are considered to cause a controlled foreign corporation's earnings and profits to have United States tax significance. For taxable years of a controlled foreign corporation beginning after December 31, 1988, events that cause a controlled foreign corporation's earnings and profits to have United States tax significance include, without limitation—

(i) The events listed in §1.964–1(c)(6),

(ii) A distribution from the controlled foreign corporation to its shareholders with respect to their stock,

(iii) Any event making the controlled foreign corporation subject to tax under section 882,

(iv) An election by the controlled foreign corporation's controlling United States shareholders to use the tax book value method of allocating interest expense under section 864(e)(4), and

(v) A sale or exchange of the controlled foreign corporation's stock by the controlling United States shareholders.

The filing of the information return required by section 6038 shall not itself constitute a significant event.

(3) *Effect of failure to make required election.* If an accounting method or election is not timely adopted or made by, or on behalf of, a controlled foreign corporation, and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause under §1.964–1(c)(6), earnings and profits shall be computed in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. Thereafter, any change in a particular accounting method or methods may be made by, or on behalf of, the controlled foreign corporation only with the Commission's consent.

(4) *Computation of earnings and profits by a minority shareholder prior to majority election or significant event.* A minority United States shareholder (as defined in section 951(b)) of a controlled foreign corporation may be required to compute a controlled foreign corporation's earnings and profits before the controlled foreign corporation or its controlling United States shareholders make, or are required under this section to make, an election or adopt a method of accounting for United States tax purposes. In such a case, the minority United States shareholder must compute earnings and profits in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. However, a later, properly filed, and timely election or adoption of method by, or on behalf of, the controlled foreign corporation shall not be treated as a change in accounting method.

(5) *Binding effect.* For taxable years beginning after December 31, 1986, except as otherwise provided in the Code

or regulations, earnings and profits of a controlled foreign corporation shall be computed consistently under the rules of sections 964(a) and 986(b) for all federal income tax purposes. An election or adoption of a method of accounting for United States tax purposes by a controlled foreign corporation, or on its behalf pursuant to §1.964–1(c) or any other provision of the regulations (*e.g.*, §1.985–2(c)(3)), shall bind both the controlled foreign corporation and its United States shareholders as to the computation of the controlled foreign corporation's earnings and profits under section 964(a) for the year of the election or adoption and in subsequent taxable years unless the Commissioner consents to a change. The preceding sentence shall apply regardless of—

(i) Whether the election or adoption of a method of accounting was made in a pre-1987 or a post-1986 taxable year;

(ii) Whether the controlled foreign corporation was a controlled foreign corporation at the time of the election or adoption of method;

(iii) When ownership was acquired; or

(iv) Whether the United States shareholder received the written notice required by §1.964–1(c)(3).

Adjustments to the appropriate separate category (as defined in §1.904–5(a)(1)) of earnings and profits and income of the controlled foreign corporation shall be required using the principles of section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any such election or adoption.

(6) *Examples.* The following examples illustrate the rules of this section.

*Example 1:* (i) *P*, a calendar year domestic corporation, owns all of the outstanding stock of *FX*, a calendar year controlled foreign corporation. None of the significant events specified in §1.964–1(c)(6) or this section has occurred. In addition, neither *P* nor *FX* has ever made or adopted, or been required to make or adopt, an election or method of accounting for United States tax purposes with respect to *FX*. On June 1, 1990, *FX* makes a distribution to *P*. *FX* does not act to make any election or adopt a method of accounting for United States tax purposes.

(ii) *P* must compute *FX*'s earnings and profits in order to determine if any portion of the distribution is taxable as a dividend and to determine *P*'s foreign tax credit on such portion under section 902. *P* must satisfy the requirements of §1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1990 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of earnings and profits of *FX* for all federal income tax purposes (including, *e.g.*, the determination of foreign tax credits on subpart F inclusions) in 1990 and subsequent taxable years unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method shall be effective only if the Commissioner consents to the change.

*Example 2:* (i) The facts are the same as in *Example 1*, except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1989 taxable year under the tax book value method of §1.861–12T(c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1989 taxable year. *P* must satisfy the requirements of §1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1989 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1989 and subsequent taxable years for all federal income tax purposes (including, *e.g.*, the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method shall be effective only if the Commissioner consents to the change.

*Example 3:* (i) The facts are the same as in *Example 2*, except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1988 taxable year under the tax book

value method of §1.861–12T (c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1988 taxable year. *P* must satisfy the requirements of §1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1988 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1988 and subsequent taxable years for all federal income tax purposes (including, *e.g.*, *P*'s basis adjustment for purposes of section 864(e)(4) in 1989 and the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* for 1988 shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. However, a properly filed, timely election or adoption of method by, or on behalf of, *FX* with respect to its 1989 taxable year, when *P*'s basis adjustment for purposes of section 864(e)(4) first constitutes a significant event, shall not be treated as a change in accounting method. No recomputation of *P*'s basis adjustment for 1988 shall be required by reason of any such election or adoption of method with respect to *FX*'s 1989 taxable year, but prospective adjustments to *FX*'s earnings and profits and income shall be made to the extent required by §1.964–1T(g)(5).

*Example 4:* (i) The facts are the same as in *Example 3,* except that *FX* had subpart F income taxable to *P* in 1986, and *P* computed *FX*'s earnings and profits for purposes of determining the amount of the inclusion and the foreign taxes deemed paid by *P* in 1986 under section 960 pursuant to §1.964–1 (a) through (e).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to §1.964–1(c) in 1986 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1986 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1990 dividend, *FX*'s earnings and profits must be computed consistently with the method used by *P* with regard to the 1986 subpart F inclusion. (However, §1.964–1 (d), (e), and (f) do not apply in computing *FX*'s earnings and profits in post-1986 taxable years.)

*Example 5:* (i) The facts are the same as in *Example 4*, except that *FX* made a dividend distribution to *P* on June 1, 1985, and *P* computed *FX*'s earnings and profits for purposes of computing the foreign taxes deemed paid by *P* in 1985 under section 902 with respect to the distribution under §1.964–1 exclusive of paragraphs (d), (e), and (f) pursuant to a timely election under §1.902–1(g)(1).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to §1.964–1(c) in 1985 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1985 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1986 subpart F inclusion and the 1990 dividend, *FX*'s earnings and profits must be computed consistently with the method used by *P* with regard to the 1985 dividend. If, rather than choosing under §1.902–1(g)(1) to use the section 964 rules, *P* computed *FX*'s earnings and profits for purposes of section 902 in 1985 in all respects as if *FX* were a domestic corporation, then *P* would have been free to make elections or adopt a method of accounting on behalf of *FX* under §1.964–1(c) with respect to the subpart F inclusion in 1986. Any such election or adoption would be binding on *P* and *FX* as to the computation of *FX*'s earnings and profits in 1986 and subsequent taxable years.

[T.D. 8283, 55 FR 2516, Jan. 25, 1990; 55 FR 7711, Mar. 5, 1990, as amended by T.D. 9260, 71 FR 24540, Apr. 25, 2006; T.D. 9260, 71 FR 77266, Dec. 26, 2006]

### §1.964–2 Treatment of blocked earnings and profits.

(a) *General rule.* If, in accordance with paragraph (d) of this section, it is established to the satisfaction of the district director that any amount of the earnings and profits of a controlled foreign corporation for the taxable year (determined under §1.964–1) was subject to a currency or other restriction or limitation imposed under the laws of any foreign country (within the meaning of paragraph (b) of this section) on its distribution to United States shareholders who own (within the meaning of section 958(a)) stock of such corporation, such amount shall not be included in earnings and profits for purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956 for such taxable year. For rules governing the treatment of amounts with respect to which such restriction

or limitation is removed, see paragraph (c) of this section.

(b) *Rules of application.* For purposes of paragraph (a) of this section—

(1) *Period of restriction or limitation.* An amount of earnings and profits of a controlled foreign corporation for any taxable year shall not be included in earnings and profits for purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956 only if such amount of earnings and profits is subject to a currency or other restriction or limitation (within the meaning of subparagraph (2) of this paragraph) throughout the 150-day period beginning 90 days before the close of the taxable year and ending 60 days after the close of such taxable year.

(2) *Restriction or limitation defined.* Whether earnings and profits of a controlled foreign corporation are subject to a currency or other restriction or limitation imposed under the laws of a foreign country must be determined on the basis of all the facts and circumstances in each case. Generally, such a restriction or limitation must prevent—

(i) The ready conversion (directly or indirectly) of such currency into United States dollars, or into property of a type normally owned by such corporation in the operation of its business or other money which is readily convertible into United States dollars; or

(ii) The distribution of dividends by such corporation to its United States shareholders.

For purposes of this subparagraph, if a United States shareholder owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 80 percent or more of the total combined voting power of all classes of stock of a foreign corporation in a chain of ownership described in section 958(a), the distribution of dividends by such corporation to such shareholder will not be considered prevented solely by reason of the existence of a currency or other restriction or limitation at an intermediate tier in such chain if dividends may be distributed directly to such shareholders.

(3) *Foreign laws.* A currency or other restriction or limitation on the distribution of earnings and profits may be imposed in a foreign country by express statutory provisions, executive orders or decrees, rules or regulations of a governmental agency, court decisions, the actions of appropriate officials who are acting within the scope of their authority, or by any similar official action. A currency restriction will not be considered to exist unless export restrictions are also imposed which prevent the exportation of property of a type normally owned by the controlled foreign corporation in the operation of its business which could be readily converted into United States dollars.

(4) *Voluntary restriction or limitation.* A currency or other restriction or limitation arising from the voluntary act of the controlled foreign corporation or its United States shareholders during a taxable year beginning after December 31, 1962, will not be taken into account. For example, if a controlled foreign corporation—

(i) Issues a stock dividend which has the effect of capitalizing earnings and profits;

(ii) Elects to restrict its earnings and profits or to make certain investments as a means of avoiding current tax or securing a reduced rate of tax; or

(iii) Allocates earnings and profits to an optional or arbitrary reserve; such restriction is voluntary and will not be taken into account.

(5) *Treatment of earnings and profits in cases of certain mandatory reserves*—(i) *In general.* If a controlled foreign corporation is required under the laws of a foreign country to establish a reserve out of earnings and profits for the taxable year, such earnings and profits shall be considered subject to a restriction or limitation by reason of such requirement only to the extent that the amount required to be included in such reserve at the close of the taxable year exceeds the accumulated earnings and profits (determined in accordance with subdivision (ii) of this subparagraph) of such corporation at the close of the preceding taxable year.

(ii) *Determination of earnings and profits.* For purposes of determining the accumulated earnings and profits of a

controlled foreign corporation under subdivision (i) of this subparagraph, such earnings and profits shall not include any amounts which are attributable to—

(*a*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder under section 951(a) and have not been distributed;

(*b*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such foreign corporation under section 551(b) and have not been distributed; or

(*c*) Amounts which become subject to a voluntary restriction or limitation (within the meaning of subparagraph (4) of this paragraph) during a taxable year beginning before January 1, 1963.

The rules of this subdivision apply only in determining the accumulated earnings and profits of a controlled foreign corporation for purposes of this subparagraph. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(6) *Exhaustion of procedures for distributing earnings and profits.* Earnings and profits of a controlled foreign corporation for a taxable year will not be considered subject to a currency or other restriction or limitation on their distribution unless the United States shareholders of such corporation demonstrate either that the available procedures for distributing such earnings and profits have been exhausted or that the use of such procedures will be futile. As a general rule, such procedures will be considered to have been exhausted if the foreign corporation applies for dollars (or foreign currency readily convertible into dollars) at the appropriate rate of exchange and complies with the applicable laws and regulations governing the acquisition and transfer of such currency including submission of the necessary documentation to the exchange authority. The fact that available procedures for distributing earnings and profits were exhausted without success with respect to a prior year is not, of itself, sufficient evidence that such procedures would not be successful with respect to the current taxable year.

(c) *Removal of restriction or limitation*—(1) *In general.* If, during any taxable year, a currency or other restriction or limitation (within the meaning of paragraph (b) of this section) imposed under the laws of a foreign country on the distribution of earnings and profits of a controlled foreign corporation to its United States shareholders is removed—

(i) *Treatment of deferred income.* Each United States shareholder of such corporation on the last day in such year that such corporation is a controlled foreign corporation shall include in his gross income for such taxable year the amounts attributable to such earnings and profits which would have been includible in his gross income under section 951(a) for prior taxable years but for the existence of the currency or other restriction or limitation except that the amounts included under this subdivision (i) shall not exceed his pro rata share of—

(*a*) The earnings and profits upon which the restriction was removed determined on the basis of his stock ownership on the last day of the immediately preceding taxable year, and

(*b*) The applicable limitations under paragraph (c) of §1.952–1, paragraph (b)(2) of §1.955–1, paragraph (b)(2) of §1.955A–1, or paragraph (b) of §1.956–1, determined as of the last day of the immediately preceding taxable year, taking into account the provisions of subdivision (ii) of this subparagraph.

(ii) *Treatment of earnings and profits.* For purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956, the earnings and profits which are no longer subject to a currency or other restriction or limitation shall be treated as included in the corporation's earnings and profits for the year in which such earnings and profits were derived.

Amounts with respect to which a currency or other restriction or limitation is removed shall be translated into United States dollars at the appropriate exchange rate for the translation period during which such currency or other restriction or limitation is removed. See paragraph (d) of §1.964–1. Amounts with respect to which a

currency or other restriction or limitation is removed shall not be taken into account in determining whether a deficiency distribution (within the meaning of §1.963–6 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975)) is required to be made for the year in which such earnings and profits were derived.

(2) *Removal of restriction or limitation defined.* An amount of earnings and profits shall be considered no longer subject to a limitation or restriction if and to the extent that—

(i) Money or property in such foreign country is readily convertible into United States dollars, or into other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars;

(ii) Notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars, or other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars; or

(iii) A mandatory reserve requirement (described in paragraph (b)(5) of this section) is removed either by a change in law of the foreign country imposing such requirement or by an accumulation of earnings and profits not subject to such requirement.

(3) *Distribution in foreign country.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation are distributed in a foreign country to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), such earnings and profits shall be considered no longer subject to a restriction or limitation. However, distributed amounts may be excluded from such shareholder's gross income for the taxable year of receipt if such shareholder elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Source of distribution.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation is distributed to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), the source of such distribution shall be determined in accordance with the rules of §1.959–3.

(5) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

*Example.* (a) M, a United States person, owns all of the only class of stock of A Corporation, a foreign corporation incorporated under the laws of foreign country X on January 1, 1963. Both M and A Corporations use the calendar year as a taxable year and A Corporation is a controlled foreign corporation throughout the period here involved.

(b) During 1963, A Corporation derives income of $100,000 all of which is subpart F income and has earnings and profits of $100,000. Under the laws of X Country, currency cannot be exported without a license. During the last 90 days of 1963 and the first 60 days of 1964, A Corporation can obtain a license to distribute only an amount equivalent to $10,000. M must include $10,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and $90,000 of A Corporation's earnings and profits for 1963 are not taken into account for purposes of sections 952, 955, and 956.

(c) During 1964, A Corporation has no income and no earnings and profits. On June 1, 1964, A Corporation converts an amount equivalent to $20,000 into property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars but does not distribute such amount. Corporation A must include $20,000 in its earnings and profits for 1963 for purposes of sections 952, 955, and 956. M must include $20,000 in his gross income for 1964.

(d) During 1965, A Corporation has no income and no earnings and profits. On December 15, 1965, A Corporation distributes an amount equivalent to $15,000 to M in X Country. Neither M nor A Corporation can obtain a license to export currency from X Country. In his return for the taxable year 1965, M elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked. Accordingly, M does not include the $15,000 in his gross income for 1965.

(e) During 1966, A Corporation has no income and no earnings and profits. On February 1, 1966, notwithstanding the laws and regulations of X Country which forbid the exchange of X Country's currency into United States dollars, M converts an amount equivalent to $15,000 into a currency which is

readily convertible into United States dollars. Since the income has ceased to be blocked, M must include $15,000 in his gross income for 1966.

(d) *Manner of claiming existence of restriction or limitation on distribution of earnings and profits.* A United States shareholder claiming that an amount of the earnings and profits of a controlled foreign corporation for the taxable year was subject to a currency or other restriction or limitation imposed under the laws of a foreign country on its distribution shall file a statement with his return for the taxable year with or within which the taxable year of the foreign corporation ends which shall include—

(1) The name and address of the foreign corporation,

(2) A description of the classes of stock of the foreign corporation and a statement of the number of shares of each class owned (within the meaning of section 958(a)) or considered as owned (by applying the rules of ownership of section 958(b)) by the United States shareholder,

(3) A description of the currency or other restriction or limitation on the distribution of earnings and profits,

(4) The total earnings and profits of the foreign corporation for the taxable year (before any amount is excluded from earnings and profits under this section) and the United States shareholder's pro rata share of such total earnings and profits,

(5) The United States shareholder's pro rata share of the amount of earnings and profits subject to a restriction or limitation on distribution,

(6) The amounts which would be includible in the United States shareholder's gross income under section 951(a) but for the existence of the currency or other restriction or limitation,

(7) A description of the available procedures for distributing earnings and profits and a statement setting forth the steps taken to exhaust such procedures or a statement setting forth the reasons that the use of such procedures would be futile, and

(8) The amount of distributions made in a foreign country and a statement as to whether a method of accounting has been elected under which the reporting of blocked income is deferred until such income ceases to be blocked, including an identification of the taxable year and place of filing of such election.

In addition, such United States shareholder shall furnish to the district director such other information as he may require to verify the status of a currency or other restriction or limitation.

[T.D. 6892, 31 FR 11142, Aug. 23, 1966, as amended by T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7893, 48 FR 22510, May 19, 1983]

### § 1.964–3 Records to be provided by United States shareholders.

(a) *Shareholder's responsibility for providing records.* For purposes of verifying his income tax liability in respect of amounts includible in income under section 951 for the taxable year of a controlled foreign corporation each United State shareholder (as defined in section 951(b)) who owns (within the meaning of section 958(a)) stock of such corporation shall, within a reasonable time after demand by the district director, provide the district director—

(1) Such permanent books of account or records as are sufficient to satisfy the requirements of section 6001 and section 964(c), or true copies thereof, as are reasonably demanded, and

(2) If such books or records are not maintained in the English language, either (i) an accurate English translation of such books or records or (ii) the services of a qualified interpreter satisfactory to the district director.

If such books or records are being used by another district director, the United States shareholder upon whom the district director has made a demand to provide such books or records shall file a statement of such fact with his district director, indicating the location of such books or records. For the length of time the United States shareholder of a controlled foreign corporation must cause such books or records as are under his control to be retained, see paragraph (e) of § 1.6001–1.

(b) *Records to be provided.* Except as otherwise provided in paragraph (c) of this section, the requirements of section 6001 and section 964(c) for record keeping shall be considered satisfied if

the books or records produced are sufficient to verify for the taxable year—

(1) The subpart F income of the controlled foreign corporation and, if any part of such income is excluded from the income of the United States shareholder under section 963 or section 970(a), the application of such exclusion,

(2) The previously excluded subpart F income of such corporation withdrawn from investment in less developed countries,

(3) The previously excluded subpart F income of such corporation withdrawn from investment in foreign base company shipping operations,

(4) The previously excluded export trade income of such corporation withdrawn from investment, and

(5) The increase in earnings invested by such corporation in United States property.

(c) *Special rules.* Verification of the subpart F income of the controlled foreign corporation for the taxable year shall not be required if—

(1) It can be demonstrated to the satisfaction of the district director that—

(i) The locus and nature of such corporation's activities were such as to make it unlikely that the foreign base company income of such corporation (determined in accordance with paragraph (c)(3) of §1.952–3) exceeded 5 percent of its gross income (determined in accordance with paragraph (b)(1) of §1.952–3) for the taxable year. (For taxable years to which §1.952–3 does not apply, such amounts shall be determined under 26 CFR §1.954–1(d)(3)(i) and (ii) (Revised as of April 1, 1975))), and

(ii) If such corporation reinsures or issues insurance or annuity contracts in connection with United States risks, the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1 has not been exceeded for the taxable year, or

(2) The United States shareholder's pro rata share of such subpart F income is excluded in full from his income under section 963 and the books or records verify the application of such exclusion.

[T.D. 6824, 30 FR 6480, May 11, 1965, as amended by T.D. 7893, 48 FR 22510, May 19, 1983]

**§ 1.964–4 Verification of certain classes of income.**

(a) *In general.* The provisions of this section shall apply for purposes of determining when books or records are sufficient for purposes of §1.964–3 to verify the classes of income described in such section.

(b) *Subpart F income.* Books or records sufficient to verify the subpart F income of a controlled foreign corporation must establish for the taxable year—

(1) Its gross income and deductions,

(2) The income derived from the insurance of United States risks (as provided in paragraph (c) of this section),

(3) The foreign base company income (as provided in paragraph (d) of this section), and

(4) In the case of a United States shareholder claiming the benefit of the exclusion provided in section 952(b) or the limitation provided in section 952(c)—

(i) The items of income excluded from subpart F income by paragraph (b) of §1.952–1 as income derived from sources within the United States, the United States income tax incurred with respect thereto, and the deductions properly allocable thereto and connected therewith, and

(ii) The earnings and profits, or deficit in earnings and profits, of any foreign corporation necessary for the determinations provided in paragraphs (c) and (d) of §1.952–1.

(c) *Income from insurance of United States risks.* Books or records sufficient to verify the income of a controlled foreign corporation from the insurance of United States risks must establish for the taxable year—

(1) That the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1 has not been exceeded, or

(2) The taxable income, as determined under §1.953–4 or §1.953–5, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks, as defined in §1.953–2 or §1.953–3.

(d) *Foreign base company income and exclusions therefrom.* Books or records sufficient to verify the income of a controlled foreign corporation which is

foreign base company income must establish for the taxable year the following items:

(1) *Foreign personal holding company income.* The foreign personal holding company income to which section 954(c) and §1.954–2 apply, for which purpose there must be established the gross income from—

(i) All rents and royalties,

(ii) Rents and royalties received in the active conduct of a trade or business from an unrelated person, as determined under section 954(c)(3)(A) and paragraph (d)(1) of §1.954–2,

(iii) Rents and royalties received from a related person for the use of property in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(C) and paragraph (e)(3) of §1.954–2,

(iv) All dividends, interest, and except where the controlled foreign corporation is a regular dealer in stock or securities, all gains and losses from the sale or exchange of stock or securities,

(v) Dividends, interest, and gains from the sale or exchange of stock or securities, received in the conduct of a banking, financing, or insurance business from an unrelated person, as determined under section 954(c)(3)(B) and paragraph (d)(2) and (3) of §1.954–2,

(vi) Dividends and interest received from a related corporation organized in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(A) and paragraph (e)(1) of §1.954–2,

(vii) Interest received in the conduct of a banking or other financing business from a related person, as determined under section 954(c)(4)(B) and paragraph (e)(2) of §1.954–2,

(viii) All annuities,

(ix) All gains from commodities transactions described in section 553(a)(3),

(x) All income from estates and trusts described in section 553(a)(4),

(xi) All income from personal service contracts described in section 553(a)(5), and

(xii) All compensation for the use of corporate property by shareholders described in section 553(a)(6).

(2) *Foreign base company sales income.* The foreign base company sales income to which section 954(d) and §1.954–3 apply, for which purpose there must be established the gross income from—

(i) All sales by the controlled foreign corporation of its personal property and all purchases or sales of personal property by such corporation on behalf of another person,

(ii) Purchases and/or sales of personal property in connection with transactions not involving related persons (as defined in paragraph (e)(2) of §1.954–1),

(iii) Purchases and/or sales of personal property manufactured, produced, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(2) of §1.954–3,

(iv) Purchases and/or sales of personal property for use, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(3) of §1.954–3, and

(v) Sales of personal property manufactured or produced by the controlled foreign corporation, as determined under paragraph (a)(4) of §1.954–3.

Where an item of income falls within more than one of subdivisions (ii) through (v) of this subparagraph, it shall be sufficient to establish that it falls within any one of them. If a branch or similar establishment is treated as a wholly owned subsidiary corporation through the application of section 954(d)(2) and paragraph (b) of §1.954–3, the requirements of this subparagraph shall be satisfied separately for each branch or similar establishment so treated and for the remainder of the controlled foreign corporation.

(3) *Foreign base company services income.* The foreign base company services income to which section 954(e) and §1.954–4 apply, for which purpose there must be established the gross income from—

(i) All services performed by the controlled foreign corporation,

(ii) Services other than those (as determined under paragraph (b) of §1.954–4) performed for, or on behalf of, a related person,

(iii) Services performed in the country of incorporation of the controlled foreign corporation, as determined under paragraph (c) of §1.954–4, and

(iv) Services performed in connection with the sale or exchange of, or with an offer or effort to sell or exchange, personal property manufactured, produced, etc., by the controlled foreign corporation, as determined under paragraph (d) of §1.954–4.

Where an item of income falls within more than one of subdivisions (ii) through (iv) of this subparagraph, it shall be sufficient to establish that it falls within any one of them.

(4) *Foreign base company oil related income.* (i) The foreign base company oil related income described in section 954(g) and §1.954–8, for which purpose there must be established, with respect to each foreign country, the gross income derived from—

(A) The processing of minerals extracted (by the taxpayer or by any other person) from oil or gas wells into their primary products, as determined under section 907(c)(2)(A),

(B) The transportation of such minerals or primary products, as determined under section 907(c)(2)(B),

(C) The distribution or sale of such minerals or primary products, as determined under section 907(c)(2)(C),

(D) The disposition of assets used by the taxpayer in a trade or business described in subdivision (A), (B) or (C), as determined under section 907(c)(2)(D),

(E) Dividends, interests, partnership distributions, and other amounts, as determined under section 907(c)(3).

Where an item of income falls within more than one of the listings in paragraphs (d)(4)(i)(A) through (E) of this section, it shall be sufficient to establish that it falls within any one of them.

(ii) If any of the items of income listed in paragraph (d)(4)(i) of this section arising from sources within a foreign country relates to oil, gas, or a primary product thereof and is described in section 954(g)(1)(A) or (B) and §1.954–8(a)(1)(i) or (ii) (and, hence, is not foreign base company oil related income), then there must be established facts sufficient to verify the amount of such item of income which is not foreign base company oil related income. In this regard, the total quantities of oil, gas and primary products thereof which gave rise to such item of income and the portions of such quantities which were extracted or sold within the foreign country must be established.

(5) *Qualified investments in less developed countries.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see 26 CFR 1.964–4(d)(4) (Revised as of April 1, 1975).

(6) *Income derived from aircraft or ships.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see CFR §1.964–4(d)(5) (Revised as of April 1, 1975).

(7) *Foreign base company shipping income.* The foreign base company shipping income to which section 954(f) and §1.954–6 apply, for which purpose there must be established—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, as determined under §1.954–6(c),

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, as determined under §1.954–6(d),

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as determined under §1.954–6(e),

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used (by the seller or by a person related to the seller) in foreign commerce,

(v) Dividends, interest, and gains described in §§1.954–6(f) and 1.954(b)(1)(viii),

(vi) Income described in §1.954–6(g) (relating to partnerships, trusts, etc.), and

(vii) Exchange gain, to the extent allocable to foreign base company shipping income, as determined under §1.952–2(c)(2)(v)(*b*).

If the controlled foreign corporation has income derived from or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, it shall be necessary to establish, from the books and records of the

controlled foreign corporation, that such aircraft or vessel was used in foreign commerce within the meaning of subparagraphs (3) and (4) of §1.954–6(b).

(8) *Income on which taxes are not substantially reduced.* The gross income excluded from foreign base company income under section 954(b)(4) and paragraph (b)(3) or (4) of §1.954–1 in the case of a controlled foreign corporation not availed of to substantially reduce income taxes, the income or similar taxes incurred with respect thereto, and all other factors necessary to verify the application of such exclusion.

(9) *Qualified investments in foreign base company shipping operations.* The foreign base company shipping income that is excluded from foreign base company income under section 954(b)(2) and §1.954–1(b)(1).

(10) *Special rule for shipping income.* The distributions received through a chain of ownership described in section 958(a) which are excluded from foreign base company income under section 954(b)(6)(B) and §1.954–1(b)(2).

(11) *Deductions.* The deductions allocable, under paragraph (c) of §1.954–1, to each of the classes and subclasses of gross income described in subparagraphs (1) through (9) of this paragraph.

(e) *Exclusion under section 963.* Books or records sufficient to verify the application of the exclusion provided by section 963 with respect to the subpart F income for the taxable year of a controlled foreign corporation must establish that the conditions set forth in paragraph (a)(2) of §1.963–1 have been met.

(f) *Exclusion under section 970(a).* Books or records sufficient to verify the application for the taxable year of the exclusion provided by section 970(a) in respect of export trade income which is foreign base company income must establish for such year—

(1) That the controlled foreign corporation is an export trade corporation, as defined in section 971(a) and paragraph (a) of §1.971–1,

(2) The export trade income, as determined under section 971(b) and paragraph (b) of §1.971–1, which constitutes foreign base company income,

(3) The export promotion expenses, as determined under section 971(d) and paragraph (d) of §1.971–1, which are allocable to the excludable export trade income,

(4) The gross receipts, and the gross amount on which is computed compensation included in gross receipts, from property in respect of which the excludable export trade income is derived, as described in section 970(a)(1)(B) and paragraph (b)(2)(ii) of §1.970–1, and

(5) The increase in investments in export trade assets, as determined under section 970(c)(2) and paragraph (d)(2) of §1.970–1.

(g–1) *Withdrawal of previously excluded subpart F income from qualified investment in less developed countries.* Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in less developed countries for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(1) and paragraph (b)(1) of §1.954–1 (as in effect for taxable years beginning before January 1, 1976; see 26 CFR 1.954–1(b)(1) (Revised as of April 1, 1975)) for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years, as determined under section 955(a) (as in effect before the enactment of the Tax Reduction Act of 1975) and paragraph (b) of §1.955–1, and

(3) The amount withdrawn from investment in less developed countries for the taxable year as determined under section 955(a) (as in effect before the enactment of the Tax Reduction Act of 1975) and paragraph (b) of §1.955–1.

(g–2) *Withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations.* Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in foreign base company shipping operations for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(2) and paragraph (b)(1) of §1.954–1 for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years, as determined under section 955(a) and paragraph (b) of §1.955A–1,

(3) The amount withdrawn from investment in foreign base company shipping operations for the taxable year as determined under section 955(a) and paragraph (b) of §1.955A–1, and

(4) If the carryover (as described in §1.955A–1(b)(3)) of amounts relating to investments in less developed country shipping companies (as described in §1.995–5(b)) is applicable, (i) the amount of the corporation's qualified investments (determined under §1.955–2 other than paragraph (b)(5) thereof) in less developed country shipping companies at the close of the last taxable year of the corporation beginning before January 1, 1976, and (ii) the amount of the limitation with respect to previously excluded subpart F income (determined under §1.955–1(b)(1)(i)(*b*)) for the first taxable year of the corporation beginning after December 31, 1975.

(h) *Withdrawal of previously excluded export trade income from investment.* Books or records sufficient to verify the previously excluded export trade income of the controlled foreign corporation withdrawn from investment for the taxable year must establish the United States shareholder's proportionate share of—

(1) The sum of the amounts by which the subpart F income of such corporation was reduced for all prior taxable years under section 970(a) and paragraph (b) of §1.970–1,

(2) The sum of the amounts described in section 970(b)(1)(B),

(3) The sum of the amounts of previously excluded export trade income of such corporation withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for all prior taxable years, and

(4) The amount withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for the taxable year.

(i) *Increase in earnings invested in United States property.* Books or records sufficient to verify the increase for the taxable year in earnings invested by the controlled foreign corporations in United States property must establish—

(1) The amount of such corporation's earnings invested in United States property (as defined in section 956(b)(1) and paragraph (a) of §1.956–2) at the close of the current and preceding taxable years, as determined under paragraph (b) of §1.956–1,

(2) The amount of excluded property described in section 956(b)(2) and paragraph (b) of §1.956–2 held by such corporation at the close of such years,

(3) The earnings and profits, to which section 959(c)(1) and paragraph (b)(1) of §1.959–3 apply, distributed by such corporation during the preceding taxable year, and

(4) The amount of increase in earnings invested by such corporation in United States property which is excluded from the United States shareholder's gross income for the taxable year under section 959(a)(2) and paragraph (c) of §1.959–1.

[T.D. 6824, 30 FR 6481, May 11, 1965, as amended by T.D. 7211, 37 FR 21436, Oct. 11, 1972; T.D. 7893, 48 FR 22511, May 19, 1983; T.D. 8331, 56 FR 2849, Jan. 25, 1991]

### §1.964–5 Effective date of subpart F.

Sections 951 through 964 and §§1.951 through 1.964–4 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 7120, 36 FR 10862, June 4, 1971]

EXPORT TRADE CORPORATIONS

### §1.970–1 Export trade corporations.

(a) *In general.* Sections 970 through 972 provide in general that if a controlled foreign corporation is an export trade corporation for any taxable year, the subpart F income of such corporation shall, subject to limitations provided by section 970(a) and paragraph (b) of this section, be reduced by so

much of such corporation's export trade income as constitutes foreign base company income. To the extent subpart F income of an export trade corporation is reduced under section 970 and this section, an amount is required by section 970(b) and paragraph (c) of this section to be included in gross income of United States shareholders of the corporation if there is a subsequent decrease in such corporation's investments in export trade assets. See section 971(a) and paragraph (a) of §1.971–1 for definition of the term ''export trade corporation'', section 971(b) and paragraph (b) of §1.971–1 for definition of the term ''export trade income'', and section 971(c) and paragraph (c) of §1.971–1 for definition of the term ''export trade assets''.

(b) *Amount by which export trade income shall reduce subpart F income*—(1) *Deductible amount.* The subpart F income, determined as provided in section 952 and the regulations thereunder but without regard to section 970 and this paragraph, of a controlled foreign corporation which is an export trade corporation for its taxable year shall be reduced by an amount equal to so much of its export trade income as constitutes foreign base company income for such taxable year, but only to the extent that such amount of export trade income does not exceed the limitation determined under subparagraph (2) of this paragraph for such taxable year. See section 972 and §1.972–1 for rules relating to the consolidation of export trade corporations for purposes of determining the limitations described in subparagraph (2) of this paragraph.

(2) *Limitation on the amount of export trade income deductible from subpart F income.* The amount by which subpart F income of an export trade corporation may be reduced for any taxable year under subparagraph (1) of this paragraph may not exceed whichever of the following limitations is the smallest:

(i) The amount which is equal to 150 percent of the export promotion expenses, as defined in section 971(d) and paragraph (d) of §1.971–1, of the export trade corporation paid or incurred during the taxable year which are properly allocable to the receipt or the production of so much of its export trade income as constitutes foreign base company income for such taxable year;

(ii) The amount which is equal to 10 percent of the gross receipts (other than from commissions, fees, or other compensation for services), plus 10 percent of the gross amount upon the basis of which are computed commissions, fees, or other compensation for services included in gross receipts, of the export trade corporation received or accrued during the taxable year from, or in connection with, the sale, installation, operation, maintenance, or use of property in respect of which such corporation derives export trade income which constitutes foreign base company income for such taxable year; or

(iii) The amount which bears the same ratio to the increase in investments in export trade assets, as defined in section 970(c)(2) and paragraph (d)(2) of this section, of the export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of such corporation for such taxable year bears to the entire export trade income of the corporation for such year.

Under subdivision (ii) of this subparagraph, in the case of minimum or maximum fee arrangements, the determination shall be made on the basis of the actual gross amounts with respect to which such fees are paid, rather than on the basis of the amounts upon which such minimum or maximum fees are computed. All determinations of limitations under this subparagraph shall be made on an aggregate basis and not with respect to separate items or categories of income described in paragraph (b)(1) of §1.971–1.

(3) *Determination of export promotion expense limitation.* For purposes of determining the limitation contained in subparagraph (2)(i) of this paragraph for any taxable year of the export trade corporation, there shall be taken into account with respect to those items or categories of export trade income which constitute foreign base company income the entire amount of those export promotion expenses which are directly related to such items or categories of income and a ratable part of any other export promotion expenses which are indirectly related to such

items or categories of income, except that no export promotion expense shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such corporation under section 882(c) and the regulations thereunder shall be taken into account.

(4) *Application of section 482.* The limitations provided in section 970(a) and subparagraph (2) of this paragraph shall not affect the authority of the district director to apply the provisions of section 482 and the regulations thereunder, relating to allocation of income and deductions among taxpayers.

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

*Example 1.* Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. For 1963, A Corporation's subpart F income determined under section 952 and the regulations thereunder is $35, the total of its gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $310, its export promotion expenses properly allocable to its export trade income which constitutes foreign base company income are $18, its increase in investments in export trade assets is $32, and its export trade income is $40, of which $30 constitutes foreign base company income and $10 does not constitute foreign base company income. The subpart F income of A Corporation for 1963 as reduced under section 970(a) is $11, determined as follows:

| | | |
|---|---|---|
| (i) Subpart F income | | $35 |
| (ii) Less: $30 export trade income which constitutes foreign base company income, but deduction not to exceed the smallest of the following limitations (smallest of (*a*), (*b*), or (*c*)): | | |
| (*a*) 150 percent of allocable export promotion expenses referred to in subparagraph (2)(i) of this paragraph (150% of $18) | $27 | |
| (*b*) 10 percent of gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph (10% of $310) | $31 | |
| (*c*) Amount which bears to the increase in investments in export trade assets ($32) the same ratio as the export trade income which constitutes foreign base company income ($30) bears to total export trade income ($40) (75% [$30/$40] of $32) | $24 | $24 |
| (iii) Subpart F income as reduced under section 970(a) | | 11 |

*Example 2.* The facts are the same as in example 1, except that A Corporation's export promotion expenses properly allocable to export trade income which constitutes foreign base company income are $14 instead of $18. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $21 (150% of $14) instead of $24. The subpart F income as reduced under section 970(a) is $14 ($35 less $21).

*Example 3.* The facts are the same as in example 1, except that the total amount of A Corporation's gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $200 instead of $310. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $20 (10 percent of $200) instead of $24. The subpart F income as reduced under section 970(a) is $15 ($35 less $20).

*Example 4.* The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 5 percent of the gross receipts from M Corporation's sales or a minimum fee of $30. Such gross receipts are $220. The gross amounts taken into account in determining the limitation under subparagraph (2)(ii) of this paragraph are $220. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $22 (10 percent of $220) instead of $24. The subpart F income as reduced under section 970(a) is $13 ($35 minus $22).

*Example 5.* The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 9 percent of the gross receipts from M Corporation's sales or a maximum fee of $30. Such gross receipts are $400. In such instance, the limitation under (ii)(*b*) of example 1 is $40 (10 percent of $400) instead of $31. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $24, the smallest of the three limitations. The subpart F income as reduced under section 970(a) is $11 ($35 less $24).

(c) *Withdrawal of previously excluded export trade income*—(1) *Inclusion of withdrawal in income of United States shareholders.* If—

(i) A controlled foreign corporation was an export trade corporation for any taxable year,

(ii) Such corporation in any such taxable year derived subpart F income which, under the provisions of section 970(a) and paragraph (b) of this section, was reduced, and

(iii) Such corporation has in a subsequent taxable year a decrease in investments in export trade assets,

every person who is a United States shareholder, as defined in section 951(b), of such corporation on the last day of such subsequent taxable year on which such corporation is a controlled foreign corporation shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such decrease in investments but only to the extent that such pro rata share does not exceed the limitations determined under subparagraph (2) of this paragraph. A United States shareholder's pro rata share of a controlled foreign corporation's decrease for any taxable year in investments in export trade assets shall be his pro rata share of such corporation's decrease for such year determined under section 970(c)(3) and paragraph (d)(3) of this section.

(2) *Limitations applicable in determining amount includible in income*—(i) *General.* A United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year of such corporation shall, for purposes of determining an amount to be included in the gross income for any taxable year of such shareholder, not exceed the lesser of the limitations determined under (*a*) and (*b*) of this subdivision:

(*a*) Such shareholder's pro rata share of the sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus his pro rata share of the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, or

(*b*)(*1*) Such shareholder's pro rata share of the sum of the amounts by which the subpart F income of such controlled foreign corporation for prior taxable years was reduced under section 970(a) and paragraph (b) of this section, plus

(*2*) Such shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of such controlled foreign corporation for such prior taxable years by reason of the application of section 972 and §1.972–1, minus

(*3*) Such shareholder's pro rata share of the sum of the amounts which were previously included in his gross income for prior taxable years under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and this paragraph with respect to such controlled foreign corporation.

The net amount determined under (*b*) of this subdivision with respect to any stock owned by the United States shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing the treatment of gain from sales or exchanges of stock in certain foreign corporations.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i) (*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*) Amounts which are, or have been, included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) (other than an amount included in the gross income of a United States shareholder under section 951(a)(1)(A)(ii) or section 951(a)(1)(B) for the taxable year) and have not been distributed, or

(*b*)(*1*) Amounts which for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the

gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets. See section 959 and the regulations thereunder for limitations on the exclusion of previously taxed earnings and profits.

(iii) *Rules of application.* The determinations made under subdivision (i) of this subparagraph for purposes of determining the United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year shall be made on the basis of the stock such shareholder owns, within the meaning of section 958(a) and the regulations thereunder, in the controlled foreign corporation on the last day in the taxable year on which such corporation is a controlled foreign corporation even though such shareholder owned more or less stock in such corporation prior to that date. See section 972 and paragraph (b)(3) of §1.972–1 for rules relating to the allocation of a decrease in investments in export trade assets of export trade corporations in a consolidated chain of such corporations. See section 951(a)(3) and the regulations thereunder for an additional limitation upon the amount of a United States shareholder's pro rata share determined under this paragraph.

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

*Example 1.* Foreign corporation A, which has one class of stock outstanding, is a wholly owned subsidiary of domestic corporation M throughout 1963 and 1964. Both corporations use the calendar year as the taxable year. For 1963, A Corporation qualifies as an export trade corporation and its subpart F income, determined in accordance with the provisions of section 952 and the regulations thereunder, is reduced by $20 under the provisions of section 970(a) and paragraph (b) of this section. Section 972 is assumed not to apply to A Corporation. For 1964, A Corporation has a decrease of $8 in investments in export trade assets. For 1963 and 1964, A Corporation has earnings and profits of $30 (determined under the provisions of subparagraph (2) of this paragraph). Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 which is includible in M Corporation's gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) is $8, determined as follows:

| | | | |
|---|---|---|---|
| (i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 (100% of $8) | | | $8 |
| (ii) Limitation on amount includible in gross income of M Corporation for 1964 (smaller of (*a*) or (*b*)): | | | |
| (*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963 and 1964 determined under subparagraph (2) of this paragraph (100% of $30) | | $30 | |
| (*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (100% of $20) | $20 | | |
| Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 by reason of the application of section 972 | 0 | | |
| Total | 20 | | |
| Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation | 0 | 20 | |
| (iii) Corporation M's pro rata share includible in gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii)) | | | 8 |

*Example 2.* Assume the same facts as in example 1, except that on February 14, 1965, M Corporation sells 25 percent of its stock in A Corporation to N Corporation. Corporation N is a domestic corporation which also uses the calendar year as a taxable year. For 1965, A Corporation has a decrease of $16 in investments in export trade assets. Corporation A's earnings and profits for 1963 and 1964 (determined under the provisions of subparagraph (2) of this paragraph) are $22 ($30 minus $8). Corporation A's earnings and profits for 1965 are $6 (determined under the provisions of subparagraph (2) of this paragraph). For 1965, M Corporation's pro rata share of A Corporation's decrease in investments in export trade assets which is includible in M Corporation's gross income under section 951(a)(1)(A)(ii) is $9, and N Corporation's pro rata share includible in gross income under such section is $0, determined as follows:

M CORPORATION

| | | | |
|---|---|---|---|
| (i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (75% of $16) | ..... | ..... | $12 |
| (ii) Limitation on amount includible in gross income of M Corporation for 1965 (smaller of (*a*) or (*b*)): | | | |
| (*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (75% of $28) | ..... | $21 | |
| (*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (75% of $20) | $15 | | |
| Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972 | 0 | | |
| Total | $15 | | |
| Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (75% of $8) | 6 | 9 | |
| (iii) Corporation M's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii)) | ..... | ..... | 9 |

N CORPORATION

| | | | |
|---|---|---|---|
| (i) Corporation N's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (25% of $16) | ..... | ..... | 0 |
| (ii) Limitation on amount includible in gross income of N Corporation for 1965 (smaller of (*a*) or (*b*)): | | | |
| (*a*) Corporation N's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (25% of $28) | ..... | 07 | |
| (*b*) Corporation N's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (amounts prior to 2/14/65 not being taken into account) | 0 | | |
| Plus: Corporation N's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972 (amounts prior to 2/14/65 not being taken into account) | 0 | | |
| Total | 0 | | |
| Less: Corporation N's pro rata share of the sum of amounts which were previously included in gross income of N Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (amounts prior to 2/14/65 not being taken into account) | 0 | 0 | |
| (iii) Corporation N's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii)) | ..... | ..... | 0 |

(d) *Investments in export trade assets*—(1) *Amount of investments.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, export trade assets shall be taken into account on the following bases:

(i) *Working capital.* Working capital to which section 971(c)(1) applies shall be taken into account at the adjusted basis of current assets, determined as of the applicable determination date, less any current liabilities (except as provided in subdivision (iii) of this subparagraph).

(ii) *Other export trade assets.* Inventory to which section 971(c)(2) applies, facilities to which section 971(c)(3) applies, and evidences of indebtedness to which section 971(c)(4) applies, shall be taken into account at their adjusted bases as of the applicable determination date, reduced by any liabilities (except as provided in subdivision (iii) of this subparagraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. A liability in excess of the adjusted basis of the property which is subject to such liability will not be taken into account for the purpose of reducing the adjusted basis

of other property which is not subject to such liability. See paragraph (c)(6) of §1.971–1 for treatment of export trade assets which constitute working capital to which section 971(c)(1) applies and which also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies.

(iii) *Treatment of certain liabilities.* For purposes of subdivisions (i) and (ii) of this subparagraph, a current liability, or a specific charge created with respect to any item of property, principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investments in export trade assets shall be taken into account in such a manner as to properly reflect the controlled foreign corporation's investments in export trade assets; whether a specific charge or current liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(iv) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes an export trade asset on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(2) *Increase in investments in export trade assets.* For purposes of section 970(a) and paragraph (b) of this section, the amount of increase in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of such taxable year, exceeds

(ii) The amount of its investments in export trade assets at the close of the preceding taxable year.

(3) *Decrease in investments in export trade assets.* For purposes of section 970(b) and paragraph (c) of this section, the amount of the decrease in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of the preceding taxable year, minus

(ii) An amount equal to the excess of recognized losses over recognized gains on sales, exchanges, involuntary conversions, assets or other dispositions, of export trade during the taxable year, exceeds

(iii) The amount of its investments in export trade assets at the close of the taxable year.

For purposes of subdivision (ii) of this subparagraph, recognized losses include a write-down of inventory to lower of cost or market in accordance with a method of inventory valuation established or adopted by or on behalf of such foreign corporation under paragraph (c) of §1.964–1.

[T.D. 6755, 29 FR 12704, Sept. 9, 1964, as amended by T.D. 6795, 30 FR 947, Jan. 29, 1965; T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7893, 48 FR 22511, May 19, 1983]

### §1.970–2 Elections as to date of determining investments in export trade assets.

(a) *Nature of elections*—(1) *In general.* In lieu of determining the increase under the provisions of paragraph (d)(2) of §1.970–1, or the decrease under the provisions of paragraph (d)(3) of §1.970–1, in a controlled foreign corporation's investments in export trade assets for a taxable year in the manner provided in such provisions, a United States shareholder of such corporation may elect, under the provisions of section 970(c)(4) and this section, to determine such increase or decrease in accordance with the provisions of subparagraph (2) of this paragraph or, in the case of export trade assets which are facilities described in section 971(c)(3), in accordance with the provisions of subparagraph (3) of this paragraph. Separate elections may be made under subparagraph (2) and/or (3) of this paragraph with respect to each controlled foreign corporation with respect to which a person is a United States shareholder, within the meaning of section 951(b).

(2) *Election of 75-day rule.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of §1.970–1 of the amount of such corporation's investments in export trade assets as of the 75th day after the close of the taxable year referred to in such subparagraphs of paragraph (d) of §1.970–1. The election provided by this subparagraph may be made with respect to export trade assets other than facilities described in section 971(c)(3) or with respect to export trade assets which are facilities or with respect to both types of export trade assets (but the election under this paragraph with respect to export trade assets which are facilities or with respect to both types of export trade assets may be made only if the election provided by subparagraph (3) of this paragraph is not made). If the election provided by this subparagraph is made, the amount of export trade assets with respect to which such election is made at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of export trade assets which was considered by application of the 75-day rule to be the amount of export trade assets at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which the 75-day rule is elected the amount of investments in export trade assets with respect to which such election is made at the close of such preceding year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of investments in export trade assets at the actual close of such preceding year. In the case of a taxable year of such corporation beginning after December 31, 1962, and before December 31, 1963, the amount of investments in export trade assets with respect to which such election is made alternatively may be determined by the United States shareholder as of the 75th day after the close of the preceding taxable year referred to in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 rather than as of the close of such preceding taxable year.

(3) *Election for export trade assets which are facilities.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of §1.970–1 of the amount of such corporation's investments in export trade assets which are facilities described in section 971(c)(3) as of the close of such corporation's taxable year following the taxable year referred to in such subparagraphs of paragraph (d) of §1.970–1. The election provided by this subparagraph may be made only if the United States shareholder does not elect the 75-day rule of subparagraph (2) of this paragraph with respect to export trade assets which are facilities. If the election provided by this subparagraph is made, the amount of investments in export trade assets which are facilities at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of export trade assets which are facilities which was considered, by reason of the application of the following-year rule provided in this subparagraph with respect to such preceding taxable year, to be the amount of export trade assets which are facilities at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which such following-year rule is elected the amount of investments in export trade assets which are facilities at the close of the preceding taxable year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of §1.970–1 shall be the amount of investments in export trade assets which are facilities at the actual close of such preceding taxable year.

(b) *Time and manner of making elections*—(1) *Without consent.* A United States shareholder may, with respect to any controlled foreign corporation, make one or both of the elections described in paragraph (a)(2) or (3) of this section without the consent of the Commissioner by filing a statement to such effect with his return for his taxable year in which or with which ends

the first taxable year of such corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning, by applying the rules of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and

(ii) Such corporation realizes subpart F income which is reduced under section 970(a) and paragraph (b) of §1.970–1.

The statement shall contain the name and address of the controlled foreign corporation, identification of such first taxable year of such corporation, and an indication as to which election or elections described in paragraph (a) of this section the United States shareholder is making. If such return has been filed on or before the 90th day after the date these regulations are published in the FEDERAL REGISTER, such United States shareholder shall file such statement with the district director with which the return was filed on or before such 90th day.

(2) *With consent.* A United States shareholder may make one or both of the elections described in paragraph (a)(2) or (3) of this section with respect to any controlled foreign corporation at any time with the consent of the Commissioner. Consent will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) in accordance with one or both of the elections provided in paragraph (a) of this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of the controlled foreign corporation;

(iii) A statement indicating which of the elections the shareholder desires to make;

(iv) The amount of the foreign corporation's investments in export trade assets (by a category which includes export trade assets other than facilities and a category which includes only export trade assets which are facilities) at the close of its preceding taxable year;

(v) The shareholder's pro rata share of the sum of the amounts by which the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, was reduced under section 970(a) and paragraph (b) of §1.970–1;

(vi) The shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, by reason of the application of section 972 and §1.972–1; and

(vii) The shareholder's pro rata share of the sum of the amounts which were previously included in his gross income, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and paragraph (b) of §1.970–1 to the foreign corporation.

(c) *Effect of elections*—(1) *In general.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election made under paragraph (a) of this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and—

(i) In the case of the election described in paragraph (a)(2) of this section, shall apply to all investments in export trade assets with respect to which such election is made acquired, or disposed of, by such corporation during the 75-day period following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding 75-day periods of such corporation, or

(ii) In the case of the election described in paragraph (a)(3) of this section, shall apply to all investments in

export trade assets which are facilities acquired, or disposed of, by such corporation during the taxable year following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's investments in export trade assets for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of such corporation's investments in export trade assets at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of such shareholder's tax for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation*—(i) *In general*—(*a*) *Consent required.* Upon application by the United States shareholder, an election made under paragraph (a) of this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected.

(*b*) *Revocation of 75-day rule.* In the case of the revocation of an election described in paragraph (a)(2) of this section, the change in the controlled foreign corporation's investments in export trade assets with respect to which such election was made for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be the amount by which—

(*1*) Such corporation's investments in export trade assets with respect to which such election was made at the close of such taxable year exceeds or, if applicable, is exceeded by

(*2*) Such corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of the preceding taxable year of such corporation.

(*c*) *Revocation of following-year rule.* In the case of the revocation of an election described in paragraph (a)(3) of this section, the change in the controlled foreign corporation's investments in export trade assets which are facilities for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be zero.

(ii) *Time and manner of applying for consent to revocation*—(*a*) *Application to Commissioner.* The application for consent to revocation of an election shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC, 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) or an inclusion under section 970(b) without regard to such election.

(*b*) *Information required.* The application shall include the following information:

(*1*) The name, address, and taxable year of the United States shareholder;

(*2*) The name, address, and taxable year of the controlled foreign corporation;

(*3*) A statement indicating the election the shareholder desires to revoke under this subparagraph;

(*4*) The information required under subdivisions (iv) through (vii) of paragraph (b)(2) of this section;

(*5*) In the case of an application for consent to revocation of an election made under paragraph (a)(2) of this section, the amount of the foreign corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of such corporation's taxable year immediately preceding the taxable year of such corporation; and

(*6*) The reasons for the request for consent to revocation.

(4) *Transfer of stock*—(i) *Election of 75-day rule in force.* (*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(2) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change during the first 75 days of such taxable year in investments in export trade assets with respect to which such election is made to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which the acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets with respect to which such election is made at the close of the 75th day after the close of such preceding taxable year.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(ii) *Election in force with respect to export trade assets which are facilities*—(*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(3) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change for such taxable year in investments in export trade assets which are facilities to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which he acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets which are facilities at the close of the taxable year in which such stock is acquired.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable

year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(d) *Illustrations.* The principles contained in this section are illustrated by the examples set forth in paragraph (d) of § 1.955.3.

[T.D. 6755, 29 FR 12707, Sept. 9, 1964]

### § 1.970–3 Effective date of subpart G.

Sections 970 through 972 and §§ 1.970–1 through 1.972–1 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 6755, 29 FR 12709, Sept. 9, 1964]

### § 1.971–1 Definitions with respect to export trade corporations.

(a) *Export trade corporations*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade corporation'' means a controlled foreign corporation which for the period specified in subparagraph (2) of this paragraph satisfies the conditions specified in subparagraph (3) of this paragraph. However, no controlled foreign corporation may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as an export trade corporation for any taxable year beginning before such date. In addition, if a corporation fails to qualify as an export trade corporation for a period of any 3 consecutive taxable years beginning after October 31, 1971, then for any taxable year beginning after such 3-year period, such corporation shall not be included within the term ''export trade corporation''.

(2) *Three-year period.* The period referred to in subparagraph (1) of this paragraph is the 3-year period ending with the close of the controlled foreign corporation's current taxable year, or such part of such 3-year period as occurs on and after the beginning of the corporation's first taxable year beginning after December 31, 1962, whichever period is shorter.

(3) *Gross income requirements.* The conditions referred to in subparagraph (1) of this paragraph are that the controlled foreign corporation derives—

(i) 90 percent or more of its gross income from sources without the United States, and

(ii)(*a*) 75 percent of more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section, or

(*b*) 50 percent or more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section in respect of agricultural products grown in the United States.

(4) *Determination of sources of gross income.* The sources of gross income of a controlled foreign corporation shall be determined for purposes of subparagraph (3)(i) of this paragraph in accordance with the rules for determining sources of gross income set forth in sections 861 through 864 and the regulations thereunder.

(b) *Export trade income*—(1) *General rule.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade income'' means the gross export trade income of a controlled foreign corporation derived from transactions, activities, or interest described in subdivisions (i) through (vii) of this subparagraph, less deductions allowed under subdivision (viii) of this subparagraph.

(i) *Sale of export property.* Gross export trade income of a controlled foreign corporation includes gross income it derives from the sale of export property (as defined in paragraph (e) of this section) which it purchases, if the sale is made to an unrelated person for use, consumption, or disposition outside the United States. See section 971(b)(1). As a general rule, property will be presumed to have been sold for use, consumption, or disposition in the country of destination of the sale. However, if at the time of the sale the controlled foreign corporation knows, or should

have known from the facts and circumstances surrounding the sales transaction, that the property will probably be used, consumed, or disposed of in the United States, such property will be presumed to have been sold for use, consumption, or disposition in the United States unless the controlled foreign corporation establishes that such property was used, consumed, or disposed of outside the United States. For purposes of this subdivision, export property must be sold by a controlled foreign corporation in essentially the same form in which such property is purchased. Whether export property sold is in essentially the same form in which such property is purchased shall be determined on the basis of all the facts and circumstances in each case. Storage, handling, transportation, packaging, or servicing of property will be considered not to alter the form in which property is purchased. However, manufacture or production, within the meaning of paragraph (a)(4) of §1.954–3, will be considered to alter the form in which property is purchased and no part of the gross income from the sale of such property will be treated as export trade income. The application of this subdivision may be illustrated by the following example:

*Example.* Controlled foreign corporation A, incorporated under the laws of foreign country Y, purchases articles manufactured in the United States from domestic corporation M and sells them in the form in which purchased to foreign corporation B, unrelated to A Corporation, for use in foreign countries, X, Y, and Z. The gross income of A Corporation from the purchase and sale of the articles constitutes gross export trade income.

(ii) *Commissions and other income derived in connection with the sale of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of a sale by such corporation in a transaction described in subdivision (i) of this subparagraph or in respect of the sale by any other person of export property to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. Such gross export trade income includes payments received for surveys made prior to, and in connection with, the sale of such export property (whether or not such sales are ultimately consummated). See section 971(b)(1). The term ''any person'' or ''any other person'' as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1. The application of this subdivision may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, receives from M Corporation a commission equal to 6 percent of the gross selling price of all personal property shipped by M Corporation as a result of services performed by A Corporation in soliciting orders in foreign countries X, Y, and Z. In fulfillment of such orders, M Corporation ships products manufactured by it in the United States. Corporation A does not assume title to the property sold. Gross commissions received by A Corporation from M Corporation in connection with the sale of such property to persons unrelated to A Corporation for use, consumption, or disposition outside the United States constitute gross export trade income.

*Example 2.* Foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation N, is engaged in the business of manufacturing heavy duty electrical equipment in the United States. By contract, N Corporation engages B Corporation for the purpose of conducting engineering, technical, and financial studies required by N Corporation in the preparation of bids to supply foreign country Y with electrical equipment for a construction project to be undertaken by such country. Corporation N pays B Corporation a fee for the services, all of which are performed in country Y, which is based upon the number of hours of work performed without regard to whether a sale is ultimately consummated. Corporation N does not receive a contract from country Y on its bid to supply equipment. Income derived by B Corporation from performance of the service contract constitutes gross export trade income.

(iii) *Commissions and other income derived in connection with the installation or maintenance of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other

income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of the installation or maintenance of export property which has been sold by such corporation in a transaction described in subdivision (i) of this subparagraph or by any other person to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. See section 971(b)(1). The term ''any person'' or ''any other person'' as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(iv) *Commissions and other income derived in connection with the use of patents, copyrights, and other like property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the use outside of the United States by an unrelated person of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, including gross income derived from obtaining licensees for patents, but only if the patent, copyright, or other like property is acquired, or developed, and owned by the manufacturer, producer, grower, or extractor of any export property, in respect of which the controlled foreign corporation also derives gross export trade income within the meaning of subdivision (i), (ii), or (iii) of this subparagraph. See section 971(b)(2). The application of this subdivision may be illustrated by the following example:

*Example.* Foreign corporation A incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation M, the owner of a patent registered in foreign country X, grants B Corporation, a corporation unrelated to A Corporation, the right to use such patent in foreign country Y in exchange for payment of a royalty. By a separate contract with B Corporation, A Corporation agrees for a gross fee of $100,000 to furnish, by maintaining a staff of technical representatives at the offices of B Corporation, technical services to B Corporation in connection with B Corporation's use of the patent. Corporation A also derives export trade income from the sale of export property which it purchases from M Corporation, the manufacturer of such property, and sells to C Corporation, an unrelated person, for use in country Y by C Corporation. The gross fee of $100,000 received by A Corporation for the furnishing of technical services in connection with B Corporation's use of M Corporation's patent constitutes gross export trade income since the service for which the fee is paid is performed in connection with the use outside the United States by an unrelated person (B Corporation) of a patent owned by a manufacturer (M Corporation) of export property in respect of which the controlled foreign corporation (A Corporation) derives gross export trade income from the sale to an unrelated person (C Corporation) for use outside the United States of export property purchased by it from the manufacturer (M Corporation).

(v) *Income attributable to use of export property by an unrelated person.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, rents, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property by such unrelated person. See section 971(b)(3). The application of this subdivision may be illustrated by the following example:

*Example.* Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A acquires by purchase bottling machines manufactured in the United States and leases the machines to B Corporation, a corporation unrelated to A Corporation, for use by B Corporation in foreign country Y. Gross rental income of A Corporation from the lease of the machines to B Corporation constitutes gross export trade income.

(vi) *Income attributable to the use of export property in the rendition of technical, scientific, or engineering services—(a) General.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income which is received by such corporation from an unrelated person and is attributable to

the use of export property in the performance of technical, scientific, or engineering services to such unrelated person. See section 971(b)(3).

(*b*) *Rule of apportionment.* If a commission, fee, or other income received by a controlled foreign corporation from an unrelated person under a contract or arrangement for the performance of technical, scientific, or engineering services is not solely attributable to the use of export property in the performance of such services and the amount of the gross income attributable to such use of export property cannot be established by reference to transactions between other unrelated persons, such gross income shall be an amount which bears the same ratio to total gross income from the contract or arrangement as the cost of the export property consumed in the performance of such services, including a reasonable allowance for depreciation with respect to the export property so used, bears to the total costs and expenses attributable to the production of income under the contract or arrangement.

(*c*) *Illustration.* The application of this subdivision may be illustrated by the following example:

*Example.* Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A is engaged in the seismograph service business in foreign country X. In an effort to establish the probable existence of oil in a concession area it owns in foreign country Y, B Corporation which is unrelated to A Corporation enters into a contract with A Corporation whereby A Corporation is required to make seismographic tests of the area in country Y for a fixed fee of $100,000. In performance of the contract, A Corporation hires a skilled crew to carry out the contract and utilizes equipment and supplies (for example, trucks, seismographic equipment, etc.) which constitute export property. Corporation A cannot establish by reference to transactions between other unrelated persons, the income attributable to the use of the export property in the performance of the contract. Corporation A's total costs and expenses (for example, salaries of the crew, administrative expenses, all supplies, total depreciation on property used in performance of the contract, etc.) incurred in performance of the contract are $80,000. The cost of export property consumed in performance of the contract (for example, dynamite, motor oil, and other supplies which were produced in the United States, reasonable depreciation on trucks and seismographic equipment manufactured in the United States and used in performance of the contract, etc.) is $30,000. Corporation A's gross export trade income from the contract is $37,500, that is, the amount which bears the same ratio to total gross income from the contract ($100,000) as the cost of the export property consumed in the rendition of the services ($30,000) bears to total costs and expenses attributable to the contract ($80,000).

(vii) *Interest from export trade assets.* Gross export trade income of a controlled foreign corporation includes interest derived by it from export trade assets described in section 971(c)(4) and paragraph (c)(5) of this section. See section 971(b)(4).

(viii) *Deductions to be taken into account.* Export trade income of a controlled foreign corporation for any taxable year shall be the amount determined by deducting from the items or categories of gross income described in subdivisions (i) through (vii) of this subparagraph the entire amount of those expenses, taxes, and other deductions properly allocable to such items or categories of income. For purposes of this section, expenses, taxes, and other deductions shall first be allocated to items or categories of gross income to which they directly relate; then, expenses, taxes, and other deductions which cannot definitely be allocated to some item or category of gross income shall be ratably apportioned among all items or categories of gross income, except that no expense, tax, or other deduction shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such controlled foreign corporation under section 882(c) and the regulations thereunder shall be taken into account.

(2) *Cross reference.* For rules governing the determination of gross income and taxable income of a foreign corporation, see §1.952–2.

(c) *Export trade assets*—(1) *In general.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ''export trade assets'' means—

(i) Working capital reasonably necessary for the production of export trade income,

(ii) Inventory of export property held for use, consumption, or disposition outside the United States,

(iii) Facilities located outside the United States for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property, and

(iv) Evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section.

(2) *Working capital.* For purposes of subparagraph (1)(i) of this paragraph, working capital of a controlled foreign corporation is the excess of its current assets over its current liabilities. Liabilities maturing in one year or less shall be considered current liabilities. A determination of the amount of working capital of a controlled foreign corporation which is reasonably necessary for the production of export trade income will depend upon the nature and volume of the activities of the controlled foreign corporation which produce export trade income as they exist on the applicable determination date. In determining working capital which is reasonably necessary for the production of export trade income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the controlled foreign corporation following the applicable determination date; anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of export trade income as of the applicable determination date.

(3) *Inventory of export property.* For purposes of subparagraph (1)(ii) of this paragraph, the inclusion of items in inventory shall be determined in accordance with rules applicable to domestic corporations. See §§1.471–1 through 1.471–9. Inventory of export property of a controlled foreign corporation includes export property held for use, consumption, or disposition outside the United States regardless of where it is located on the applicable determination date. Thus, such property may be physically located in the United States on such date. However, for property physically located in the United States to constitute export property, it must have been acquired by the controlled foreign corporation with a clear intent that it would dispose of the property for use, consumption, or disposition outside the United States. As a general rule, if during the year following the applicable determination date export property which was physically located in the United States on such date is actually exported for use, consumption, or disposition outside the United States, such property will be deemed held for such purpose on the applicable determination date. On the other hand, the indefinite warehousing of export property in the United States by the controlled foreign corporation, or the subsequent sale of export property by such corporation for use, consumption, or disposition in the United States, will evidence a lack of intent by such corporation on the applicable determination date to hold such property for use, consumption, or disposition outside the United States.

(4) *Facilities located outside the United States*—(i) *In general.* For purposes of subparagraph (1)(iii) of this paragraph, a facility, as defined in subdivision (ii)(*a*) of this subparagraph, will be considered an export trade asset only—

(*a*) If such facility is located outside the United States, and

(*b*) To the extent that such facility is used, within the meaning of subdivision (ii)(*c*) of this subparagraph, by the controlled foreign corporation for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property in essentially the same form in which such property is acquired by such corporation.

Thus, a facility in which property is manufactured or produced, even though export property is used or consumed in the production or becomes a component part of the manufactured article, will not qualify as an export trade asset.

(ii) *Special rules*—(*a*) *Facility defined.* For purposes of subdivision (i) of this subparagraph, the term ''facility'' includes any asset or group of assets used

for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property. Thus, such term includes warehouse, storage, or sales facilities (for example, sales office equipment), transportation equipment (for example, motor trucks, vessels, etc.), and machinery and equipment (for example, packaging equipment, servicing equipment, cranes, forklift trucks used in warehouses, etc.).

(*b*) *Determination of location of transportation facilities.* A transportation facility shall be considered to be located outside the United States for purposes of subdivision (i)(*a*) of this subparagraph if such property is predominantly located outside the United States. As a general rule, on an applicable determination date a transportation facility will be considered to be predominantly located outside the United States if 70 percent or more of the miles traversed (during the 12-month period immediately preceding such determination date or for such part of such period as such facility is owned by the controlled foreign corporation) in the use of such facility are traversed outside the United States or if such facility is located outside the United States at least 70 percent of the time during such period or such part thereof.

(*c*) *Determination of use.* For purposes of subdivision (i)(*b*) of this subparagraph, the extent to which a facility is used in carrying on the activities described in such subdivision depends on the use made of the facility for the 12-month period immediately preceding the applicable determination date or for such part of such period as such facility is owned by the controlled foreign corporation. The method of measuring such use will depend upon the facts and circumstances in each case. However, such determinations of use will generally be made for a facility as a whole and not on the basis of individual items used in the operation of a facility. Thus, a determination as to the use of a warehouse facility will generally be made with respect to the entire facility and not separately for the items used in such warehouse, such as forklift trucks, storage bins, etc.

(5) *Evidences of indebtedness.* For purposes of subparagraph (1)(iv) of this paragraph, the term ''evidence of indebtedness'' shall mean a note, installment sales contract, a time bill of exchange evidencing a sale on credit, or similar written instrument executed by an unrelated person which evidences the obligation of an unrelated person to pay for export property which an unrelated person purchases for use, consumption, or disposition outside the United States or to pay for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section which are performed for an unrelated person. Receivables which arise out of the delivery of export property, or the performance of services, which are evidenced by invoices, bills of lading, bills of exchange which do not evidence a sale on credit, sales slips, and similar documents created by the unilateral act of a creditor shall not be considered evidences of indebtedness for purposes of section 971(c)(4).

(6) *Duplication of treatment and priority of application.* No asset which constitutes an export trade asset shall be taken into account more than once in determining the investments in export trade assets of a controlled foreign corporation. Assets which constitute working capital and also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies shall be taken into account in determining whether the amount of working capital of the controlled foreign corporation is reasonably necessary for the production of export trade income. However, to the extent that the amount of inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies is not included in working capital to which section 971(c)(1) applies on the ground that such amount is not reasonably necessary for the production of export trade income, the amount shall be included under section 971(c)(2) or 971(c)(4), as the case may be, in a controlled foreign corporation's investments in export trade assets.

(d) *Export promotion expenses*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export promotion

expenses'' means, subject to the provisions of subparagraph (2) of this paragraph, all the ordinary and necessary expenses paid or incurred during the taxable year by the controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income including—

(i) A reasonable allowance for salaries or other compensation for personal services actually rendered for such purpose,

(ii) Rentals or other payments for the use of property actually used for such purpose, and

(iii) A reasonable allowance for the exhaustion, wear and tear, or obsolescence of property actually used for such purpose.

In determining for purposes of this subparagraph whether expenses are reasonably allocable to the receipt or production of export trade income, consideration shall be given to the facts and circumstances of each case. As a general rule, if export trade income results from the sale of export property, export promotion expenses allocable to such income shall include warehousing, advertising, selling, billing, collection, other administrative, and similar costs properly allocable to the marketing activity, but shall not include cost of goods sold, income or similar tax, any expense which does not advance the distribution or sale of export property for use, consumption, or disposition outside the United States, or any expense for which the controlled foreign corporation is reimbursed. If export trade income results from the rental of export property, export promotion expenses allocable to such income shall include a reasonable allowance for depreciation and servicing of such property, and the administrative and similar costs properly allocable to the rental activity. If export trade income results from the performance of services, export promotion expenses shall include a reasonable allowance for compensation of the persons performing services for the controlled foreign corporation in the execution of the service contract or arrangement and administrative expenses reasonably allocable to the service activity. In no case shall income taxes be included in export promotion expenses.

(2) *Expenses incurred within the United States.* No expense incurred within the United States shall be treated as an export promotion expense for purposes of section 971(d) and subparagraph (1) of this paragraph unless at least—

(i) 90 percent of all salaries and other personal service compensation incurred in the receipt or the production of export trade income,

(ii) 90 percent of rents and other payments for the use of property used in the receipt or the production of export trade income,

(iii) 90 percent of the allowances for the exhaustion, wear and tear, or obsolescence of property used in the receipt or the production of export trade income, and

(iv) 90 percent of all other ordinary and necessary expenses reasonably allocable to the receipt or the production of export trade income,

is incurred outside the United States. For this purpose, personal service compensation will be considered incurred at the place where the service is performed (for example, salaries will be considered incurred at the place where the employee works; payments for art work will be considered incurred at the place where the art work is prepared, etc.); rent, depreciation, and other expenses related to real or personal property will be considered incurred at the place where the property is located; and expenses for media advertising will be considered incurred at the place where the advertising is consumed. For such purpose, newspaper or periodical advertising will be considered consumed where the newspaper or periodical is principally distributed, and television and radio advertising will be considered consumed at the place where the audience is primarily located. Technicalities of contract or payment, for example, the place where a contract is executed or the location of a bank account from which payment is made, shall not be determinative of the place where an expense is incurred.

(e) *Export property.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export property'' means property, or any interest in property, which is manufactured, produced, grown, or extracted in the United States. Whether property

will be considered manufactured or produced in the United States will depend on the facts and circumstances of each case. As a general rule, if—

(1) The property sold, serviced, used, or rented by the controlled foreign corporation is substantially transformed in the United States prior to its export from the United States, or

(2) The operations conducted in the United States with respect to the property sold, serviced, used, or rented by the controlled foreign corporation, whether performed in the United States by one person or a series of persons in a chain of distribution, are substantial in nature and are generally considered to constitute the manufacture or production of property,

then the property sold, serviced, used, or rented will be considered to have been manufactured or produced in the United States. The rules under paragraph (a)(4)(ii) of §1.954–3, relating to the substantial transformation of property, and paragraph (a)(4)(iii) of such section, dealing with a substantive test for determining whether property will be treated as having been manufactured or produced, shall apply for purposes of making determinations under this paragraph.

(f) *Unrelated person.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ''unrelated person'' means a person other than a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

[T.D. 6755, 29 FR 12710, Sept. 9, 1964, as amended by T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7533, 43 FR 6603, Feb. 15, 1978]

### § 1.972–1 Consolidation of group of export trade corporations.

(a) *Election to consolidate*—(1) *In general.* One or more United States shareholders (as defined in section 951(b)) owning (within the meaning of section 958(a)) or who are considered as owning by applying the rules of ownership of section 958(b) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of an export trade corporation, which is the top-tier corporation in a chain (within the meaning of subparagraph (2) of this paragraph) of export trade corporations, may, subject to the provisions of this section, elect to consolidate such chain for purposes of determining—

(i) The limitations, described in section 970(a) and paragraph (b)(2) of §1.970–1, on the amount by which subpart F income of an export trade corporation in such chain shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1, and

(ii) The amount includible in gross income of such shareholders under section 951(a)(1)(A)(ii) with respect to such a corporation's decrease in investments in export trade assets to which section 970(b) applies as described in paragraph (c) of §1.970–1.

(2) *''Chain'' defined.* A chain of export trade corporations shall include—

(i) The top-tier export trade corporation referred to in subparagraph (1) of this paragraph which is the first export trade corporation in a chain of ownership described in section 958(a);

(ii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by such top-tier export trade corporation on the last day of its taxable year; and

(iii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by the export trade corporations described in subdivision (ii) of this subparagraph on the last day of the taxable year of the export trade corporation described in subdivision (i) of this subparagraph.

For purposes of this section, a reference to a top-tier corporation shall mean an export trade corporation described in subdivision (i) of this subparagraph, a reference to a second-tier corporation shall mean an export trade corporation described in subdivision (ii) of this subparagraph, and a reference to a third-tier corporation shall mean an export trade corporation described in subdivision (iii) of this subparagraph.

(3) *Inclusion requirement.* If an election is made by a United States shareholder under this paragraph with respect to a chain of export trade corporations (as defined in subparagraph (2) of this paragraph), all export trade corporations which are included in the

chain must be included in the consolidation. If such an election is made, the determinations under section 970 shall be made on a consolidated basis with respect to the entire interest which the electing United States shareholder owns in each of the export trade corporations in the chain, including any minority interests owned directly or indirectly by such shareholder in second-tier and third-tier corporations in the chain. A United States shareholder may elect to consolidate his interest in export trade corporations in one chain of such corporations without electing to consolidate his interest in export trade corporations in other chains.

(4) *Conditions for making initial election*—(i) *Without consent.* The initial election to consolidate a chain of export trade corporations may be made without the consent of the Commissioner only if, immediately before the election to consolidate, each of the export trade corporations to be included in the consolidation is using the same taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be. The election shall be made by the electing shareholder or shareholders with respect to the taxable year in which or with which ends the first taxable year of the top-tier corporation to which the election to consolidate applies and at the time of filing such shareholders' returns for such taxable year or within 90 days after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later. Each United States shareholder making such an election shall attach to his return a statement showing:

(*a*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which an election is made,

(*b*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*c*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who are making the same election to consolidate and a statement that such shareholders are also making the election.

(ii) *With consent.* If, immediately before the election to consolidate, each of the export trade corporations in a chain of such corporations does not use the same taxable year or does not have the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, the initial election to consolidate such chain may be exercised by the electing shareholder or shareholders only with the consent of the Commissioner. Consent will not be granted unless each electing United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which such consolidation is to be effected and unless, subject to such terms, conditions, and adjustments as the Commissioner may prescribe, each of the export trade corporations in the chain adopts a common taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be. The application for consent to consolidate shall be made by mailing a letter, signed by each of the electing United States shareholders, to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the top-tier corporation with respect to which the electing shareholder or shareholders desire to make a consolidation or before the close of the 90th day after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later, and shall include the statement described in subdivision (i) of this subparagraph.

(5) *Effect of election.* If an election to consolidate a chain of export trade corporations is made for a taxable year of a United States shareholder, such election shall, except as provided in subparagraph (6) of this paragraph, be binding on such shareholder for such taxable year and for all succeeding taxable years. If, in a subsequent taxable year of the United States shareholder, an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain on the last day of the taxable year of the top-tier corporation which ends in or

with the subsequent taxable year of such shareholder, the shareholder's interest in such export trade corporation shall be included in the consolidation to which the election applies, but only if such export trade corporation as of such last day uses the same taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation. The United States shareholder shall, with respect to such additional export trade corporation, submit with his return for such subsequent taxable year the statement described in subparagraph (4)(i) of this paragraph.

(6) *Termination of election.* An election under this paragraph to consolidate a chain of export trade corporations shall terminate for the first taxable year of the foreign corporation which during the period of consolidation is a top-tier corporation—

(i) At the close of which any foreign corporation which was included in such consolidation for the preceding taxable year ceases to qualify as an export trade corporation or to be eligible under this paragraph for inclusion in such chain,

(ii) At the close of which an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain but does not as of such close of the year use the same taxable year or have the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation, or

(iii)(*a*) In respect of which the Commissioner, upon application made by a United States shareholder who made the election to consolidate, or his successor in interest, consents to a termination of the election. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the termination will be effected.

(*b*) The application for consent to termination shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the taxable year of the foreign corporations with respect to which the shareholder desires to terminate the consolidation and shall include the following information:

(*1*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which the election was made,

(*2*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*3*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who participated in making the election with such United States shareholder, or their successors in interest, and a statement whether such other persons are or are not terminating the election.

(7) *Election subsequent to initial election.* If a United States shareholder elects under subparagraph (4) of this paragraph to consolidate his interest in a chain of export trade corporations and the election to consolidate such corporations terminates under the provisions of subparagraph (6) of this paragraph, such shareholder may not thereafter elect under this section to consolidate his interest in any corporation which was in that chain of export trade corporations unless he receives the consent of the Commissioner to do so. Application to obtain such consent of the Commissioner shall be made by a letter mailed to the Commissioner of Internal Revenue, Washington, DC, 20224, before the close of the first taxable year of the top-tier corporation of the chain of export trade corporations in which the election to include such interest is to apply. Such application for consent shall include a statement showing:

(i) With respect to such chain, the information required to be shown in the statement described in subparagraph (4)(i) of this paragraph, and

(ii) The United States shareholder's interest in such chain which was previously included in a consolidation, the taxable years of such previous consolidation, and the manner in which such previous consolidation was terminated.

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

*Example.* Domestic corporation M owns 60 percent of the only class of stock of foreign corporation A, and 100 percent of the only class of stock of foreign corporation F, respectively. Corporation A owns 80 percent of the only class of stock of foreign corporations B and C, respectively. Corporation M also owns 20 percent of the stock of B Corporation. Corporation B owns 80 percent of the only class of stock of foreign corporation D. Corporations B and C each own 50 percent of the only class of stock of foreign corporation E. Corporation F owns 100 percent of the only class of stock of foreign corporation G, which owns 100 percent of the only class of stock of foreign corporation H. Corporation F also owns 20 percent of the stock of C Corporation. Domestic corporations N and R own 30 percent and 10 percent, respectively, of the stock of A Corporation. All corporations use the calendar year as a taxable year, and all foreign corporations qualify as export trade corporations for 1963. Corporation M may elect for 1963 to consolidate its interest in the chain (the ''A'' chain) of export trade corporations which includes corporations A, B, C, D, and E; and Corporation M need not, but may, elect to consolidate its interest in the chain (the ''F'' chain) of export trade corporations which includes corporations F, G, and H. Consolidation of M Corporation's interest in the ''A'' chain with its interest in the ''F'' chain is not permitted. If M Corporation elects to consolidate the ''A'' chain, M Corporation must include in the consolidation its 20 percent directly owned interest in B Corporation and its 20 percent indirectly owned (through F Corporation) interest in C Corporation. Either N Corporation or R Corporation, or both, may join M Corporation in electing to consolidate their interests in the ''A'' chain. However, neither N Corporation nor R Corporation may elect to consolidate the ''A'' chain unless M Corporation also agrees to so elect, because corporations N and R, neither jointly nor separately, own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of A Corporation. If corporations M, N, and R elect to consolidate the ''A'' chain, the determinations specified in subparagraph (1) of this paragraph will be made on a consolidated basis with respect to such corporations' respective interest in the chain as shown in the following tabulation:

| | A % | B % | C % | D % | E % |
|---|---|---|---|---|---|
| M Corporation's interest: | | | | | |
| Direct interest | 60 | | | | |
| (60%×80%)+20% direct interest | | 68 | | | |
| (68%×80%) | | | 68 | | |
| (68%×50%)+(68%×50%) | | | | 54.4 | |
| N Corporation's interest: | | | | | 68 |
| Direct interest | 30 | | | | |
| (30%×80%) | | 24 | | | |
| (30%×80%) | | | 24 | | |
| (24%×80%) | | | | 19.2 | |
| (24%×50%)+(24%×50%) | | | | | 24 |
| R Corporation's interest: | | | | | |
| Direct interest | 10 | | | | |
| (10%×80%) | | 8 | | | |
| (10%×80%) | | | 8 | | |
| (8%×80%) | | | | 6.4 | |
| (8%×50%)+(8%×50%) | | | | | 8 |
| Total interests to which consolidation applies | 100 | 100 | 100 | 80 | 100 |

(b) *Effect of consolidation*—(1) *Determination of subpart F income, export trade income, etc.* An election under paragraph (a) of this section to consolidate export trade corporations in a chain of such corporations shall have no effect on the determination of the character of income as subpart F income or on the determination of export trade income, export trade income which constitutes foreign base company income, or earnings and profits of the individual export trade corporations in the chain. Thus, the consolidation of export trade corporations under this section shall not have the effect of reducing earnings and profits of such corporations or of changing the characterization of income from that which is, for example, foreign base company income to that which is not. The application of this paragraph may be illustrated by the following example:

*Example.* Corporation A, incorporated under the laws of foreign country X, and corporation B, incorporated under the laws of foreign country Y, are both wholly owned subsidiaries of domestic corporation M. Corporations A and B both qualify under section 971(a) as export trade corporations. Corporation A purchases personal property produced in the United States from an unrelated person and sells the property to B Corporation for use outside of country X. Corporation B resells the property to an unrelated person for use in foreign country Z. Corporations A and B each derive foreign base company sales income described in §1.954–3 from the purchase and sale transactions. Consolidation of Corporations A and B under this section does not result in the two transactions being treated as one transaction which is a purchase of property from an unrelated person

and a sale of property to an unrelated person or the nonrecognition of gain on the sale of export property by A Corporation to B Corporation.

(2) *Determination of amount by which consolidated subpart F income is reduced*—(i) *In general.* In determining the amount by which the subpart F income of each export trade corporation includible in a consolidation of export trade corporations shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1 for any taxable year of consolidation, the limitations provided by section 970(a) and paragraph (b)(2) of §1.970–1 on such amount for each such export trade corporation shall be determined on the basis of such corporation's separate share of—

(*a*) Amounts included in the total export promotion expense,

(*b*) The total gross receipts from the sale, installation, operation, maintenance, or use of property in respect of which each such corporation derives such export trade income as is properly allocable to the export trade income which constitutes foreign base company income, and

(*c*) The total increase in investments in export trade assets,

of all export trade corporations to which the consolidation applies for the taxable year.

(ii) *Limitations not effective.* If for any taxable year each of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, equals or exceeds the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the subpart F income of each includible corporation shall be reduced under section 970(a) for such year by its separate export trade income which constitutes foreign base company income.

(iii) *Limitation effective.* If for any taxable year one of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, is less than the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the amount by which the subpart F income of each includible corporation shall be reduced under section 970(a) for such year shall be an amount which bears the same ratio to the amount by which the subpart F income may be reduced on a consolidated basis as the export trade income which constitutes foreign base company income of each includible corporation bears to the total export trade income which constitutes foreign base company income of all export trade corporations includible in the consolidation of export trade corporations.

(iv) *Illustration.* The application of this subparagraph may be illustrated by the following example:

*Example.* (a) Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as the taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects under this section to consolidate corporations A and B for the entire period here involved. Corporation M elects under paragraph (a)(2) of §1.970–2 for 1963 to determine both A Corporation's and B Corporation's investments in export trade assets as of the close of the 75th day after the close of such corporations' taxable year.

(b) The following amounts are applicable to corporations A and B for 1964:

| | Corporation A | Corporation B |
|---|---|---|
| Subpart F income | $100 | $200 |
| Export trade income which constitutes foreign base company income | 25 | 75 |
| Other export trade income | 10 | 15 |
| Export promotion expenses allocable to export trade income which constitutes foreign base company income | 10 | 80 |
| Gross receipts from the sale of property in respect of which export trade income which constitutes foreign base company income is derived | 400 | 600 |
| Increase in investments in export trade assets for period beginning with March 16, 1964, and ending with March 16, 1965 | 35 | 120 |

(c) The amount by which subpart F income of corporations A and B is reduced for 1964 on a separate-company basis without regard to section 972 may be determined as set forth in items (i) through (vii) below, and the results of the consolidation of corporations A and B for 1964 are set forth in items (viii) through (x). Assuming an alternative case in which for 1964 the facts are the same as set forth in paragraphs (a) and (b) of this example except that B Corporation incurs export promotion

expenses of $50 (rather than $80) which are allocable to the export trade income which constitutes foreign base company income, the results of the consolidation of corporations A and B for such year (a case where one of the limitations under paragraph (b)(2) of § 1.970–1 is effective) are set forth in items (xi) through (xiii):

| | A Corporation (1) | B Corporation (2) | Total (3) |
|---|---|---|---|
| (i) Subpart F income | $100 | $200 | $300 |
| (ii) Export trade income which constitutes foreign base company income | 25 | 75 | 100 |
| (iii) Other export trade income | 10 | 15 | 25 |
| (iv) Total export trade income | 35 | 90 | 125 |
| (v) Limitations under § 1.970–1(b)(2): | | | |
| (*a*) Increase in export trade assets limitation: | | | |
| ($35×$25/$35) | 25 | | |
| ($120×$75/$90) | | 100 | |
| ([$35+$120]×$100/$125) | | | 124 |
| (*b*) Gross receipts limitation: | | | |
| (10% of $400) | 40 | | |
| (10% of $600) | | 60 | |
| (10% of $1,000) | | | 100 |
| (*c*) Export promotion expenses limitation: | | | |
| (150% of $10) | 15 | | |
| (150% of $80) | | 120 | |
| (150% of $90) | | | 135 |
| (*d*) Export promotion expenses limitation (alternative case): | | | |
| (150% of $10) | 15 | | |
| (150% of $50) | | 75 | |
| (150% of $60) | | | 90 |
| (vi) Reduction in subpart F income on a separate company basis determined without regard to section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in columns (1) and (2)) | 15 | 60 | 75 |
| (vii) Subpart F income as reduced on a separate company basis (item (i) minus item (vi)) | 85 | 140 | 225 |
| (viii) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in column (3)) | | | 100 |
| (ix) Apportionment of reduction in subpart F income (item (ii)) | 25 | 75 | 100 |
| (x) Subpart F income as reduced on a consolidated basis (item (i) minus item (ix)) | 75 | 125 | 200 |
| ALTERNATIVE CASE | | | |
| (xi) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii) but not to exceed smallest of items (v) (*a*), (*b*), and (*d*), in column (3)) | | | 9 |
| (xii) Apportionment of reduction in subpart F income (item (xi) times [item (ii) of column (1) over item (ii) of column (3)] and item (xi) times [item (ii) of column (2) over item (ii) of column (3)]); ($90 × $25/$100) | $22.50 | | |
| ($90 × $75/$100) | | $67.50 | 90 |
| (xiii) Subpart F income as reduced on a consolidated basis (item (i) minus item (xii)) | 77.50 | 132.50 | 210 |

(3) *Determination of pro rata share of consolidated withdrawal of previously excluded export trade income*—(i) *In general.* If, for any taxable year, there is a decrease in investments in export trade assets under section 970(b) and paragraph (c)(1) of § 1.970–1, determined on a consolidated basis, of export trade corporations includible in a consolidated chain of such corporations, each United States shareholder who has elected under paragraph (a) of this section to consolidate his interest in such chain of corporations shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such consolidated decrease in investments but only to the extent such pro rata share does not exceed the lesser of the limitations provided by section 970(b) and paragraph (c)(2) of § 1.970–1 with respect to such shareholder determined on a consolidated basis. The consolidated decrease in investments and the consolidated limitations shall be determined by aggregating the applicable amounts determined under paragraph (c) of § 1.970–1 with respect to such shareholder's interest in each corporation includible in the consolidation.

(ii) *Allocation of pro rata share of consolidated decrease in investments in export trade assets.* For purposes of determining the amount referred to in paragraph (c)(2)(i)(*b*)(*3*) of §1.970–1 for a subsequent taxable year, a United States shareholder's pro rata share of a consolidated decrease in investments determined under subdivision (i) of this subparagraph for the current taxable year shall be allocated to such shareholder's interest in each of the export trade corporations includible in the consolidation in that ratio which—

(*a*) The net amount determined under paragraph (c)(2)(i)(*b*) of §1.970–1 with respect to such shareholder's interest in such corporation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation) bears to

(*b*) The total of the net amounts determined under paragraph (c)(2)(i) (*b*) of §1.970–1 with respect to such shareholder's interests in all export trade corporations includible in such consolidation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation).

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

*Example.* (a) Domestic corporation M owns 60 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects to consolidate corporations A and B for the entire period here involved.

(b) The following amounts are applicable to corporations A and B for 1964:

| | A (1) | B (2) | Consolidated (3) |
|---|---|---|---|
| (i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2)) | ..... | ..... | $100 |
| (ii) M Corporation's pro rata share of consolidated decrease (60%) | ..... | ..... | 60 |
| (iii) M Corporation's pro rata share of earnings and profits for 1963 and 1964 (§1.970–1(c) (2)(i)(*a*) | $120 | $90 | 210 |
| (iv) M Corporation's pro rata share of net amount determined under §1.970–1(c)(2)(i)(*b*) for 1963 | 180 | 60 | 240 |
| (v) Amount includible in M Corporation's gross income for 1964 (smallest of items (ii), (iii), and (iv) in column (3)) | ..... | ..... | 60 |

Corporation M must include $60 in its gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of §1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1964 is allocated as follows: to M Corporation's interest in A Corporation, $45 ($60 times $180/$240); and to its interest in B Corporation, $15 ($60 times $60/$240).

(c) The following amounts are applicable to corporations A and B for 1965:

| | A(1) | B(2) | Consolidated (3) |
|---|---|---|---|
| (i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2)) | ..... | ..... | $150 |
| (ii) M Corporation's pro rata share of consolidated decrease (60%) | ..... | ..... | 90 |
| (iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, and 1965 (§1.970–1(c)(2)(i)(*a*)) | $100 | ($20) | 80 |
| (iv) M Corporation's pro rata share of the net amount determined under §1.970–1(c)(2)(i)(*b*) for 1963 and 1964. | | | |
| ($180 − $45) | 135 | | |
| ($60 − $15) | | 45 | |
| Total | | | 180 |
| (v) Amount includible in M Corporation's gross income for 1965 (smallest of items (ii), (iii), and (iv) in column (3)). | | | 80 |

Corporation M must include $80 in its gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of §1.970–1 with respect to M Corporation's interest in each

of corporations A and B for a subsequent taxable year, such consolidated decrease for 1965 is allocated as follows: to M Corporation's interest in A Corporation, $60 ($80 times $135/$180); and to its interest in B Corporation, $20 ($80 times $45/$180).

(d) The following amounts are applicable to corporations A and B for 1966:

| | A(1) | B(2) | Consolidated (3) |
|---|---|---|---|
| (i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970–1(c)(2)) | ..... | ..... | $200 |
| (ii) M Corporation's pro rata share of consolidated decrease (60%) | ..... | ..... | 120 |
| (iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, 1965, and 1966 (§ 1.970–1(c)(2)(i)(*a*)) | $120 | $50 | 170 |
| (iv) M Corporation's pro rata share of the net amount determined under § 1.970–1(c)(2)(i)(b) for 1963, 1964, and 1965. | | | |
| ($180 minus [$45+$60]) | 75 | | |
| ($60 – [$15+$20]) | | 25 | |
| Total | | | 100 |
| (v) Amount includible in M Corporation's gross income for 1966 (smallest of items (ii), (iii), and (iv) in column (3)) | ..... | ..... | 100 |

Corporation M must include $100 in its gross income for 1966 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(b)(3) of § 1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1966 is allocated as follows: to M Corporation's interest in A Corporation, $75 ($100 times $75/$100); and to its interest in B Corporation, $25 ($100 times $25/$100).

[T.D. 6754, 29 FR 12714, Sept. 9, 1964, as amended by T.D. 7893, 48 FR 22512, May 19, 1983]

### § 1.981–0 Repeal of section 981; effective dates.

The provisions of section 981 are not effective for taxable years beginning after December 31, 1976. For the treatment of the community income of aliens and their spouses for taxable years beginning after December 31, 1976, see section 879 and the regulations thereunder.

[T.D. 7670, 45 FR 6929, Jan. 31, 1980]

### § 1.981–1 Foreign law community income for taxable years beginning after December 31, 1966, and before January 1, 1977.

(a) *Election for special treatment*—(1) *In general.* An individual citizen of the United States who meets the requirements of section 981(a)(1) and subparagraph (2) of this paragraph for any open taxable year beginning after December 31, 1966, and before January 1, 1977, may make a binding election with his nonresident alien spouse to have section 981(b) and paragraph (b) of this section apply to their income for such year which is treated as community income under the applicable community property laws of a foreign country or countries. Generally, the community property laws of a foreign country operate upon land situated within its jurisdiction and upon personal property owned by spouses domiciled therein. If the election is made for any taxable year, it shall also apply for all subsequent open taxable years of such citizen and his nonresident alien spouse for which all the requirements of section 981(a)(1) and subparagraph (2) of this paragraph are met, unless the Director of International Operations consents, in accordance with paragraph (c)(2) of this section, to a termination of the election. An election under section 981(a) and this section has no effect for any taxable year beginning before January 1, 1967, for which a separate election, if made, must be made under section 981(c)(1) and § 1.981–2. For the definition of ''open taxable year'' see section 981(e)(2) and paragraph (a) of § 1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981–3. If one of the spouses is deceased, see paragraph (d) of § 1.981–3.

(2) *Requirements to be met.* In order for a U.S. citizen and his nonresident alien spouse to make an election under section 981(a) and this section for any taxable year and in order for the election to apply for any subsequent taxable year it is required under section 981(a)(1) that, for each such taxable year, such citizen be (i) a citizen of the United States, (ii) a bona fide resident of a foreign country or countries during the entire taxable year, and (iii) married at the close of the taxable year

to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such subsequent taxable year, the same nonresident alien individual to whom the citizen was married at the close of the earliest of such taxable years. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated, solely for purposes of making the determination under subdivision (iii) of this subparagraph, as ending on the date of such death. A citizen of the United States shall be considered as not married at the close of his taxable year if he is legally separated from his spouse under a decree of divorce or of separate maintenance. However, the mere fact that spouses have not lived together during the course of the taxable year shall not cause them to be considered as not married at the close of the taxable year. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final.

(3) *Determination of residence.* The principles of paragraphs (a)(2) and (b)(7) of §1.911–1 (26 CFR 1.911–1 (1978)) shall apply in order to determine for purposes of this paragraph whether a U.S. citizen is a *bona fide* resident of a foreign country or countries during the entire taxable year. The principles of §§1.871.2 through 1.871–5 shall apply in order to determine whether the alien spouse of a U.S. citizen is a nonresident during the entire taxable year.

(4) *Manner of electing.* The election under section 981(a) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income for any taxable year to which an election under section 981(a) and this section applies, and the deductions properly allocable to such income, shall be divided between the electing U.S. citizen and nonresident alien spouses in accordance with the rules set forth in section 981(b) and subparagraphs (2) through (6) of this paragraph. Community income for this purpose means 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 foreign country having jurisdiction to determine the legal ownership of the income. A spouse has ownership of the income for this purpose if under the applicable foreign law he has a proprietary vested interest in the income.

(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 subparagraph does not apply, however, to community income (i) derived from any trade or business carried on by the husband or the wife, (ii) attributable to a spouse's distributive share of the income of a partnership to which subparagraph (4) of this paragraph applies, (iii) 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, or (iv) derived from property which is acquired as consideration for personal services performed.

(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 such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of the trade or business, in which case all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This subparagraph 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. For purposes of this subparagraph, 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 foreign country. For example, a wife who operates a beauty parlor 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 foreign country vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of the beauty parlor 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 such 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 such income of a partnership 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 981(b)(1) or (2) and subparagraph (2), (3), or (4) of this paragraph, 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 foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that the income from such property is community income.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 981(b)(1), (2), or (3), and subparagraph (2), (3), (4), or (5) of this paragraph, shall be treated as the income of that spouse who has a proprietary vested interest in that income under the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that such income is community income. Thus, for example, this subparagraph applies to community income not described in subparagraph (2), (3), (4), or (5) of this paragraph 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 nonresident alien individual and W, a U.S. citizen, each of whose taxable years is the calendar year, were married throughout 1967. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. During 1967, 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 1967. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of such income is considered to belong to the other spouse. In addition, such 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 1967, even though such laws recognize the stock as the separate property of H. If the election under this section is in effect for 1967, under the rules of subparagraphs (2) and (5) of this paragraph all of the income of $10,500 derived during 1967 shall be treated, for U.S. income tax purposes, as the income of H.

*Example 2.* The facts are the same as in example 1 except that H is the sole proprietor of a retail merchandising company and such company has a $10,000 profit during 1967. 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 such laws both H and W are treated as realizing $7,500 of such income. If the election under this section is in effect for 1967, under the rule of subparagraphs (3) and (4) of this paragraph all $15,000 of such income

shall be treated as the income of H for U.S. income tax purposes.

*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; and the dividends, to be community income, one-half of such income being treated as the income of each spouse. If the election under this section is in effect for 1967, under the rule of subparagraph (6) of this paragraph, $500 of the dividend income shall be treated, for U.S. income tax purposes, as the income of each spouse.

(c) *Time and manner of making or terminating an election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse shall, for the first taxable year beginning after December 31, 1966, for which an election under section 981(a) and this section is to apply, make the election by filing a return, an amended return, or a claim for refund, whichever is proper, for such taxable year and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for such taxable year. The statement must show the name, address, and account number, if any, of each spouse, the name and address of the executor, administrator, or other person making the election for a deceased spouse, the taxable year to which the election applies, and the name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(b) and paragraph (b) of this section. The statement must be signed by both persons making the election. An election under this section may be made only for a taxable year which, on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3.

(2) *Termination only with consent of Director of International Operations*—(i) *In general.* An election under this section for any taxable year is binding and may not be revoked. The election shall also remain in effect for all subsequent taxable years of the spouses for which the requirements of paragraph (a)(2) of this section are met and which on the date of the election are open, within the meaning of paragraph (a) of §1.981–3, unless the election is terminated for any such subsequent taxable year or years in accordance with subdivision (ii) of this subparagraph. Any return, amended return, or claim for refund in respect of any such subsequent taxable year for which the election is in effect shall have attached thereto a copy of the statement filed in accordance with subparagraph (1) of this paragraph and an additional signed statement that for such subsequent taxable year the requirements of paragraph (a)(2) of this section are met.

(ii) *Written request to terminate required.* A request to terminate an election under this section for a subsequent taxable year or years shall be made in writing by the persons who made the election and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, DC 20225. The request must include the name, address, and account number, if any, of each spouse and must be signed by the persons making the request. It must specify the taxable year or years for which the termination is to be effective and the grounds which justify the termination. The request shall be filed not later than 90 days before the close of the period for assessing a deficiency against the U.S. citizen for the earliest taxable year of such citizen for which the termination is to be effective. The Director of International Operations may require such other information as may be necessary in order to determine whether the termination will be permitted. A copy of the consent by the Director of International Operations to terminate must be attached to an amended income tax return for each taxable year for which the termination is effective and for which a return has previously been filed.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7330, 39 FR 38372, Oct. 31, 1974, as amended by T.D. 7670, 45 FR 6929, Jan. 31, 1980; T.D. 7736, 45 FR 76143, Nov. 18, 1980]

**§ 1.981–2 Foreign law community income for taxable years beginning before January 1, 1967.**

(a) *Election for special treatment*—(1) *In general.* For all open taxable years beginning before January 1, 1967, for which an individual citizen of the United States meets the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph, such citizen and his nonresident alien spouse may make a joint election to have section 981(c)(2) and paragraph (b) of this section apply to their income which is treated as community income under the applicable community property laws of a foreign country or countries. However, if the conditions prescribed by section 981(d)(3) and subparagraph (3) of this paragraph are met, the nonresident alien spouse is not required to join in the election and such citizen may make a separate election to have section 981(c)(2) and paragraph (b) of this section apply to such income for such taxable years. An election under section 981(c)(1) and this section shall apply to every open taxable year of such citizen and his nonresident alien spouse beginning before January 1, 1967, for which all the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph are met. It is immaterial whether such open taxable year is a taxable year subject to the provisions of the 1954 Code, the 1939 Code, or any other internal revenue law in effect before the 1939 Code. An election under section 981(c)(1) and this section has no effect for any taxable year beginning after December 31, 1966. For the definition of ''open taxable year'' see section 981(e)(2) and paragraph (a) of § 1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981–3. If one of the spouses is deceased, see paragraph (d) of § 1.981–3. An election under section 981(c)(1) and this section is binding and may not be revoked.

(2) *Requirements to be met.* In order for the citizen of the United States to make an election under this section, whether required to be made jointly with his nonresident alien spouse or permitted to be made separately, it is required under section 981(c)(1) that, for each taxable year to which the election applies, the citizen making the election be (i) a citizen of the United States and (ii) married at the close of the taxable year to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such taxable years subsequent to the first, the same nonresident alien individual to whom the citizen was married at the close of such first taxable year. The provisions of paragraph (a)(2) of § 1.981–1 apply to determine whether a U.S. citizen making an election under section 981(c)(1) and this section is married at the close of a taxable year to an individual who is a nonresident alien during the entire taxable year.

(3) *Cases where joint election is not required.* A nonresident alien spouse is not required to join in an election under section 981(c)(1) and this section if the Director of International Operations determines in accordance with paragraph (c)(4) of this section—

(i) That an election under section 981(c)(1) and this section would not affect the liability for Federal income tax of the nonresident alien spouse for any taxable year, whether beginning on, before, or after January 1, 1967, or

(ii) That the effect of the election on the liability of the nonresident alien spouse for Federal income tax for any such taxable year cannot be ascertained and that to deny the election to the U.S. citizen spouse would be inequitable and cause undue hardship to the U.S. citizen.

If in accordance with this subparagraph the nonresident alien spouse is not required to join in the election by the U.S. citizen, the provisions of section 981(d)(2) and paragraph (e) of § 1.981–3 shall not apply so as to extend the period for assessing deficiencies or filing a claim for credit or refund for any taxable year of the nonresident alien spouse.

(4) *Manner of electing.* The election under section 981(c)(1) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income, as defined in paragraph (b)(1) of § 1.981–1, for

any taxable year beginning before January 1, 1967, to which an election under section 981(c)(1) and this section applies, and the deductions properly allocable to such income, shall be divided between the U.S. citizen and his nonresident alien spouse in accordance with the rules set forth in section 981(c)(2) and subparagraphs (2) and (3) of this paragraph. The income shall be divided in such manner even though the nonresident alien spouse is not required, in accordance with paragraph (a)(3) of this section, to join in the election by the U.S. citizen.

(2) *Earned income, business income, partnership income, and income from separate property.* All community income for any taxable year to which this paragraph applies which is treated as the income of one of the spouses in accordance with section 981(b)(1), (2), or (3) and paragraph (b)(2), (3), (4), or (5) of §1.981–1 shall be treated as the income of that spouse for purposes of this paragraph.

(3) *Other community income.* All community income for any taxable year to which this paragraph applies, other than income described in subparagraph (2) of this paragraph, shall be treated as the income of the spouse who, for such taxable year, has a greater amount of gross income than the other spouse, determined by adding to the amount of gross income which is treated as the gross income of that spouse in accordance with subparagraph (2) of this paragraph the amount of the gross income for the taxable year which is treated as the separate income of that spouse under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated as ending on the date of such death for the purpose of determining which spouse has the greater amount of gross income for such taxable year. Moreover, if the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the periods for which the amounts of gross income are to be compared under this subparagraph are (i) the taxable year of the citizen and (ii) that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen. See paragraph (c) of §1.981–3.

(c) *Time and manner of making election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse or, if subparagraph (4) of this paragraph applies, such citizen alone may make an election under section 981(c)(1) and this section at any time on or after November 13, 1966, for each and every taxable year beginning before January 1, 1967, which on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3. The election shall be made by filing a return, an amended return, or a claim for refund, whichever is proper, for each taxable year to which the election applies and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for each such taxable year. The statement must also show the information required by subparagraph (2) of this paragraph and must, where applicable, be signed by both persons making the election.

(2) *Information required.* The statement described in subparagraph (1) of this paragraph must show—

(i) The name, address, and account number, if any, of each spouse,

(ii) The name and address of the executor, administrator, or other person making the election for a deceased spouse,

(iii) The taxable years to which the election applies,

(iv) The office of the district director, or the service center, where the return or returns, if any, for such taxable year or years were filed,

(v) The dates on which such return or returns, if any, were filed and on which the tax for such taxable year or years was paid, if the tax has been paid, and

(vi) The name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(c)(2) and paragraph (b) of this section.

(3) *Place for filing.* Any return, amended return, or claim for refund filed under subparagraph (1) of this paragraph in respect of any taxable year shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225. (See § 1.6091–3.)

(4) *Determination that joint election is not required.* A U.S. citizen spouse entitled to make an election under section 981(c)(1) and this section for open taxable years beginning before January 1, 1967, may apply to the Director of International Operations for a determination under section 981(d)(3) that the nonresident alien spouse is not required to join in the election by such citizen. This application shall be made by filing with the Director of International Operations, Internal Revenue Service, Washington, DC 20225, a statement setting forth the same information required by subparagraph (2) of this paragraph and such other information as is required by the Director of International Operations to justify a claim that the requirements of section 981(d)(3) and paragraph (a)(3) of this section are met. The Director of International Operations shall notify the U.S. citizen by letter of his determination with respect to the application. If the determination is that the nonresident alien spouse is not required to join in the election, a copy of the letter of determination shall be attached to each return, amended return, or claim for refund, to be filed pursuant to subparagraph (1) of this paragraph.

[T.D. 7330, 39 FR 38373, Oct. 31, 1974]

### § 1.981–3 Definitions and other special rules.

(a) *Open taxable years.* (1) For purposes of paragraph (a) of § 1.981–1, and paragraph (a) of § 1.981–2, a taxable year of the U.S. citizen, and the taxable year or years of his nonresident alien spouse ending or beginning within such taxable year of such citizen, shall be treated as open if the period prescribed by section 6501(a) (or section 6501(c)(4) if the period is extended by agreement) for assessing a deficiency against the citizen for his taxable year has not expired before the date of the election, determined under paragraph (b) of this section. Thus, for example, a taxable year of a U.S. citizen beginning before January 1, 1967, is open for purposes of this subparagraph if, before the election under section 981(c)(1) and § 1.981–2, such citizen has never filed a return for such year and a return was required under section 6012 without reference to section 981. For example, if a U.S. citizen spouse on a calendar year basis who has never filed a return for 1960 decides in 1975 that he wishes to make the election under section 981(c)(1) and § 1.981–2 in order to avoid being subject to tax for 1960 on his share of the community income for that year, he may in 1975 elect the benefits of section 981(c)(2) by filing an election in accordance with paragraph (c) of § 1.981–2. In such case, a taxable year or years of the nonresident alien spouse of such citizen ending or beginning within 1960 shall be treated in 1975 as an open taxable year.

(2) Subparagraph (1) of this paragraph shall apply even though the period prescribed by section 6501 for assessing a deficiency against the nonresident alien spouse for his taxable year or years ending or beginning within the taxable year of the U.S. citizen has expired before the election is made.

(3) If either spouse dies during a taxable year to which an election under § 1.981–1 or § 1.981–2 applies, the taxable year of the decedent and the surviving spouse shall be determined under this paragraph without regard to section 981(e)(4), relating to death of spouse during the taxable year. See paragraph (a)(2) of § 1.443–1.

(4) For definition of the term ''taxable year'', see section 441(b) and the regulations thereunder.

(b) *Date of election.* (1) For purposes of § 1.981–1 and this section the date of an election made under section 981(a) and § 1.981–1 is the date on which the return, amended return, or claim for refund required by paragraph (c)(1) of § 1.981–1 is filed.

(2) For purposes of § 1.981–2 and this section the date of an election made under section 981(c)(1) and § 1.981–2 is the date on which the returns, amended returns, or claims for refund, required by paragraph (c)(1) of § 1.981–2 are filed.

(3) For provisions treating timely mailing as timely filing, see section 7502 and the regulations thereunder.

(c) *Spouses with different taxable years.* If the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the election under §1.981–1 or §1.981–2 shall apply to each taxable year of such citizen in respect of which the election is made and to that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen.

(d) *Election on behalf of deceased spouse.* Any election, statement, or request, required to be made under paragraph (c) of §1.981–1, or paragraph (c) of §1.981–2, by one of the spouses may, if such spouse is deceased, be made by the executor, administrator, or other person charged with the property of such deceased spouse.

(e) *Extension of period of limitations on assessment or refund*—(1) *Assessment of deficiency.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a deficiency may be assessed for any taxable year to which the election applies shall, to the extent the deficiency is attributable to the application of such election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(2) *Refund of tax.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a claim for credit or refund of an overpayment for any taxable year to which the election applies may be filed shall, to the extent the overpayment is attributable to the application of the election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(3) *Exception in case of nonelecting alien.* Subparagraphs (1) and (2) of this paragraph shall not apply to any taxable year of a nonresident alien spouse who, in accordance with paragraph (a)(3) of §1.981–2, is not required to join in the election by the U.S. citizen spouse under section 981(c)(1) and §1.981–2.

(f) *Payment of interest for extension period.* To the extent that an overpayment or deficiency for any taxable year is attributable to an election made under §1.981–1 or §1.981–2, no interest shall be allowed or paid for any period ending with the day before the date which is one year after the date of the election, determined under paragraph (b) of this section.

[T.D. 7330, 39 FR 38374, Oct. 31, 1974]

### §1.985–0 Outline of regulation.

This section lists the paragraphs contained in §§1.985–1 through 1.985–6.

*§1.985–1 Functional currency.*

(a) Applicability and effective date.
(b) Dollar functional currency.
(c) Functional currency of a QBU that is not required to use the dollar.
(d) Single functional currency for a foreign corporation.
(e) Translation of nonfunctional currency transactions.
(f) Examples.

*§1.985–2 Election to use the United States dollar as the functional currency of a QBU.*

(a) Background and scope.
(b) Eligible QBU.
(c) Time and manner for dollar election.
(d) Effect of dollar election.

*§1.985–3 United States dollar approximate separate transactions method.*

(a) Scope and effective date.
(b) Statement of method.
(c) Translation into United States dollars.
(d) Computation of DASTM gain or loss.
(e) Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits.

*§1.985–4 Method of accounting.*

(a) Adoption or election.
(b) Condition for changing functional currencies.
(c) Relationship to certain other sections of the Code.

*§1.985–5 Adjustments required upon change in functional currency.*

(a) In general.
(b) Step 1—Taking into account exchange gain or loss on certain section 988 transactions.

(c) Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.
(d) Step 3A—Additional adjustments that are necessary when a branch changes functional currency.
(e) Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency.
(f) Examples.

*Section 1.985–6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.*

(a) In general.
(b) Certain controlled foreign corporations.
(c) All other foreign corporations.
(d) Pre-1987 section 902 amounts.
(e) Net worth branch.
(f) Profit and loss branch.

[T.D. 8263, 54 FR 38653, Sept. 20, 1989, as amended by T.D. 8464, 58 FR 232, Jan. 5, 1993; T.D. 8556, 59 FR 37672, July 25, 1994]

### § 1.985–1 Functional currency.

(a) *Applicability and effective date*—(1) *Purpose and scope.* These regulations provide guidance with respect to defining the functional currency of a taxpayer and each qualified business unit (QBU), as defined in section 989(a). Generally, a taxpayer and each QBU must make all determinations under subtitle A of the Code (relating to income taxes) in its respective functional currency. This section sets forth rules for determining when the functional currency is the United States dollar (dollar) or a currency other than the dollar. Section 1.985–2 provides an election to use the dollar as the functional currency for certain QBUs that absent the election would have a functional currency that is a hyperinflationary currency, and explains the effect of making the election. Section 1.985–3 sets forth the dollar approximate separate transactions method that certain QBUs must use to compute their income or loss or earnings and profits. Section 1.985–4 provides that the adoption of a functional currency is a method of accounting and sets forth conditions for a change in functional currency. Section 1.985–5 provides adjustments that are required to be made upon a change in functional currency. Finally, §1.985–6 provides transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning after December 31, 1986.

(2) *Effective date.* These regulations apply to taxable years beginning after December 31, 1986. However, any taxpayer desiring to apply temporary Income Tax Regulations §1.985–0T through §1.985–4T in lieu of these regulations to all taxable years beginning after December 31, 1986, and on or before October 20, 1989 may (on a consistent basis) so choose. For the text of the temporary regulations, see 53 FR 20308 (1988).

(b) *Dollar functional currency*—(1) *In general.* The dollar shall be the functional currency of a taxpayer or QBU described in paragraph (b)(1)(i) through (v) of this section regardless of the currency used in keeping its books and records (as defined in §1.989(a)–1(d)). The dollar shall be the functional currency of—

(i) A taxpayer that is not a QBU (e.g., an individual);

(ii) A QBU that conducts its activities primarily in dollars. A QBU conducts its activities primarily in dollars if the currency of the economic environment in which the QBU conducts its activities is primarily the dollar. The facts and circumstances test set forth in paragraph (c)(2) of this section shall apply in making this determination;

(iii) Except as otherwise provided by ruling or administrative pronouncement, a QBU that has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence (as defined in section 988(a)(3)(B));

(iv) A QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted. Whether a QBU keeps such books and records is determined in accordance with paragraph (c)(3) of this section; or

(v) A QBU that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

(2) *QBUs operating in a hyperinflationary environment*—(i) *Taxable years beginning on or before August 24, 1994.* For taxable years beginning on or before August 24, 1994, see §1.985–2 with respect to a QBU that elects to

use, or is otherwise required to use, the dollar as its functional currency.

(ii) *Taxable years beginning after August 24, 1994*—(A) *In general.* For taxable years beginning after August 24, 1994, except as otherwise provided in paragraph (b)(2)(ii)(B) of this section, any QBU that otherwise would be required to use a hyperinflationary currency as its functional currency must use the dollar as its functional currency and compute income or loss or earnings and profits under the rules of §1.985–3.

(B) *Exceptions—(1)—Certain QBU branches.* The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a branch of a foreign corporation having a non-dollar functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation. Such QBU's income or loss or earnings and profits shall be determined under §1.985–3 by substituting the functional currency of the foreign corporation for the dollar.

(*2*) *Corporation that is not a controlled foreign corporation.* A foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency pursuant to paragraph (b)(2)(ii)(A) of this section if that foreign corporation is not a controlled foreign corporation as defined in section 957 or 953(c)(1)(B). However, a noncontrolled section 902 corporation, as defined in section 904(d)(2)(E), may elect to use the dollar (or, if appropriate, the currency specified in paragraph (b)(2)(ii)(B)(*1*) of this section) as its (or its QBU branch's) functional currency under the procedures set forth in §1.985–2(c)(3).

(C) *Change in functional currency. (1) In general.* If a QBU is required to change its functional currency to the dollar under paragraph (b)(2)(ii)(A) of this section, or chooses or is required to change its functional currency to the dollar for any open taxable year (and all subsequent taxable years) under §1.985–3(a)(2)(ii), the change is considered to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing functional currency must make adjustments described in §1.985–7 if the year of change (as defined in §1.481–1(a)(1)) begins after 1987, or the adjustments described in §1.985–6 if the year of change begins in 1987. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(*2*) *Effective date.* This paragraph (b)(2)(ii)(C) applies to taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this paragraph (b)(2)(ii)(C) to all open years after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985–2(d)(3)) also applies to this paragraph (b)(2)(ii)(C).

(D) *Hyperinflationary currency.* For purposes of sections 985 through 989, the term hyperinflationary currency means the currency of a country in which there is cumulative inflation during the base period of at least 100 percent as determined by reference to the consumer price index of the country listed in the monthly issues of the ''International Financial Statistics'' or a successor publication of the International Monetary Fund. If a country's currency is not listed in the monthly issues of ''International Financial Statistics,'' a QBU may use any other reasonable method consistently applied for determining the country's consumer price index. Base period means, with respect to any taxable year, the thirty-six calendar months immediately preceding the first day of the current calendar year. For this purpose, the cumulative inflation rate for the base period is based on compounded inflation rates. Thus, if for 1991, 1992, and 1993, a country's annual inflation rates are 29 percent, 25 percent, and 30 percent, respectively, the cumulative inflation rate for the three-year base period is 110 percent [((1.29 × 1.25 × 1.3) − 1.0 × 1.10)x100=110%] and the currency of the country for the QBU's 1994 year is considered hyperinflationary. In making the determination whether a currency is hyperinflationary, the determination for purposes of United States generally accepted accounting principles may be used for income tax purposes provided the determination is based on criteria that is substantially similar to the rules previously set forth in this paragraph (b)(2)(ii)(D), the

method of determination is applied consistently from year to year, and the same method is applied to all related persons as defined in §1.985–3(e)(2)(vi).

(E) *Change in functional currency when currency ceases to be hyperinflationary—(1) In general.* A QBU that has been required to use the dollar as its functional currency under paragraph (b)(2) of this section, or has elected to use the dollar as its functional currency under paragraph (b)(2)(ii)(B)(*2*) of this section or §1.985–2, must change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment, determined under paragraph (c)(2) of this section, is not a hyperinflationary currency. The functional currency of the QBU for such year shall be determined in accordance with paragraph (c) of this section. For purposes of §1.985–4, the change is considered to be made with the consent of the Commissioner. See §1.985–5 for adjustments that are required upon a change in functional currency.

(*2*) *Effective Date.* This paragraph (b)(2)(ii)(E) of this section applies to taxable years beginning after April 6, 1998.

(c) *Functional currency of a QBU that is not required to use the dollar*—(1) *General rule.* The functional currency of a QBU that is not required to use the dollar under paragraph (b) of this section shall be the currency of the economic environment in which a significant part of the QBU's activities is conducted, if the QBU keeps, or is presumed under paragraph (c)(3) of this section to keep, its books and records in such currency.

(2) *Economic environment.* For purposes of section 985 and the regulations thereunder, the economic environment in which a significant part of a QBU's activities is conducted shall be determined by taking into account all the facts and circumstances.

(i) *Facts and circumstances.* The facts and circumstances that are considered in determining the economic environment in which a significant part of a QBU's activities is conducted include, but are not limited to, the following:

(A) The currency of the country in which the QBU is a resident as determined under section 988(a)(3)(B);

(B) The currencies of the QBU's cash flows;

(C) The currencies in which the QBU generates revenues and incurs expenses;

(D) The currencies in which the QBU borrows and lends;

(E) The currencies of the QBU's sales markets;

(F) The currencies in which pricing and other financial decisions are made;

(G) The duration of the QBU's business operations; and

(H) The significance and/or volume of the QBU's independent activities.

(ii) *Rate of inflation.* The rate of inflation (regardless of how it is determined) shall not be a factor used to determine a QBU's economic environment.

(iii) *Consistency.* A taxpayer must consistently apply the facts and circumstances test set forth in this paragraph (c)(2) in evaluating the economic environment of its QBUs, *e.g.,* its branches, that engage in the same or similar trades or businesses.

(3) *Books and records presumption.* A QBU shall be presumed to keep books and records in the currency of the economic environment in which a significant part of its activities are conducted. The presumption may be overcome only if the QBU can demonstrate to the satisfaction of the district director that a substantial nontax purpose exists for not keeping any books and records in such currency. A taxpayer may not use this presumption affirmatively in determining a QBU's functional currency.

(4) *Multiple currencies.* If a QBU has more than one currency that satisfies the requirements of paragraph (c)(1) of this section, the QBU may choose any such currency as its functional currency.

(5) *Relationship of United States accounting principles.* In making the functional currency determination under this paragraph (c), the currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) will ordinarily be accepted as the functional currency of the QBU for income tax purposes, provided that the

GAAP determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section.

(6) *Effect of changed circumstances.* Regardless of any change in circumstances, a QBU may change its functional currency determined under this paragraph (c) only if the QBU complies with §1.985–4 or the Commissioner's consent is considered to have been granted under §1.985–2(d)(4) or §1.985–3(a)(2)(ii). For special rules relating to the conversion to the euro, see §1.985–8.

(d) *Single functional currency for a foreign corporation*—(1) *General rule.* This paragraph (d) applies to a foreign corporation that has two or more QBUs that do not have the same functional currency. The foreign corporation shall be treated as having a single functional currency for the corporation as a whole that is different from the functional currency of one or more of its QBUs. The determination of a foreign corporation's functional currency shall be made by first applying paragraph (d)(1)(i) and then paragraph (d)(l)(ii) of this section.

(i) *Step 1.* Each QBU of the foreign corporation determines its functional currency in accordance with the rules set forth in paragraphs (b) and (c) of this section and §1.985–2.

(ii) *Step 2.* The foreign corporation determines its functional currency applying the principles of paragraphs (b) and (c) of this section to the corporation's activities as a whole. Thus, if a foreign corporation has two branches, the corporation shall determine its functional currency by applying the principles of paragraphs (b) and (c) of this section to the combined activities of the corporation and the branches. For purposes of this paragraph (d)(1), if a QBU of a foreign corporation has the dollar as its functional currency under paragraph (b)(2) of this section, the QBU's activities shall be considered dollar activities of the corporation.

(2) *Translation of income or loss of QBUs having different functional currencies than the foreign corporation as a whole.* Where the functional currency of a foreign corporation as a whole differs from the functional currency of one or more of its QBUs, each such QBU shall determine the amount of its income or loss or earnings and profits (or deficit in earnings and profits) in its functional currency under the principles of section 987 (relating to branch transactions). The amount of income or loss or earnings and profits (or deficit in earnings and profits) of each QBU in its functional currency shall then be translated into the foreign corporation's functional currency using the appropriate exchange rate as defined in section 989(b)(4) for purposes of determining the corporation's income or loss or earnings and profits (or deficit in earnings and profits).

(e) *Translation of nonfunctional currency transactions.* Except for a QBU using the dollar approximate separate transactions method described in §1.985–3, *see* section 988 and the regulations thereunder for the treatment of nonfunctional currency transactions.

(f) *Examples.* The provisions of this section are illustrated by the following examples:

*Example 1.* P, a domestic corporation, operates exclusively through foreign branch X in Country A. X is a QBU within the meaning of section 989(a) and its residence is Country A as determined under section 988 (a)(3)(B). The currency of Country A is the LC. All of X's purchases, sales, and expenses are in the LC. The laws of A require X to keep books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the functional currency of P is the dollar since its residence is the United States, the functional currency of X is the LC.

*Example 2.* P, a publicly-held domestic regulated investment company (as defined under section 851), operates exclusively through foreign branch B in Country R. B is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. B's principal activities consist of purchasing and selling stock and securities of Country R companies and securities issued by Country R. It is determined that the dollar is the currency of B under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the functional currency of P is the dollar since its residence is the United States, B may

choose the LC as its functional currency because it has significant activities in the LC provided it keeps books and records in the LC. The fact that the dollar is the currency of B under generally accepted accounting principles is irrelevant for purposes of determining B's functional currency because the GAAP determination was not based on factors similar to those set forth in paragraph (c)(2) of this section.

*Example 3.* P, a domestic bank, operates through foreign branch X in Country R. X is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. The laws of R require X to keep books and records in the LC. The branch customarily loans dollars and LCs. In the case of its LC loans, X ordinarily fixes the terms of the loans by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits. For instance, the interest on the amount of the outstanding LC loan principal might equal LIBOR plus 2 percent and the amount of the outstanding LC loan principal would be adjusted to reflect changes in the dollar value of the LC. X is primarily funded with dollar-denominated funds borrowed from related and unrelated parties. X's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. Under these facts, X's activities are primarily conducted in dollars. Thus, although X keeps its books and records in LCs, X's functional currency is the dollar.

*Example 4.* S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of Country U is the LC. S's sole function is acting as a financing vehicle for P and domestic corporations that are affiliated with P. All borrowing and lending transactions between S and P and its domestic affiliates are in dollars. Furthermore, primarily all of S's other borrowings are dollar-denominated or based on a dollar index. S's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. S keeps its books and records in the LC. Under these facts, S's activities are primarily conducted in dollars. Thus, although S keeps its books and records in LCs, S's functional currency is the dollar.

*Example 5.* D is a domestic corporation whose primary activity is the extraction of natural gas and oil through foreign branch X in Country Y. X is a QBU within the meaning of section 989(a) and its residence is Country Y as determined under section 988(a)(3)(B). The currency of Country Y is the LC. X bills a significant amount of its natural gas and oil sales in dollars and a significant amount in LCs. X also incurs significant LC and dollar expenses and liabilities. The laws of Country Y require X to keep its books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Absent other factors indicating that X primarily conducts its activities in the dollar, D could choose either the dollar or the LC as X's functional currency because X has significant activities in both the dollar and the LC, provided the books and records requirement is satisfied. If, instead, X's activities were determined to be primarily in the dollar, then X would have to use the dollar as its functional currency.

*Example 6.* S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of U is the LC. S purchases the products it sells from related and unrelated parties, including P. These purchases are made in the LC. In addition, most of S's gross receipts are generated by transactions denominated in the LC. S attempts to determine its LC price for goods sold in such a manner as to obtain an LC equivalent of a certain dollar amount after reduction for all LC costs. However, local market conditions sometimes result in pricing adjustments. Thus, changes in the LC-dollar exchange rate from period to period generally result in corresponding changes in the LC price of S's products. S pays local taxes, employee wages, and other local expenses in the LC. It is determined that the dollar is the currency of S under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, S could choose either the dollar or the LC as its functional currency because S has significant activities in both the dollar and the LC, provided that the books and records requirement is satisfied.

*Example 7.* S, a foreign corporation organized in Country X, is wholly-owned by P, a domestic corporation. S conducts all of its operations through two branches. Branch A is located in Country F and branch B is located in Country G. S, A, and B are QBUs within the meaning of section 989(a). Branch A's and branch B's residences are Country F and Country G respectively as determined under section 988(a)(3)(B). The currency of Country F is the FC and the currency of Country G is the LC. The functional currencies of S, A, and B are determined in a two step procedure.

*Step 1: The functional currency of branches A and B.* Branch A and branch B both conduct all activities in their respective local currencies. The FC is the currency of branch A and the LC is the currency of branch B under United States generally accepted accounting principles. This determination is based on

facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, the functional currency of branch A is the FC and the functional currency of branch B is the LC.

*Step 2: The functional currency of S.* S's functional currency is determined by disregarding the fact that A and B are branches. When A's activities and B's activities are viewed as a whole, S determines that it only conducts significant activities in the LC. Therefore, S's functional currency is the LC. See Examples 9, 10, and 11 for how the earnings and profits of a foreign corporation, which has branches with different functional currencies, are determined.

*Example 8.* Assume the same facts as in Example 7, except that S does not exist and P conducts all of its operations through branch A and branch B. In this instance P's functional currency in Step 2 is the dollar, regardless of the fact that its branches' activities viewed as a whole are in the LC, because P is a taxpayer whose residence is the United States under section 988(a)(3)(B)(i). Therefore, while the functional currency of branch A is the FC and the functional currency of branch B is the LC, the functional currency of P is the dollar because its residence is the United States.

*Example 9.* The facts are the same as in Example 7. ln addition, assume that in 1987 branch A has earnings of 100 FC and branch B has earnings of 100 LC as determined under section 987. The weighted average exchange rate for the year is 1 FC/2 LC. Branch A's earnings are translated into 200 LC for purposes of computing S's earnings and profits in 1987. Thus, the total earnings and profits of S from branch A and branch B for 1987 is 300 LC.

*Example 10.* (i) X, a foreign corporation organized in Country W, is wholly-owned by P, a domestic corporation. Both X and P are calendar year taxpayers that began business during 1987. X operates exclusively through two branches, A and B both of which are located outside of Country W. The functional currency of X and A is the LC, while the functional currency of B is the DC as determined under section 985 and §1.985–1. The earnings of B must be computed under section 987, relating to branch transactions. In 1987, A earns 900 LCs of nonsubpart F income and B earns 200 DCs of nonsubpart F income. Under section 904(d)(2), A's income is financial service income and B's income is general limitation income. In order to determine X's earnings and profits, B's income must be translated into LCs (the functional currency of X). The weighted average exchange rate for 1987 is 1 LC/2 DC. Thus, in 1987 X's current earnings and profits (and its post-1986 undistributed earnings) are 1000 LCs consisting of 900 LCs of financial services income earned by A and 100 LCs (200 DC/2) of general limitation income earned by B. Neither A nor B makes any remittances during 1987.

(ii) In 1988, neither A nor B earns any income or generates any loss. On December 31, 1988, A remits 50 LCs directly to P. The remittance to P is considered to be remitted by A to X and then immediately distributed by X as a dividend. The 50 LC remittance does not result in an exchange gain or loss under section 987 to X because the functional currency of X and A is the LC. See section 987(3). Under section 904(d)(3)(D), the 50 LC dividend is treated as income in a separate category to the extent of the dividend's pro rata share of X's earnings and profits in each separate limitation category. Thus, 90 percent, or 45 LCs, is treated as financial services income, and 10 percent, or 5 LCs, is treated as general limitation income. After the dividend distribution, X has 950 LCs of accumulated earnings and profits (and post-1986 undistributed earnings) consisting of 855 LCs of financial service limitation income and 95 LCs of general limitation income.

*Example 11.* The facts are the same as in Example 10, except that A makes no remittance during 1988 but B remits 120 DCs to X on December 31, 1988, which X immediately converts into LCs, and X makes no dividend distribution during 1988. Assume that the appropriate exchange rate for the remittance is 1 LC/3 DCs. B's remittance triggers exchange loss to X. See section 987(3). Under section 987, the exchange loss on the remittance is 20 LCs calculated as follows: 40 LCs, which is the LC value of the 120 DC remittance (120 DCs/3), less 60 LCs, their LC basis (120 DCs/2). This loss is sourced and characterized under section 987 and regulations thereunder.

*Example 12.* F, a foreign corporation, has gain from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business. F's disposition activity shall be treated as a separate QBU with a dollar functional currency because such activity produced income that is treated as effectively connected with a trade or business within the United States. Therefore, F must compute its gain from the disposition by giving the United States real property interest an historic dollar basis.

[T.D. 8263, 54 FR 38653, Sept. 20, 1989, as amended by T.D. 8556, 59 FR 37672, July 25, 1994; T.D. 8765, 63 FR 10774, Mar. 5, 1998; 63 FR 15760, Apr. 1, 1998; T.D. 8776, 63 FR 40368, July 29, 1998; T.D. 8927, 66 FR 2216, Jan. 11, 2001]

**§ 1.985–2 Election to use the United States dollar as the functional currency of a QBU.**

(a) *Background and scope*—(1) *In general.* This section permits an eligible QBU to elect to use the dollar as its functional currency for taxable years beginning on or before August 24, 1994. An election to use a dollar functional currency is not permitted for a QBU other than an eligible QBU. Paragraph (b) of this section defines an eligible QBU. Paragraph (c) of this section describes the time and manner for making the dollar election and paragraph (d) of this section describes the effect of making the election. For the definition of a QBU, see section 989(a). See §1.985–1(b)(2)(ii) for rules requiring a QBU to use the dollar as its functional currency in taxable years beginning after August 24, 1994.

(2) *Exception.* Pursuant to §1.985–1(b)(2)(ii)(B)(*2*), the rules of paragraph (c)(3) of this section shall apply with respect to the procedure required to be followed by a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) to elect the dollar as its (or its QBU branch's) functional currency and the application of §1.985–3.

(b) *Eligible QBU*—(1) *In general.* The term ''eligible QBU'' means a QBU that could have used a hyperinflationary currency as its functional currency absent the dollar election. *See* §1.985–1 for how a QBU determines its functional currency absent the dollar election.

(2) *Hyperinflationary currency.* See §1.985–1(b)(2)(ii)(D) for the definition of hyperinflationary currency.

(c) *Time and manner for dollar election*—(1) *QBUs that are branches of United States persons*—(i) *Rule.* If an eligible QBU is a branch of a United States person, the dollar election shall be made by attaching a completed Form 8819 to the United States person's timely filed (taking extensions into account) tax return for the first taxable year for which the election is to be effective.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, the election shall be made in accordance with §1.985–2T(c)(1). Failure to file an amended return within the time period prescribed in §1.985–2T(c)(1) shall not invalidate the dollar election if it is established to the satisfaction of the district director that reasonable cause existed for such failure. A subsequent election for 1988 will not prejudice the taxpayer with respect to such reasonable cause determination. Nevertheless, each United States person making an election under the §1.985–2T(c)(1) must file a Form 8819 in the time and manner provided in the Form's instructions.

(2) *Eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations*—(i) *Rule.* If an eligible QBU is a controlled foreign corporation (as described in section 957), or a branch of a controlled foreign corporation, the election may be made either by the foreign corporation or by the controlling United States shareholders on behalf of the foreign corporation by—

(A) Filing a completed Form 8819 in the time and manner provided in the Form's instructions, and

(B) Providing the written notice required by paragraph (c)(2)(ii) of this section at the time and in the manner prescribed therein.

The term *controlling United States shareholders* means those United States shareholders (as defined in section 951(b)) who, in the 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. If the foreign corporation is a controlled foreign corporation (as described in section 957) but the United States shareholders do not, in the aggregate, own the requisite voting power, 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.

(ii) *Notice.* Prior to filing Form 8819, the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) shall provide written notice that the dollar election will be made to all United States persons known to be shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall

also include all information required in Form 8819.

(iii) *Reasonable cause exception.* Failure of the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) to timely file Form 8819 or provide written notice to a United States person required to be notified by paragraph (c)(2)(ii) of this section shall not invalidate the dollar election, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.

(iv) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(2)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(2). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(3) *Eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations*—(i) *Rule.* If an eligible QBU is a noncontrolled foreign corporation (a foreign corporation not described in section 957), or a branch of a noncontrolled foreign corporation, the dollar election must be made by the corporation or the majority domestic corporate shareholders on behalf of the corporation by applying the rules provided in paragraph (c)(2)(i)(A) and (B), (ii), (iii), and (iv) of this section substituting ''majority domestic corporate shareholders'' for ''controlling United States shareholders'' wherever it appears therein. The term ''majority domestic corporate shareholders'' means those domestic corporate shareholders (as described in section 902(a)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting stock of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned (within the meaning of section 958(a)) by all the domestic corporate shareholders.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(3)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(3). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(4) *Others.* Any other person making a dollar election under this section shall elect by filing Form 8819 and fulfilling any other notice requirements that may be required by the Commissioner.

(d) *Effect of dollar election*—(1) *General rule.* If a dollar election is made (or considered made under paragraph (d)(3) of this section) by or on behalf of an eligible QBU, the QBU shall be deemed to have the dollar as its functional currency. Each United States person that owns (within the meaning of section 958(a)) stock of a foreign corporation which has the dollar as its functional currency under §1.985–2 must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency (regardless of when ownership was acquired or whether the United States person received the written notice required by paragraph (c)(2)(i)(B) of this section).

(2) *Computation*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, any eligible QBU that pursuant to this §1.985–2 has a dollar functional currency must compute income or loss or earnings and profits (or deficit in earnings and profits) in dollars using the dollar approximate separate transactions method described in §1.985–3.

(ii) *Alternative method.* An eligible QBU that has a dollar functional currency pursuant to this §1.985–2 may use a method other than the dollar approximate separate transactions method described in §1.985–3 only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method. Generally, the QBU must show that it could compute foreign currency gain or loss under the principles of section 988 with respect to each of its section 988 transactions. If subsequently the QBU can no longer demonstrate to the satisfaction of the district director that it can properly employ such an alternative method, then the QBU will be deemed to have changed its method of accounting to

the dollar approximate separate transactions method described in §1.985–3. This change in accounting will be treated as having been made with the consent of the Commissioner. No adjustments under either §1.985–5T (or any succeeding final regulation) or section 481(a) shall be required solely because of the change. Rather the QBU shall begin accounting for its operations under §1.985–3 based on its dollar books and records as of the time of the change.

(3) *Conformity*—(i) *General rule.* If a dollar election is made under this §1.985–2 for an eligible QBU (''electing QBU''), then the dollar shall be the functional currency of any related person (regardless of when such person became related to the electing QBU) that is an eligible QBU, or any branch of any such related person that is an eligible QBU. For purposes of the preceding sentence, the term ''related person'' means any person with a relationship defined in section 267 (b) to the electing QBU (or to the United States or foreign person of which the electing QBU is a part). 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).

(ii) *Branches of United States and foreign persons.* If a dollar election is made for a QBU branch of any person, each eligible QBU branch of such person shall have the dollar as its functional currency.

(4) *Required adjustments.* If an eligible QBU's functional currency changes due to a dollar election, or due to the conformity requirements of paragraph (d)(3) of this section, such change shall be deemed for purposes of §1.9B5–4 to be consented to by the Commissioner. No adjustments under section 481(a) shall be required solely because of the change. However, the QBU must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(5) *Taxable year conformity required.* Generally, the adjustments required by paragraph (d)(4) of this section shall be made for a related person's taxable year—

(i) That includes the date in which the electing QBU made the dollar election if the person was related to such electing QBU at any time during the QBU's taxable year that includes such date, or

(ii) During which the person first becomes related to any electing QBU, in all other cases.

For purposes of this paragraph (d)(5), the date in which the electing QBU makes the dollar election shall be the last day of the electing QBU's taxable year. The district director may permit the related party to make such adjustments beginning one taxable year later if, in the district director's sole judgment, reasonable cause exists for the related party not being able to make the required adjustments for the earlier year.

(6) *Availability of election.* A dollar election may be made by or on behalf of a QBU, or considered made under the conformity rule of paragraph (d)(3), in any year in which the QBU is an eligible QBU. If a dollar election is not made by or on behalf of a QBU for its first taxable year beginning after December 31, 1986 in which it is an eligible QBU, then any dollar election made by or on behalf of the QBU, or considered made under the conformity rules of paragraph (d)(3) of this section, that results in a change in the QBU's functional currency shall be treated as having been made with the consent of the Commissioner. In such a case, however, the taxpayer must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(7) *Effect of changed circumstances.* Regardless of any change in circumstances (*e.g.*, a currency ceases to qualify as hyperinflationary), a QBU whose functional currency is the dollar under this section may change its functional currency only if the QBU complies with §1.985–4.

(8) *Examples.* The provisions of this section are illustrated by the following examples.

*Example 1.* X is a calendar year domestic corporation that in 1987 establishes a branch, A, in Country Z. A's functional currency under sections 985(b)(1) and (2) and §1.985–1 is the ''h'', the currency of Country Z. The cumulative inflation in Country Z exceeds 100 percent for the thirty-six months prior to

January 1987, as measured by the consumer price index of Country Z listed in the monthly issues of the ''International Financial Statistics''. Accordingly, A is an eligible QBU in 1987 because the h is a hyperinflationary currency. Thus, X may elect the dollar as the functional currency of A for 1987.

*Example 2.* The facts are the same as in Example (1). X does not elect the dollar as the functional currency of A for 1987. Rather, X elects the dollar as the functional currency of A for 1991, a year A is an eligible QBU. The election constitutes a change in A's functional currency that is made with the consent of the Commissioner. However, A must make the adjustments required under §1.985–5T (or any succeeding final regulation).

*Example 3.* X is a domestic corporation that establishes A, an eligible QBU branch. X is wholly owned by domestic corporation Y. Y has an eligible QBU branch, B. Both X and Y are calendar year taxpayers. X makes a dollar election for A in 1987. Thus, A is an electing QBU. X and Y are related persons as defined in section 267(b) (*i.e.*, Y has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in B, the eligible QBU branch of Y, also having the dollar as its functional currency for 1987.

*Example 4.* The facts are the same as in Example 3, except that Y does not have an eligible QBU branch but owns all the stock of C, a calendar year controlled foreign corporation, which is not itself an eligible QBU but which has an eligible QBU branch, D. X and C are related persons as defined in section 267(b) (*i.e.*, C has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in D, the eligible QBU branch of C, also having the dollar as its functional currency for 1987.

*Example 5.* X, whose taxable year ends September 30, is an eligible QBU that does not use the dollar as its functional currency. X is wholly-owned by domestic corporation W. On January 1, 1989, X acquires all the stock of Y, an unrelated eligible QBU that made the dollar election under §1.985–2. Y is a calendar year taxpayer. After the stock purchase, X and Y are related persons as defined in section 267(b). Under §§1.985–2(d)(3) and (5), the dollar shall be the functional currency of X, any person related to X, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes December 31, 1989. Thus, X must change to the dollar for its taxable year beginning October 1, 1988. However, the district director may allow X to change to the dollar for its taxable year beginning October 1, 1989, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

*Example 6.* The facts are the same as in Example 5, except that before X purchased the Y stock, X made the dollar election under §1.985–2 but Y did not use the dollar as its functional currency. Under §§1.985–2(d)(3) and (5) the dollar shall be the functional currency of Y, any person related to Y, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes September 30, 1989. Thus, Y must change to the dollar for its taxable year beginning January 1, 1989. However the district director may allow Y to change to the dollar for its taxable year beginning January 1, 1990, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

[T.D. 8263, 54 FR 38656, Sept. 20, 1989, as amended by T.D. 8556, 59 FR 37673, July 25, 1994]

### § 1.985–3 United States dollar approximate separate transactions method.

(a) *Scope and effective date*—(1) *Scope.* This section describes the United States dollar (dollar) approximate separate transactions method of accounting (DASTM). For all purposes of subtitle A, this method of accounting must be used to compute the gross income, taxable income or loss, or earnings and profits (or deficit in earnings and profits) of a QBU (as defined in section 989(a)) that has the dollar as its functional currency pursuant to §1.985–1(b)(2).

(2) *Effective date*—(i) *In general.* This section is effective for taxable years beginning after August 24, 1994.

(ii) *DASTM prior-year election.* A taxpayer may elect to apply this section to any open taxable year beginning after December 31, 1986 (whether or not DASTM has been previously elected for some or all of those years). In order to make this election, the taxpayer must apply §1.985–3 to that year and all subsequent years. In addition, each person that is related (within the meaning of §1.985–3(e)(2)(vi)) to the taxpayer on the last day of any taxable year for which the election is effective and that would have been eligible to elect DASTM must also apply these rules to that year and all subsequent years. A taxpayer that has not previously elected to apply DASTM to its prior taxable

years may make the DASTM election for the pertinent years by filing amended returns and complying with the applicable election procedures of §1.985–2. Form 8819 shall be attached to the return for the first year for which the election is to be effective. A taxpayer that has elected DASTM for prior taxable years and applied the rules under §1.985–3 (as contained in the April 1, 1994 edition of 26 CFR part 1 (1.908 to 1.1000)) may amend its returns to apply the rules of this §1.985–3. In either case, the DASTM election for prior taxable years shall be deemed to be made with the consent of the Commissioner.

(b) *Statement of method.* Under DASTM, income or loss or earnings and profits (or a deficit in earnings and profits) of a QBU for its taxable year shall be determined in dollars by—

(1) Preparing an income or loss statement from the QBU's books and records (within the meaning of §1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency (as defined in §1.985–1(b)(2)(ii)(D));

(2) Making the adjustments necessary to conform such statement to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles);

(3) Translating the amounts of hyperinflationary currency as shown on such adjusted statement into dollars in accordance with paragraph (c) of this section; and

(4) Adjusting the resulting dollar income or loss or earnings and profits (or deficit in earnings and profits) and, where necessary, particular items of gross income, deductible expense or other amounts, in accordance with paragraph (e) of this section to reflect the amount of DASTM gain or loss as determined under paragraph (d) of this section.

(c) *Translation into United States dollars*—(1) *In general.* Except as otherwise provided in this paragraph (c), the amounts shown on the income or loss statement, as adjusted under paragraph (b)(2) of this section, shall be translated into dollars at the exchange rate (as defined in paragraph (c)(6) of this section) for the translation period (as defined in paragraph (c)(7) of this section) to which they relate. However, if the QBU previously changed its functional currency to the dollar, and the rules of §1.985–5 (or, if applicable, §1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, depreciation with respect to an asset acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the asset was acquired.

(2) *Cost of goods sold.* The dollar value of cost of goods sold shall equal the sum of the dollar values of beginning inventory and purchases less the dollar value of closing inventory as these amounts are determined under paragraph (c)(3) of this section.

(3) *Beginning inventory, purchases, and closing inventory*—(i) *Beginning inventory.* Amounts representing beginning inventory shall be translated so as to obtain the same amount of dollars which represented such items in the closing inventory balance for the preceding taxable year.

(ii) *Purchases.* Amounts representing items purchased or otherwise first included in inventory during the taxable year shall be translated at the exchange rate for the translation period in which the cost of such items was incurred.

(iii) *Closing inventory*—(A) *In general.* Amounts representing items included in the closing inventory balance shall be translated at the exchange rate for the translation period in which the cost of such items was incurred. However, if amounts representing items included in the closing inventory balance are either valued at market or written down to market value, they shall be translated at the exchange rate existing on the last day of the taxable year. For purposes of determining lower of

cost or market, items of inventory included in the closing inventory balance shall be translated into dollars at the exchange rate for the translation period in which the cost of such items was incurred and compared with market as determined in the QBU's hyperinflationary currency translated into dollars at the exchange rate existing on the last day of the taxable year.

(B) *Determination of translation period.* The method used to determine the translation period of amounts representing items of closing inventory for purposes of paragraph (c)(3)(iii)(A) of this section may be based upon reasonable approximations and averages, including rates of turnover, provided that the method is used consistently from year to year.

(4) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the exchange rate for the translation period in which the cost of the underlying asset was incurred, except as provided in paragraph (c)(1) of this section.

(5) *Prepaid expenses or income.* Amounts representing expense or income paid or received in a prior taxable year shall be translated at the exchange rate for the translation period during which they were paid or received.

(6) *Exchange rate.* The exchange rate for a translation period may be determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting. Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period. Once chosen, a method for determining an exchange rate can be changed only with the consent of the district director.

(7) *Translation period*—(i) *In general.* Except as provided in paragraphs (c)(3)(iii)(B) and (c)(7)(ii) of this section, a translation period shall be each month within a QBU's taxable year.

(ii) *Exception.* A taxpayer may divide its taxable year into translation periods of equal length (with not more than one short period annually) that are less than one month. Once such a translation period is established, it may not be changed without the consent of the district director.

(8) *Dollar transactions*—(i) *In general.* Except as provided in paragraph (c)(8)(ii) of this section, no DASTM gain or loss is realized with respect to dollar transactions since the dollar is the functional currency of the QBU. Thus, the amount of any payment or receipt of dollars shall be reflected in the income or loss statement by the amount of such dollars. Also, the income or loss attributable to any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of the dollar, or is determined by reference to the value of the dollar, must be computed transaction by transaction. For example, if a foreign corporation lends 20 LC when 20 LC=$20 and is entitled to receive the LC equivalent of $20 at maturity plus a market rate of interest in dollars (or its LC equivalent), the loan is a dollar transaction. Similarly, this paragraph applies to any transaction that is determined to be a dollar transaction under section 988.

(ii) *Non-dollar functional currency.* If pursuant to §1.985–1(b)(2)(ii)(B)(*1*), a QBU is required to use a functional currency other than the dollar, then that currency shall be substituted for the dollar in applying paragraph (c)(8)(i) of this section.

(9) *Third currency transactions.*—A taxpayer may use any reasonable method of accounting for transactions described in sections 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions) so long as such method is consistent with its method of financial accounting.

(10) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

*Example 1.* S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S accrues 100 dollars attributable to dollar-denominated sales. Because

this is a dollar transaction under paragraph (c)(8) of this section, S's income or loss for 1994 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued).

*Example 2.* (i) S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S's sales amounted to 240,000,000h, its currently deductible expenses were 26,000,000h, and its total inventory purchases amounted to 100,000,000h. During January and February of 1994, S purchased depreciable assets for 80,000,000h and was allowed depreciation of 4,000,000h. At the end of 1994, S's closing inventory was 23,000,000h. No election to use a translation period other than the month is made, S had no transactions described in paragraph (c)(8) or (c)(9) of this section, and S's closing inventory was computed on the first-in, first-out inventory method. S's adjusted income or loss statement for 1994 is translated into dollars as follows:

| | Hyperinflationary currency | Exchange rate | United States dollars |
|---|---|---|---|
| **Sales** | | | |
| (Jan.–Feb.) | 10,000,000h | [1] 20:1 | $500,000 |
| (Mar.–Apr.) | 20,000,000 | 21:1 | 952,381 |
| (May.–June.) | 50,000,000 | 22:1 | 2,272,727 |
| (July) | 50,000,000 | 23:1 | 2,173,913 |
| (August) | 20,000,000 | 26:1 | 769,231 |
| (Sept.) | 20,000,000 | 28:1 | 714,286 |
| (Oct.) | 20,000,000 | 29:1 | 689,655 |
| (Nov.) | 20,000,000 | 30:1 | 666,667 |
| (Dec.) | 30,000,000 | 31:1 | 967,742 |
| Total | 240,000,000h | | 9,706,602 |
| **Cost of Goods Sold** | | | |
| Opening Inventory Purchases: | 0 | | 0 |
| (Jan.-Feb.) | 15,000,000h | 20:1 | 750,000 |
| (Mar.-Apr.) | 10,000,000 | 21:1 | 476,190 |
| (May-June) | 30,000,000 | 22:1 | 1,363,636 |
| (July) | 20,000,000 | 23:1 | 869,565 |
| (August) | 10,000,000 | 26:1 | 384,615 |
| (Sept.) | 5,000,000 | 28:1 | 178,571 |
| (Oct.) | 5,000,000 | 29:1 | 172,414 |
| (Nov.) | 2,500,000 | 30:1 | 83,333 |
| (Dec.) | 2,500,000 | 31:1 | 80,645 |
| Less Closing Inventory | (23,000,000) | [2] | (822,655) |
| | 77,000,000h | | 3,536,314 |

[1] Where multiple months are indicated, the exchange rate applies for all months.
[2] See paragraph (ii) of this *Example.*

(ii) Since S uses the first-in, first-out inventory method, the closing inventory is assumed to consist of purchases made during the most recent translation period as follows:

| | Hyperinflationary currency | Exchange rate | United States dollars |
|---|---|---|---|
| December | 2,500,000h | 31:1 | $80,645 |
| November | 2,500,000 | 30:1 | 83,333 |
| October | 5,000,000 | 29:1 | 172,414 |
| September | 5,000,000 | 28:1 | 178,571 |
| August | 8,000,000 | 26:1 | 307,692 |
| Total | 23,000,000h | | 822,655 |
| **Non-Capitalized Expenses** | | | |
| (Jan.-Feb.) | 4,000,000h | 20:1 | 200,000 |
| (Mar.-Apr.) | 2,500,000 | 21:1 | 119,048 |
| (May-June) | 2,500,000 | 22:1 | 113,636 |
| (July) | 2,000,000 | 23:1 | 86,957 |
| (August) | 3,000,000 | 26:1 | 115,385 |
| (Sept.) | 3,000,000 | 28:1 | 107,143 |
| (Oct.) | 2,000,000 | 29:1 | 68,966 |
| (Nov.) | 3,000,000 | 30:1 | 100,000 |

| | Hyperinflationary currency | Exchange rate | United States dollars |
|---|---|---|---|
| (Dec.) | 4,000,000 | 31:1 | 129,032 |
| Total | 26,000,000h | | 1,040,167 |
| Depreciation | 4,000,000h | 20:1 | 200,000 |
| Total Cost & Expenses | 107,000,000h | | 4,776,481 |
| Operating Profit | 133,000,000h | | 4,930,121 |

(d) *Computation of DASTM gain or loss*—(1) *Rule.* DASTM gain or loss of a QBU equals—

(i) The net worth of the QBU (as determined under paragraph (d)(2) of this section) at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year; plus

(ii) The dollar amount of the items described in paragraph (d)(3) of this section and minus the dollar amount of the items described in paragraph (d)(4) of this section; minus

(iii) The amount of dollar income or earnings and profits (or plus the amount of any dollar loss or deficit in earnings and profits) as determined for the taxable year pursuant to paragraphs (b)(1) through (b)(3) of this section.

(2) *Net worth.* Net worth of a QBU at the end of any taxable year equals the aggregate dollar amount representing assets on the QBU's balance sheet at the end of the taxable year less the aggregate dollar amount representing liabilities on the balance sheet. Notwithstanding any other provision in this paragraph (d)(2), the district director may adjust the amount of any asset or liability if a purpose for acquiring (or disposing of) the asset or incurring (or discharging) the liability is to manipulate the composition of the balance sheet for any period during the taxable year in order to avoid tax. The taxpayer shall determine net worth by—

(i) Preparing a balance sheet as of the end of the taxable year from the QBU's books and records (within the meaning of §1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency;

(ii) Making adjustments necessary to conform such balance sheet to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles); and

(iii) Translating the asset and liability amounts shown on the balance sheet into United States dollars in accordance with paragraph (d)(5) of this section.

(3) *Positive adjustments*—(i) *In general.* The items described in this paragraph (d)(3) are dividend distributions for the taxable year and any items that decrease net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a transfer to the home office of a QBU branch and a return of capital.

(ii) *Translation.* Except as provided by ruling or administrative pronouncement, items described in paragraph (d)(3)(i) of this section shall be translated into dollars as follows:

(A) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the last translation period of the taxable year if it were shown on the QBU's year-end balance sheet, such item shall be translated at the exchange rate on the date the item is transferred.

(B) If the item giving rise to the adjustment would be translated under paragraph (d)(5) of this section at the exchange rate for the translation period in which the cost of the item was incurred if it were shown on the QBU's year-end balance sheet, such item shall be translated at the same historical rate.

(iii) *Effective date.* Paragraph (d)(3)(ii) of this section is applicable for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005, and that gives rise to an adjustment under this paragraph (d)(3).

(4) *Negative adjustments.* The items described in this paragraph (d)(4) are items that increase net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a capital contribution or a transfer from a home office to a QBU branch. Except as otherwise provided by ruling or administrative pronouncement, if the contribution or transfer is not in dollars, the amount of a capital contribution or transfer shall be translated into dollars at the exchange rate on the date made.

(5) *Translation of balance sheet.* Asset and liability amounts shown on the balance sheet in hyperinflationary currency (adjusted pursuant to paragraph (d)(2)(ii) of this section) shall be translated into dollars as provided in this paragraph (d)(5). However, if the QBU previously changed its functional currency to the dollar and the rules of §1.985–5 (or, if applicable, §1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, the basis of real property acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the cost was incurred.

(i) *Closing inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (c)(3)(iii) of this section.

(ii) *Bad debt reserves.* Amounts representing bad debt reserves shall be translated at the exchange rate for the last translation period for the taxable year.

(iii) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (c)(5) of this section.

(iv) *Hyperinflationary currency.* Amounts of the hyperinflationary currency and hyperinflationary demand deposit balances shall be translated at the exchange rate for the last translation period of the taxable year.

(v) *Certain assets*—(A) *In general.* Amounts representing plant, real property, equipment, goodwill, and patents and other intangibles shall be translated at the exchange rate for the translation period in which the cost of the asset was incurred.

(B) *Adjustment to certain assets.* Amounts representing depreciation, depletion, and amortization reserves shall be translated in accordance with paragraph (c)(4) of this section.

(vi) *Hyperinflationary debt obligations.* Except as provided in paragraph (d)(5)(vii) of this section, amounts representing a hyperinflationary debt obligation (including accounts receivable and payable) shall be translated at the exchange rate for the last translation period for the taxable year.

(vii) *Accrued foreign income taxes.* Amounts representing an accrued but unpaid foreign income tax shall be translated at the exchange rate on the last day of the last translation period of the taxable year of accrual.

(viii) *Certain hyperinflationary financial instruments.* Amounts representing any item described in section 988(c)(1)(B)(iii) (relating to forward contracts, futures contracts, options, or similar financial instruments) denominated in or determined by reference to the hyperinflationary currency shall be translated at the exchange rate for the last translation period for the taxable year.

(ix) *Other assets and liabilities.* Amounts representing assets and liabilities, other than those described in paragraphs (d)(5)(i) through (viii) of this section, shall be translated at the exchange rate for the translation period in which the cost of the asset or the amount of the liability was incurred.

(6) *Dollar transactions.* Notwithstanding any other provisions of this paragraph (d), where the amount representing an item shown on the balance sheet reflects a dollar transaction (described in paragraph (c)(8) of this section), the transaction shall be taken

into account in accordance with that paragraph.

(7) *Third currency transactions.* A taxpayer may use any reasonable method of accounting for transactions described in section 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions), so long as such method is consistent with its method of financial accounting.

(8) *Character.* The amount of DASTM gain or loss determined under paragraph (d)(1) of this section shall be ordinary income or loss.

(9) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

*Example.* (i) S, an accrual method calendar year foreign corporation, uses DASTM. S's hyperinflationary currency is the ''h.'' S's net worth at December 31, 1993 was $3,246,495. For 1994, S's operating profit is 81,340,000h, or $2,038,200. S made a 5,000,000h distribution in April and again in December of 1994. S's translation period is the month. None of S's assets or liabilities reflect a dollar or third currency transaction described in paragraph (c)(8) or (c)(9) of this section, respectively. The exchange rate for each month in 1994 is as follows:

| | |
|---|---|
| January | 32h:$1 |
| Feb.-Mar. | 33:1 |
| April-May | 34:1 |
| June | 35:1 |
| July | 36:1 |
| Aug.-Sept. | 37:1 |
| Oct. | 38:1 |
| Nov. | 39:1 |
| Dec. | 40:1 |

(ii) At the end of 1994, S's assets and liabilities, as adjusted and translated pursuant to paragraphs (d)(2) and (d)(5) of this section, are as follows:

| | Hyperinflationary | Exchange rate | U.S. dollar |
|---|---|---|---|
| Hyperinflationary cash on hand | 40,000h | 40:1 | $1,000 |
| Checking account | 400,000 | 40:1 | 10,000 |
| Accounts Receivable- 30 Day Accounts | 20,000,000 | [1] 40:1 | 500,000 |
| 60 Day Accounts | 25,000,000 | 40:1 | 625,000 |
| Inventory | 65,000,000 | [2] | 2,500,000 |
| Fixed assets—Property | 90,000,000 | 27:1 | 3,333,333 |
| Plant | 190,000,000 | [3] | 6,785,714 |
| Accumulated Depreciation | (600,000) | [3] | (21,428) |
| Equipment | 10,000,000 | [4] | 340,000 |
| Accumulated Depreciation | (400,000) | [4] | (13,333) |
| Common Stock—Stock A | 500,000 | 34:1 | 14,706 |
| Stock B | 400,000 | 26:1 | 15,385 |
| Preferred Stock | 1,000,000 | 32:1 | 31,250 |
| C.D.s | 5,000,000 | 40:1 | 125,000 |
| Total Assets | 406,340,000 | | 14,246,627 |
| Accounts Payable Long-term liabilities: | 35,000,000 | 40:1 | 875,000 |
| Liability A | 150,000,000 | 40:1 | 3,750,000 |
| Liability B | 80,000,000 | 40:1 | 2,000,000 |
| Liability C | 30,000,000 | 40:1 | 750,000 |
| Total Liabilities | 295,000,000h | | $7,375,000 |

[1] S ages its accounts receivable and groups them into two categories—those outstanding for 30 days and those outstanding for 60 days.

[2] Translated the same as closing inventory under paragraph (c)(3)(iii).

[3] The cost of S's plant was incurred in several translation periods. Therefore, the dollar cost and dollar depreciation reflect several translation rates.

[4] S has a variety of equipment. Therefore, S's dollar basis represents the sum of the hyperinflationary cost of each, translated according to the exchange rate for the translation period incurred.

(iii) The DASTM gain of S for 1994 is computed as follows:

| | | |
|---|---|---|
| Net worth—1994 | | $6,871,627 |
| Less—Net worth—1993 | | $3,246,495 |
| Plus—1994 Dividends:. | | |
| April | $149,254 | |
| December | [1] 126,582 | 275,836 |
| Less Operating Profit—1994 | | 2,038,200 |
| DASTM Gain | | $1,862,768 |

[1] The exchange rates on the date of the April and December dividends were 33.5h:$1 and 39.5h:$1, respectively.

(iv) Thus, total profit = $2,038,200 + $1,862,768 = $3,900,968

(e) *Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits*—(1) *In general.* For all purposes of subtitle A, the amount of DASTM gain or loss of a QBU determined under paragraph (d) of this section is taken into account by the QBU for purposes of determining the

amount of its gross income, taxable income or loss, earnings and profits (or deficit in earnings and profits), and, where necessary, particular items of income, expense or other amounts. DASTM gain or loss is allocated under one of two methods. Certain small QBUs may elect the small QBU DASTM allocation described in paragraph (e)(2) of this section. All other QBUs must use the 9-step procedure described in paragraph (e)(3) of this section.

(2) *Small QBU DASTM allocation*—(i) *Election threshold.* A taxpayer may elect to use the small QBU DASTM allocation described in paragraph (e)(2)(iv) of this section with respect to a QBU that has an adjusted basis in assets (translated as provided in paragraph (d)(5) of this section) of $10 million or less at the end of any taxable year. In calculating the $10 million threshold, a QBU shall be treated as owning all of the assets of each related QBU (as defined in paragraph (e)(2)(vi) of this section) having its residence (as defined in section 988(a)(3)(B)) in the QBU's country of residence (related same- country QBU). For this purpose, appropriate adjustment shall be made to eliminate the double counting of assets created in transactions between related QBUs resident in the same country. For example, assume QBU–1, resident in country X, sells inventory to related QBU–2, also resident in country X, in exchange for an account receivable. For purposes of determining the assets of QBU–1 under this paragraph (e)(2)(i), the taxpayer shall take into account either the inventory shown on the books of QBU–2 or QBU–1's receivable from QBU–2 (but not both).

(ii) *Consent to election.* The election of the small QBU DASTM allocation or subsequent application of the rules of paragraph (e)(3) of this section due to an increase in the adjusted basis of the QBU's assets shall be deemed to have been made with the consent of the Commissioner. Once the election under paragraph (e)(2)(iii) of this section is made, it shall apply for all years in which the adjusted basis of the assets of the QBU (and any related same-country QBU) is $10 million or less, unless revoked with the Commissioner's consent. If the adjusted basis of the assets of the QBU (and any related same-country QBU) exceeds $10 million at the end of any taxable year, the rules of paragraph (e)(3) of this section shall apply to that QBU (and any related same-country QBU) for such year and each subsequent year unless such QBU again qualifies, and applies for and obtains the Commissioner's consent, to use the small QBU DASTM allocation. However, if a QBU acquires assets with a principal purpose of avoiding the application of paragraph (e)(2)(iv) of this section, the Commissioner may disregard the acquisition of such assets.

(iii) *Manner of making election*—(A) *QBUs that are branches of United States persons.* For the first year in which this election is effective, in the case of a QBU branch of a United States person, a statement shall be attached to the United States person's timely filed Federal income tax return (taking extensions into account). The statement shall identify the QBU (or QBUs) for which the election is being made by describing its business and its country of residence, state the adjusted basis of the assets of the QBU (and any related same-country QBUs) to which the election applies, and include a statement that the election is being made pursuant to §1.985–3(e)(2).

(B) *Other QBUs.* In the case of a QBU other than one described in paragraph (e)(2)(iii)(A) of this section, an election must be made in the manner prescribed in §1.964–1. The statement filed with the Internal Revenue Service as required under §1.964–1 must include the information required under paragraph (e)(2)(iii)(A) of this section.

(iv) *Effect of election.* If a taxpayer elects under this paragraph (e)(2) to use the small QBU DASTM allocation, DASTM gain or loss, as determined under paragraph (d) of this section, of a small QBU shall be allocated ratably to all items of the QBU's gross income (determined prior to adjustment for DASTM gain or loss). Therefore, for purposes of the foreign tax credit, DASTM gain or loss shall be allocated on the basis of the relative amounts of gross income in each separate category as defined in §1.904–5(a)(1). In the case of a controlled foreign corporation (within the meaning of section 957 or 953(c)(1)(B)), for purposes of section 952,

DASTM gain or loss shall be allocated to subpart F income in a separate category in the same ratio that the gross subpart F income in that category for the taxable year bears to its total gross income in that category for the taxable year.

(v) *Conformity.* If a person (or a QBU of such person) makes an election under this paragraph (e)(2) to use the small QBU DASTM allocation, then each QBU of any related person (as defined in paragraph (e)(2)(vi) of this section) that satisfies the threshold requirement of paragraph (e)(2)(i) of this section (after application of the aggregation rule of paragraph (e)(2)(i) of this section) shall be deemed to have made the election.

(vi) *Related person.* The term related person means any person with a relationship to the QBU (or to the United States or foreign person of which the electing QBU is a part) that is defined in section 267(b) or section 707(b).

(3) *DASTM 9-step procedure*—(i) *Step 1—prepare balance sheets.* The taxpayer shall prepare an opening and a closing balance sheet for the QBU for each balance sheet period during the taxable year. The balance sheet period is the most frequent period for which balance sheet data are reasonably available (but in no event less frequently than quarterly). The balance sheet period may not be changed without the consent of the district director. The balance sheets must be prepared under the principles of paragraph (d)(2) of this section.

(ii) *Step 2—identify certain assets and liabilities.* The taxpayer shall identify each item on the balance sheet that is described in section 988(c)(1)(B) or (C) and that would have been translated under paragraph (d)(5) of this section into dollars at the exchange rate for the last translation period for the taxable year (or the exchange rate on the last day of the last translation period of the taxable year in the case of an accrued foreign income tax liability).

(iii) *Step 3—characterize the assets.* The taxpayer shall characterize and group the assets identified in paragraph (e)(3)(ii) of this section (Step 2) according to the source and the type of income that they generate, have generated, or may reasonably be expected to generate by applying the principles of §1.861–9T(g)(3) or its successor regulation (relating to characterization of assets for purposes of interest expense allocation). If a purpose for a taxpayer's business practices is to manipulate asset characterization or groupings, the district director may allocate or apportion DASTM gain or loss attributable to the assets. Thus, if a taxpayer that previously did not separately state interest on accounts receivable begins to impose an interest charge and a purpose for the change was to manipulate tax characterizations or groupings, then the district director may require that none of the DASTM gain or loss attributable to those receivables be allocated or apportioned to interest income.

(iv) *Step 4—determine DASTM gain or loss attributable to certain assets*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to assets in each group identified in paragraph (e)(3)(iii) of this section (Step 3) as follows:

$$\left[\left(\text{bb}+\text{eb}\right)\div 2\right]\times\left[\text{er}-\text{br}\right]$$

where

bb = the hyperinflationary currency adjusted basis of the assets in the group at the beginning of the balance sheet period.

eb = the hyperinflationary currency adjusted basis of the assets in the group at the end of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

(B) *Weighting to prevent distortion.* If averaging the adjusted basis of assets in a group at the beginning and end of a balance sheet period results in an allocation of DASTM gain or loss that does not clearly reflect income, as might be the case in the event of a purchase or disposition of an asset that is not in the normal course of business, the taxpayer must use a weighting method that reflects the time the assets are held by the QBU during the translation period.

(C) *Example.* The provisions of this paragraph (e)(3)(iv) are illustrated by the following example:

*Example.* S is a foreign corporation that operates in the hyperinflationary currency ''h'' and computes its income or loss or earnings and profits under DASTM. S's adjusted basis in a group of assets described in section 988(c)(1)(B) or (C) that generate general limitation foreign source income (as characterized under paragraph (e)(3)(iii) of this section) at the beginning of the balance sheet period is 750,000h. S's basis in such assets at the end of the balance sheet period is 1,250,000h. The exchange rate at the beginning of the balance sheet period is $1 = 200h. The exchange rate at the end of the balance sheet period is $1 = 500h. The DASTM loss attributable to the assets described above is $3,000, determined as follows:

[(750,000h+1,250,000h)÷2]×
[($1÷500h)−($1÷200h)]=($3000)

(v) *Step 5—adjust dollar gross income by DASTM gain or loss from assets.* The taxpayer shall adjust the dollar amount of the QBU's gross income (computed under paragraphs (b)(1) through (b)(3) of this section) generated by each group of assets characterized in paragraph (e)(3)(iii) of this section (Step 3) by the amount of DASTM gain or loss attributable to those assets computed under paragraph (e)(3)(iv) of this section (Step 4). Thus, if a group of assets, such as accounts receivable, generates both a category of income described in section 904(d)(1)(I) (relating to general limitation income) that is not foreign base company income as defined in section 954 and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's gross income in that category. Similarly, if a group of assets, such as short-term bank deposits, generates both foreign personal holding company income that is passive income (described in sections 954(c)(1)(A) and 904(d)(1)(A)) and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's foreign personal holding company income and passive income. See section 904(f) and the regulations thereunder in the case where that section would apply and DASTM loss attributable to a group of assets exceeds the income generated by such assets.

(vi) *Step 6—determine DASTM gain or loss attributable to liabilities*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to liabilities identified in paragraph (e)(3)(ii) of this section (Step 2), and described in paragraph (e)(3)(vi)(B) of this section as follows:

$$\left[\left(\mathrm{bl}+\mathrm{el}\right)\div 2\right]\times\left[\mathrm{br}-\mathrm{er}\right]$$

where

bl = the hyperinflationary currency amount of liabilities at the beginning of the balance sheet period.

el = the hyperinflationary currency amount of liabilities at the end of the balance sheet translation period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

(B) *Separate calculation.* The calculation shall be made separately for interest-bearing liabilities described in paragraph (e)(3)(vii) of this section (Step 7) and for each of the classes of non-interest-bearing liabilities described in paragraph (e)(3)(viii) of this section (Step 8).

(C) *Weighting to prevent distortion.* Where a distortion would result from averaging the amount of liabilities at the beginning and end of a balance sheet period, as might be the case where a taxpayer incurs or retires a substantial liability, the taxpayer must use a different method that more clearly reflects the average amount of liabilities weighted to reflect the time the liability was outstanding during the balance sheet period.

(vii) *Step 7—adjust dollar income and expense by DASTM gain or loss from interest-bearing liabilities*—(A) *In general.* The taxpayer shall apply the amount of DASTM gain on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) to reduce interest expense generated by such liabilities (*e.g.*, prior to the application of §1.861–9T or its successor regulation). To the extent DASTM gain on

such liabilities exceeds interest expense, it shall be sourced or otherwise classified in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation. The amount of DASTM loss on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) shall be allocated and apportioned in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation (without regard to the exceptions to fungibility in §1.861–10T or its successor regulation). For purposes of this section, an interest-bearing liability is a liability that requires payment of periodic interest (whether fixed or variable), has original issue discount, or would have interest imputed under subtitle A.

(B) *Allocation of DASTM gain or loss from interest-bearing liabilities that generate related person interest expense.* DASTM gain or loss from interest-bearing liabilities that generate related person interest expense (as provided in section 954(b)(5)) shall be allocated for purposes of subtitle A (including sections 904 and 952) in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5) and §1.904–5(c)(2).

(C) *Modified gross income method.* In applying the modified gross income method described in §1.861–9T(j) or its successor regulation, gross income shall be adjusted for any DASTM gain or loss from assets as provided in paragraph (e)(3)(v) of this section (Step 5) and any DASTM gain or loss with respect to short-term, non-interest-bearing trade payables as provided in paragraph (e)(3)(viii)(A) of this section.

(viii) *Step 8—adjust dollar income and expense by DASTM gain or loss from non-interest bearing liabilities*—(A) *Short-term, non-interest-bearing trade payables.* The taxpayer shall allocate DASTM gain or loss on short-term non-interest-bearing trade payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest-bearing liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business.

(B) *Excise tax payables.* The taxpayer shall allocate DASTM gain or loss on excise tax payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as would be derived from the activity to which the excise tax relates.

(C) *Other non-interest-bearing liabilities*—(*1*) *In general.* Except as provided in paragraphs (e)(3)(viii)(A), (e)(3)(viii)(B), and (e)(3)(viii)(C)(*2*) of this section, DASTM gain or loss on non-interest-bearing liabilities shall be allocated under paragraph (e)(3)(ix) of this section (Step 9).

(*2*) *Tracing if substantial distortion of income.* DASTM gains and losses on liabilities described in paragraph (e)(3)(viii)(C)(*1*) of this section may be attributed to the same section 904(d) separate category or subpart F category as the transaction to which the liability relates if the taxpayer demonstrates to the satisfaction of the district director, or it is determined by the district director, that application of paragraph (e)(3)(viii)(C)(*1*) of this section results in a substantial distortion of income.

(ix) *Step 9—allocate residual DASTM gain or loss.* If there is a difference between the net DASTM gain or loss determined under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8) and the DASTM gain or loss determined under paragraph (d) of this section, the amount of the difference must be allocated for purposes of subtitle A (including sections 904 and 952) to the QBU's gross income (computed under paragraphs (b)(1) through (3) of this section, as adjusted under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8)) on the basis of the relative amounts of each category or type of gross income.

[T.D. 8556, 59 FR 37673, July 25, 1994, as amended by T.D. 9320, 72 FR 15044, Mar. 30, 2007]

### § 1.985–4 Method of accounting.

(a) *Adoption of election.* The adoption of, or the election to use, a functional currency shall be treated as a method

of accounting. The functional currency shall be used for the year of adoption (or election) and for all subsequent taxable years unless permission to change is granted, or considered to be granted under §1.985–2 or 1.985–8, by the Commissioner.

(b) *Condition for changing functional currencies.* Generally, permission to change functional currencies shall not be granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. If the determination of the functional currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) is based on facts and circumstances substantially similar to those set forth in §1.985–1(c)(2), then ordinarily the Commissioner will grant a taxpayer's request to change its functional currency (or the functional currency of its branch that is a QBU) to a new functional currency only if the taxpayer (or its QBU) also changes to the new functional currency for purposes of GAAP. However, permission to change will not necessarily be granted merely because the new functional currency will conform to the taxpayer's GAAP functional currency.

(c) *Relationship to certain other sections of the Code.* Nothing in this section shall be construed to override the provisions of any other sections of the Code of regulations that require the use of consistent accounting methods. Such provisions must be independently satisfied separate and apart from the identification of a functional currency. For instance, while separate geographical divisions of a taxpayer's trade or business may have different functional currencies, such geographical divisions may nevertheless be required to consistently use other methods of accounting.

[T.D. 8263, 54 FR 38661, Sept. 20, 1989, as amended by T.D. 8776, 63 FR 40368, July 29, 1998; T.D. 8927, Jan. 11, 2001]

### §1.985–5 Adjustments required upon change in functional currency.

(a) *In general.* This section applies in the case of a QBU that changes from one functional currency (old functional currency) to another functional currency (new functional currency). A taxpayer or QBU subject to the rules of this section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. The adjustments shall be made on the last day of the taxable year ending before the year of change as defined in §1.481–1(a)(1). Gain or loss required to be recognized under paragraphs (b), (d)(2), and (e)(2) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change. Except as provided in §1.985–6, a QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this §1.985–5 for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987. However, a QBU that changes to the dollar pursuant to §1.985–1(b)(2) after 1987 shall apply §1.985–7.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions.* The QBU shall recognize or otherwise take into account for all purposes of the Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A), (B), and (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (*i.e.*, whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) *Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.* The new functional currency adjusted basis of property and the new functional currency amount of liabilities and any

other relevant items (*e.g.*, items described in section 988(c)(1)(B)(iii)) shall equal the product of the amount of the old functional currency adjusted basis or amount multiplied by the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change (spot rate).

(d) *Step 3A—Additional adjustments that are necessary when a branch changes functional currency*—(1) *Branch changing to a functional currency other than the taxpayer's functional currency*—(i) *Rule.* If a QBU that is a branch of a taxpayer changes to a functional currency other than the taxpayer's functional currency, the branch shall make the adjustments set forth in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section for purposes of section 987. See §1.987–5(d) for rules for computing the branch's equity pool and basis pool.

(ii) *Where prior to the change the branch and taxpayer had different functional currencies.* If the branch and the taxpayer had different functional currencies prior to the change, the branch's new functional currency equity pool shall equal the product of the old functional currency amount of the equity pool multiplied by the spot rate. No adjustment to the basis pool is necessary.

(iii) *Where prior to the change the branch and taxpayer had the same functional currency.* If the branch and the taxpayer had the same functional currency prior to the change, the branch's basis pool shall equal the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. The branch's equity pool shall equal the product of the basis pool multiplied by the spot rate.

(2) *Branch changing to the taxpayer's functional currency.* If a branch changes its functional currency to the taxpayer's functional currency, the branch shall be treated as if it terminated on the last day of the taxable year ending before the year of change. In such a case, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency*—(1) *Corporations.* The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital shall equal the product of the old functional currency amounts of such items multiplied by the spot rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the new functional currency at the spot rate.

(2) *Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change. Such a shareholder shall also recognize gain or loss attributable to the corporation's paid-in capital to the same extent, if any, that such gain or loss would be recognized under the regulations under section 367(b) if the corporation was liquidated completely.

(3) *Taxpayers that are not corporations.* [Reserved]

(4) *Adjustments to a branch's accounts when a taxpayer changes functional currency*—(i) *Taxpayer changing to a functional currency other than the branch's functional currency.* If a taxpayer changes to a functional currency that differs from the functional currency of a branch of the taxpayer, the branch shall adjust its basis pool in the manner prescribed in paragraph (d)(1)(ii) of this section for adjusting the equity pool, if the taxpayer's old functional currency was different from the branch's functional currency. If the

taxpayer's old functional currency was the same as the branch's functional currency, the branch shall determine its equity pool and basis pool in the manner set forth in paragraph (d)(1)(iii) of this section for determining the basis pool and equity pool, respectively.

(ii) *Taxpayer changing to the same functional currency as the branch.* If a taxpayer changes to the same functional currency as a branch of the taxpayer, the taxpayer shall realize gain or loss as set forth in paragraph (d)(2) of this section.

(f) *Examples.* The provisions of this section are illustrated by the following examples.

*Example 1.* S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

| | 1:2 | |
|---|---|---|
| | LC | FC |
| Assets: | | |
| Cash on hand | 40,000 | 80,000 |
| Accounts Receivable | 10,000 | 20,000 |
| Inventory | 100,000 | 200,000 |
| 100,000 FC Bond (100,000 LC historical basis) | [1]50,000 | 100,000 |
| Fixed assets: | | |
| Property | 200,000 | 400,000 |
| Plant | 500,000 | 1,000,000 |
| Accumulated Depreciation | (200,000) | (400,000) |
| Equipment | 1,000,000 | 2,000,000 |
| Accumulated Depreciation | (400,000) | (800,000) |
| Total Assets | 1,300,000 | 2,600,000 |
| Liabilities: | | |
| Accounts Payable | 50,000 | 100,000 |
| Long-term Liabilities | 400,000 | 800,000 |
| Paid-in-Capital | 800,000 | 1,600,000 |
| Retained Earnings | [2]50,000 | 100,000 |
| Total Liabilities and Equity | 1,300,000 | 2,600,000 |

[1] Under § 1.985–5(b), S will recognize a 50,000 LC loss (100,000 LC basis − 50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.

[2] The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

*Example 2.* P, a domestic corporation, operates a foreign branch, S. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. As of December 31, 1992, S's equity pool was 2,000 LC and its basis pool was $4,000. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. On January 1, 1993, the new functional currency amount of S's equity pool is 4,000 FC. The basis pool is not affected.

[T.D. 8464, 58 FR 233, Jan. 5, 1993; 58 FR 11099, Feb. 23, 1993, as amended by T.D. 8765, 63 FR 10774, Mar. 5, 1998]

### § 1.985–6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.

(a) *In general.* This section sets forth transition rules for a QBU that used the dollar approximate separate transactions method of accounting set forth in § 1.985–3 or § 1.985–3T (as contained in the April 1, 1989 edition of 26 CFR part 1 (1.908 to 1.1000)) for its first taxable year beginning in 1987 (DASTM QBU). A DASTM QBU must determine the dollar and hyperinflationary currency basis of its assets and the dollar and hyperinflationary currency amount of its liabilities that were acquired or incurred in taxable years beginning before January 1, 1987. In addition, a DASTM QBU must determine its net worth, including its retained earnings, at the end of the QBU's last taxable year beginning before January 1, 1987. This section provides rules for controlled foreign corporations (as defined in section 957 or section 953(c)(1)(B)), other foreign corporations, and branches of United States persons that must make these determinations.

(b) *Certain controlled foreign corporations.* If a DASTM QBU was a controlled foreign corporation for its last taxable year beginning before January 1, 1987, and it had a significant event as described in § 1.964–1(c)(6) in a taxable year beginning before January 1, 1987, then the rules of this paragraph (b) shall apply.

(1) *Basis in assets and amount of liabilities.* The hyperinflationary currency adjusted basis of the QBU's assets and the hyperinflationary currency amount of the QBU's liabilities acquired or incurred by the QBU in a taxable year beginning before January 1, 1987, shall be the basis or the amount as determined under § 1.964–1(e) prior to translation under § 1.964–1(e)(4). The dollar adjusted basis of such assets and the dollar

amount of such liabilities shall be the adjusted basis or the amount as determined under the rules of §1.964–1(e) after translation under §1.964–1(e)(4).

(2) *Retained earnings.* The dollar amount of the QBU's retained earnings at the end of its last taxable year beginning before January 1, 1987, shall be the dollar amount determined under §1.964–1(e)(3).

(c) *All other foreign corporations.* If a foreign corporation is a DASTM QBU that is not described in paragraph (b) of this section, then the hyperinflationary currency and dollar adjusted basis in the QBU's assets acquired in taxable years beginning before January 1, 1987, the hyperinflationary currency and dollar amount of the QBU's liabilities acquired or incurred in taxable years beginning before January 1, 1987, and the dollar amount of the QBU's net worth, including its retained earnings, at the end of its last taxable year beginning before January 1, 1987, shall be determined by applying the principles of §1.985–3T or §1.985–3. Thus, for example, the dollar basis of plant and equipment shall be determined using the appropriate historical exchange rate.

(d) *Pre-1987 section 902 amounts*—(1) *Translation of pre-1987 section 902 accumulated profits and taxes into United States dollars.* The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, shall be translated into dollars at the spot exchange rate on the first day of its first taxable year beginning after December 31, 1986. Once translated into dollars, these accumulated profits and taxes shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(2) *Carryforward of accumulated deficits in accumulated profits from pre-1987 taxable years to post-1986 taxable years.* For purposes of sections 902 and 960, the post-1986 undistributed earnings of a foreign corporation that is subject to the rules of this section shall be reduced by the dollar amount of the corporation's deficit in accumulated profits, if any, determined under section 902 and the regulations thereunder, that was accumulated at the end of the corporation's last taxable year beginning before January 1, 1987. The dollar amount of the accumulated deficit shall be determined by multiplying the foreign currency amount of such deficit by the spot exchange rate on the last day of the corporation's last taxable year beginning before January 1, 1987, and shall be taken into account on the first day of the corporation's first taxable year beginning after December 31, 1986. Post-1986 undistributed earnings may not be reduced by the dollar amount of a pre-1987 deficit in retained earnings determined under §1.964–1(e).

(e) *Net worth branch.* If a DASTM QBU is a branch of a United States person and the QBU used a net worth method of accounting for its last taxable year beginning before January 1, 1987, then the rules of this paragraph (e) shall apply. A net worth method of accounting is any method of accounting under which the taxpayer calculates the taxable income of a QBU based on the net change in the dollar value of the QBU's equity (assets minus liabilities) during the course of a taxable year, taking into account any contributions or remittances made during the year. See, *e.g.*, Rev. Rul. 75–106, 1975–1 C.B. 31. (See §601.601(d)(2)(ii)(*b*) of this chapter).

(1) *Basis in assets and amount of liabilities*—(i) *Hyperinflationary amounts.* For the first taxable year beginning in 1987, the hyperinflationary currency adjusted basis of a QBU's assets or the hyperinflationary currency amounts of its liabilities acquired or incurred in a taxable year beginning before January 1, 1987 is the hyperinflationary currency basis or amount at the date when acquired or incurred, as adjusted according to United States generally accepted accounting and tax accounting principles. If a hyperinflationary currency basis or amount was not determined at such date, the dollar basis or amount, as adjusted according to United States generally accepted accounting and tax accounting principles, shall be translated into hyperinflationary currency at the spot exchange rate on the date when the

asset or liability was acquired or incurred.

(ii) *Dollar amounts.* For the first taxable year beginning in 1987, the dollar adjusted basis of the QBU's assets and the amounts of its liabilities shall be those amounts reflected on the QBU's dollar books and records at the end of the taxpayer's last taxable year beginning before January 1, 1987, after adjusting the books and records according to United States generally accepted accounting and tax accounting principles.

(2) *Ending net worth.* The dollar amount of the QBU's net worth at the end of its last taxable year beginning before January 1, 1987 shall equal the QBU's net worth at that date as determined under paragraph (e)(1)(ii) of this section.

(f) *Profit and loss branch.* If a DASTM QBU is a branch of a United States person and the QBU used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, then the United States person shall first apply the transition rules of §1.987–5 in order to determine the beginning amount and dollar basis of the branch's EQ pool, the hyperinflationary currency basis of the branch's assets, and the hyperinflationary currency amounts of its liabilities. A profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU by computing the QBU's profits in its functional currency and translating the net result into dollars. See *e.g.*, Rev. Rul. 75–107, 1975–1 C.B. 32. (See §601.601(d)(2)(ii)(*b*) of this chapter). The QBU and the taxpayer must then make the adjustments required by §1.985–5, *e.g.*, the QBU must take into account unrealized exchange gain or loss on dollar-denominated section 988 transactions, the taxpayer must account for the deemed termination of the branch, and the taxpayer must translate the QBU's balance sheet items from hyperinflationary currency into dollars at the spot rate.

[T.D. 8464, 58 FR 234, Jan. 5, 1993]

### §1.985–7 Adjustments required in connection with a change to DASTM.

(a) *In general.* If a QBU begins to use the dollar approximate separate transactions method of accounting set forth in §1.985–3 (DASTM) in a taxable year beginning after April 6, 1998, adjustments shall be made as provided by this section. For the rules with respect to foreign corporations, see paragraph (b) of this section. For the rules with respect to adjustments to the income of United States shareholders of controlled foreign corporations, see paragraph (c) of this section. For the rules with respect to adjustments relating to QBU branches, see paragraph (d) of this section. For the effective date of this section, see paragraph (e). For purposes of applying this section, the look-back period shall be the period beginning with the first taxable year after the transition date and ending on the last day prior to the taxable year of change. The term transition date means the later of the last day of the last taxable year ending before the base period as defined in §1.985–1(b)(2)(ii)(D) or the last day of the taxable year in which the QBU last applied DASTM. The taxable year of change shall mean the taxable year of change as defined in §1.481–1(a)(1). The application of this paragraph may be illustrated by the following examples:

*Example 1.* A calendar year QBU that has not previously used DASTM operates in a country in which the functional currency of the country is hyperinflationary as defined under §1.985–1(b)(2)(ii)(D) for the QBU's 1999 tax year. The look-back period is the period from January 1, 1996 through December 31, 1998, the transition date is December 31, 1995, and the taxable year of change is the taxable year beginning January 1, 1999.

*Example 2.* A QBU that has not previously used DASTM with a taxable year ending June 30, operates in a country in which the functional currency of the country is hyperinflationary for the QBU's tax year beginning July 1, 1999 as defined under §1.985–1(b)(2)(ii)(D) (where the base period is the thirty-six calendar months immediately preceding the first day of the current calendar year 1999). The look-back period is the period from July 1, 1995 through June 30, 1999, the transition date is June 30, 1995, and the taxable year of change is the taxable year beginning July 1, 1999.

(b) *Adjustments to foreign corporations*—(1) *In general.* In the case of a

foreign corporation, the corporation shall make the adjustments set forth in paragraphs (b)(2) through (4) of this section. The adjustments shall be made on the first day of the taxable year of change.

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A foreign corporation shall adjust earnings and profits by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the corporation on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the corporation with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (b)(2). See §1.985–5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A foreign corporation shall reduce earnings and profits by the amount of any gain, and increase earnings and profits by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Opening balance sheet.* The opening balance sheet of a foreign corporation for the taxable year of change shall be determined as if the corporation had changed its functional currency to the dollar by applying §1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under §1.985–3.

(4) *Earnings and profits adjustments*—(i) *Pre-1987 accumulated profits.* The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that are attributable to taxable years beginning before January 1, 1987, as stated on the transition date, and that were maintained for purposes of section 902 in the old functional currency, shall be translated into dollars at the spot rate in effect on the transition date. The applicable accumulated profits shall be reduced on a last-in, first-out basis by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period to the extent such amounts distributed exceed the earnings and profits calculated under (b)(4)(ii) or (b)(4)(iii), as applicable. See §1.902–1(b)(2)(ii). Once translated into dollars, these pre-1987 taxes and accumulated profits or deficits in accumulated profits shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(ii) *Post-1986 undistributed earnings of a CFC.* In the case of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B))(CFC) or a foreign corporation subject to the rules of §1.904–6(a)(2), the corporation's post-1986 undistributed earnings in each separate category as defined in §1.904–5(a)(1) as of the first day of the taxable year of change (and prior to adjustment under paragraph (c)(1) of this section) shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings and profits (or deficit in earnings and profits) in each separate category as defined in §1.904–5(a)(1) as stated on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) in each separate category determined under §1.985–3 for each post-transition date taxable year prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that

were distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits in such separate category. For purposes of applying this paragraph (b)(4)(ii)(B), the opening balance sheet for calculating earnings and profits under §1.985–3 for the first post-transition year shall be translated into dollars pursuant to §1.985–5(c).

(iii) *Post-1986 undistributed earnings of other foreign corporations.* In the case of a foreign corporation that is not a CFC or subject to the rules of §1.904–6(a)(2), the corporation's post-1986 undistributed earnings shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings (or deficit) on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) determined under §1.985–3 for each post-transition date taxable year (or such later year determined under section 902(c)(3)(A)) prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) that was distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits. For purposes of applying this paragraph (b)(4)(iii)(B), the opening balance sheet for calculating earnings and profits under §1.985–3 for the first post-transition year shall be translated into dollars pursuant to §1.985–5(c).

(c) *United States shareholders of controlled foreign corporations*—(1) *In general.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(B)) of a CFC that changes to DASTM shall make the adjustments set forth in paragraphs (c)(2) through (5) of this section on the first day of the taxable year of change. Adjustments under this section shall be taken into account by the shareholder (or such shareholder s successor in interest) ratably over four taxable years beginning with the taxable year of change. Similar rules shall apply in determining adjustments to income of United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund.

(2) *Treatment under subpart F of income recognized on section 988 transactions.* The character of amounts taken into account under paragraph (b)(2) of this section for purposes of sections 951 through 964, shall be determined on the transition date and to the extent characterized as subpart F income shall be taken into account in accordance with the rules of paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038).

(3) *Recognition of foreign currency gain or loss on previously taxed earnings and profits on the transition date.* Gain or loss is recognized under section 986(c) as if all previously taxed earnings and profits as determined on the transition date, if any, were distributed on such date. Such gain or loss shall be reduced by any foreign currency gain and increased by any foreign currency loss that was recognized under section 986(c) with respect to distributions of previously taxed earnings and profits during the look-back period. Such amount shall be characterized in accordance with section 986(c) and taken into account in accordance with the rules of paragraph (c)(1) of this section.

(4) *Subpart F income adjustment.* Subpart F income in a separate category shall be determined under §1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985–5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985–3 and amount that was included in income for each year shall be taken into account in the taxable year of change pursuant to paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038). For rules applicable if an adjustment under this section results in a loss for the taxable year in a separate category, see section 904(f) and the regulations thereunder. The amount of previously taxed earnings and profits as determined under section 959(c)(2)

shall be adjusted (positively or negatively) by the amount taken into account under this paragraph (c)(4) as of the first day of the taxable year of change.

(5) *Foreign tax credit.* A United States shareholder of a CFC shall compute an amount of foreign taxes deemed paid under section 960 with respect to any positive adjustments determined under paragraph (c) of this section. The amount of foreign tax deemed paid shall be computed with reference to the full amount of the adjustment and to the post-1986 undistributed earnings determined under paragraph (b)(4) (i) and (ii) of this section and the post-1986 foreign income taxes of the CFC on the first day of the taxable year of change (i.e., without taking into account earnings and taxes for the taxable year of change). For purposes of section 960, the associated taxes in each separate category shall be allocated pro rata among, and deemed paid in, the shareholder's taxable years in which the income is taken into account. (No adjustment to foreign taxes deemed paid in prior years is required solely by reason of a negative adjustment to income under paragraph (c)(1) of this section).

(d) *QBU branches*—(1) *In general.* In the case of a QBU branch, the taxpayer shall make the adjustments set forth in paragraphs (d)(2) through (d)(4) of this section. Adjustments under this section shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A QBU branch shall adjust income by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1) (A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the QBU branch on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the QBU branch with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (d)(2). See §1.985–5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A QBU branch shall reduce income by the amount of any gain, and increase income by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Deemed termination income adjustment.* The taxpayer shall realize gain or loss attributable to the QBU branch's equity pool (as stated on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such amount shall be reduced by section 987 gain and increased by section 987 loss that was recognized by such taxpayer with respect to remittances during the look-back period.

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under §1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985–5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985–3 and amount taken into account for each year shall be taken into account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their character for all federal income tax purposes.

(5) *Opening balance sheet.* The opening balance sheet of a QBU branch for the taxable year of change shall be determined as if the branch had changed its functional currency to the dollar by applying §1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under §1.985–3.

(e) *Effective date.* This section is effective for taxable years beginning

after April 6, 1998. However, a taxpayer may choose to apply this section to all open taxable years beginning after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985–2(d)(3)) to the taxpayer also applies this section.

[T.D. 8765, 63 FR 10774, Mar. 5, 1998]

### §1.985–8 Special rules applicable to the European Monetary Union (conversion to euro).

(a) *Definitions*—(1) *Legacy currency*. A legacy currency is the former currency of a Member State of the European Community which is substituted for the euro in accordance with the Treaty establishing the European Community signed February 7, 1992. The term legacy currency shall also include the European Currency Unit.

(2) *Conversion rate*. The conversion rate is the rate at which the euro is substituted for a legacy currency.

(b) *Operative rules*—(1) *Initial adoption*. A QBU (as defined in §1.989(a)–1(b)) whose first taxable year begins after the euro has been substituted for a legacy currency may not adopt a legacy currency as its functional currency.

(2) *QBU with a legacy currency as its functional currency*—(i) *Required change*. A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning the first day of the first taxable year—

(A) That begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union); and

(B) In which the QBU begins to maintain its books and records (as described in §1.989(a)–1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(3) *QBU with a non-legacy currency as its functional currency*—(i) *In general*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro pursuant to this §1.985–8 if—

(A) Under the rules set forth in §1.985–1(c), the euro is the currency of the economic environment in which a significant part of the QBU's activities are conducted;

(B) After conversion, the QBU maintains its books and records (as described in §1.989(a)–1(d)) in the euro; and

(C) The QBU is not required to use the dollar as its functional currency under §1.985–1(b).

(ii) *Time period for change*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro under this section only if it does so within the period set forth in paragraph (b)(2) of this section as if the functional currency of the QBU was a legacy currency.

(4) *Consent of Commissioner*. A change made pursuant to paragraph (b) of this section shall be deemed to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing its functional currency to the euro pursuant to paragraph (b)(2) of this section must make adjustments as provided in paragraph (c) of this section. A QBU changing its functional currency to the euro pursuant to paragraph (b)(3) must make adjustments as provided in §1.985–5.

(5) *Statement to file upon change*. With respect to a QBU that changes its functional currency to the euro under paragraph (b) of this section, an affected taxpayer shall attach to its return for the taxable year of change a statement that includes the following: ''TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS. REG. §1.985–8.'' For purposes of this paragraph (b)(5), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation

(as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in §1.902–1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) *Adjustments required when a QBU changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section*—(1) *In general.* A QBU that changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985–5 shall not apply.

(2) *Determining the euro basis of property and the euro amount of liabilities and other relevant items.* The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) *Taking into account exchange gain or loss on legacy currency section 988 transactions*—(i) *In general.* Except as provided in paragraphs (c)(3)(iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

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

*Example 1.* X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks (DM) into Dutch guilders (fl) at the spot rate of fl1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1= DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive €4444.44 (fl10,000/2.25) of principal and €444.44 (fl1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of §1.988–2(b)(5). For this purpose, the exchange rate used under §1.988–2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under §1.988–2(b)(5)(ii) is determined by translating the fl10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of €555.56 determined as follows: [€4444.44 (fl10,000/2.25)–5000 ((fl10,000/1)/2) = – €555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

*Example 2.* (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency. On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl1.07 = DM1. Pursuant to §1.988–2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1 = DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. In 1999, X will accrue one month of interest equal to €44.44 (fl100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of €533.33 (fl1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of §1.988–2(b)(3). For this purpose, the exchange rate used under §1.988–2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under §1.988–2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued in 1998, X will realize exchange loss of €25.13 under §1.988–2(b)(3) as follows: [€488.89 (fl1100/2.25)–€514.02 (DM1028.04/2) =– €25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued

and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of €666.67 on repayment of the loan principal computed in the same manner as in Example 1 [€5333.33 (fl12,000/2.25)– €6000 fl12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) *Special rule for legacy nonfunctional currency.* The QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) *Legacy currency denominated accounts receivable and payable*—(A) *In general.* A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) *Time and manner of election.* With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(5) of this section) shall attach a statement to its tax return for the taxable year ending immediately prior to the year of change which includes the following: ''TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO.'' A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) *Adjustments when a branch changes its functional currency to the euro*—(i) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is other than the euro.* If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is the euro.* If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) *Adjustments to a branch's accounts when a taxpayer changes to the euro*—(i) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is other than the euro.* If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is the euro.* If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) *Additional adjustments that are necessary when a corporation changes its functional currency to the euro.* The

amount of a corporation's euro currency earnings and profits and the amount of its euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the euro at the conversion rate.

(d) *Treatment of legacy currency section 988 transactions with respect to a QBU that has the euro as its functional currency*—(1) *In general.* This §1.985–8(d) applies to a QBU that has the euro as its functional currency and that holds a section 988 transaction denominated in, or determined by reference to, a currency that is substituted by the euro. For example, this paragraph (d) will apply to a German QBU with the euro as its functional currency if the QBU is holding Country X currency or other section 988 transactions denominated in such currency on the day in the year 2005 when the euro is substituted for the Country X currency.

(2) *Principles of paragraph (c)(3) of this section shall apply.* With respect to a QBU described in paragraph (d) of this section, the principles of paragraph (c)(3) of this section shall apply. For example, if a German QBU with the euro as its functional currency is holding a Country X currency denominated debt instrument on the day in the year 2005 when the euro is substituted for the Country X currency, the instrument shall continue to be treated as a section 988 transaction pursuant to the principles of paragraph (c)(3)(i) of this section. However, if such QBU holds Country X currency, the QBU shall take into account any unrealized exchange gain or loss pursuant to the principles of paragraph (c)(3)(iii) of this section as if the currency was disposed of on the day prior to the day the euro is substituted for the Country X currency. Similarly, if the QBU makes an election under the principles of paragraph (c)(3)(iv) of this section, the QBU shall take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the day prior to the day the euro is substituted for the Country X currency.

(e) *Effective date.* This section applies to tax years ending after July 29, 1998.

[T.D. 8927, 66 FR 2216, Jan. 11, 2001; T.D. 8927, 66 FR 21447, Apr. 30, 2001]

### §1.987–1 Profit and loss method of accounting for a qualified business unit of a taxpayer having a different functional currency from the taxpayer. [Reserved]

### §1.987–2 Accounting for gain or loss on certain transfers of property. [Reserved]

### §1.987–3 Termination. [Reserved]

### §1.987–4 Special rules relating to QBU branches of foreign taxpayers. [Reserved]

### §1.987–5 Transition rules for certain qualified business units using a profit and loss method of accounting for taxable years beginning before January 1, 1987.

(a) *Applicability*—(1) *In general.* This section applies to qualified business unit (QBU) branches of United States persons, whose functional currency (as defined in section 985 of the Code and the regulations thereunder) is other than the United States dollar (dollar) and that used a profit and loss method of accounting for their last taxable year beginning before January 1, 1987. Generally, a profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU branch in its functional currency and translates the net result into dollars. For all taxable years beginning after December 31, 1986, such QBU branches must use the profit and loss method of accounting as described in section 987, except to the extent otherwise provided in regulations under section 985 or any other provision of the Code. See §1.989(c)–1 regarding transition rules for QBU branches of United States persons that have a nondollar functional currency and that used a net worth method of

accounting for their last taxable year beginning before January 1, 1987.

(2) *Insolvent QBU branches.* A taxpayer may apply the principles of this section to a QBU branch that used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, whose $E pool (as defined in paragraph (d)(3)(i) of this section) is negative. For taxable years beginning on or after October 25, 1991, the principles of this section shall apply to insolvent QBU branches.

(b) *General rules.* Generally, section 987 gain or loss occurs when a QBU branch makes a remittance. A remittance is considered to be made from one or more functional currency pools under rules provided in paragraph (c) of this section. In general, the amount of section 987 gain or loss from a remittance equals the difference between the dollar value of the functional currency adjusted basis of the property remitted and the portion of the dollar basis in the applicable pool. Section 987 gain or loss is calculated under a 4-step procedure described in paragraph (d) of this section. Section 987 gain or loss attributable to a remittance is realized and must be recognized in the taxable year of the remittance except to the extent otherwise provided in regulations.

(c) *Determining the pool(s) from which a remittance is made*—(1) *Remittances made during taxable years beginning after December 31, 1986, and before October 25, 1991.* A remittance made during taxable years beginning after December 31, 1986 and before October 25, 1991, first represents an amount of the QBU branch's post-86 profits pool (including functional currency profits for the current taxable year determined without regard to remittances made during the current year). To the extent the functional currency amount of the remittance exceeds the post-86 profits pool, it is considered to come out of the EQ pool. Paragraph (d)(2) of this section describes the EQ pool and the post-86 profits pool.

(2) *Remittances made in taxable years beginning on or after October 25, 1991.* For remittances made in taxable years beginning on or after October 25, 1991, the post-86 profits and EQ pools are combined into one pool called the equity pool. Therefore, remittances made during those taxable years will only come from the equity pool. The dollar basis of, and section 987 gain or loss on, such remittances shall be calculated utilizing the principles set forth in paragraphs (d)(4) and (5) of this section.

(d) *Calculation of section 987 gain or loss*—(1) *In general.* This paragraph (d) describes the 4-step procedure for calculating section 987 gain or loss.

(2) *Step 1—Calculate the amount of the functional currency pools*—(i) *EQ pool*—(A) *Beginning pool.* The beginning amount of the EQ pool is equal to the functional currency adjusted bases of a QBU branch's assets less the functional currency amount of the QBU branch's liabilities at the end of the taxpayer's last taxable year beginning before January 1, 1987, as these amounts are determined under the rules of paragraphs (e) and (f) of the section. The district director may allow for additional adjustments to the beginning amount of the EQ pool to prevent the recognition of section 987 gain or loss due to factors unrelated to the movement of exchange rates.

(B) *Adjusting the EQ pool.* The EQ pool is increased by the functional currency amount of any transfer (as determined under section 987) to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If the transfer is made in a nonfunctional currency, this amount is translated into the QBU branch's functional currency at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the rate must be applied consistently each quarter. The EQ pool is decreased by the functional currency amount of any remittance (as determined under section 987) made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the EQ pool under paragraph (c) of this section. The EQ pool must also be decreased by any transfer from the QBU branch that is not a remittance.

(ii) *Post-86 profits pool.* The amount of a QBU branch's post-86 profits pool is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the post-86

profits pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The post-86 profits pool is increased by the functional currency amount of the QBU branch's profits (determined under section 987) for the taxable year. The post-86 profits pool is decreased by the functional currency amount of the QBU branch's losses (determined under section 987) for the taxable year and the amount of any remittances by the QBU branch during the taxable year from the post-86 profits pool as provided under paragraph (c) of this section.

(iii) *Adjustments to the equity pool.* For remittances made in taxable years beginning on or after October 25, 1991 under paragraph (c)(2) of this section, the post-86 profits and EQ pools are combined into one pool called the equity pool. Additions to and subtractions from the equity pool shall be made utilizing the principles of paragraphs (d)(2)(i)(B) and (ii) of this section. For example, remittances shall reduce the equity pool.

(3) *Step 2—Calculate the dollar basis of the pools*—(i) *Dollar basis of the EQ pool*—(A) *Beginning dollar basis.* The beginning dollar basis of the EQ pool (hereinafter referred to as the $E pool) equals:

(*1*) The dollar amount of all the QBU branch's profits reported on the taxpayer's income tax returns for taxable years beginning before January 1, 1987, plus the total dollar amount of all transfers to the QBU branch during that period (properly reflected on the taxpayer's books), less

(*2*) The dollar amount of all the QBU branch's losses reported on the taxpayer's income tax returns for such years, and the total dollar basis of all remittances and all transfers made by the QBU branch during that period (properly reflected on the taxpayer's books).

A QBU branch's profits and losses shall be properly adjusted for foreign taxes of the QBU branch.

(B) *Adjusting the $E pool.* The $E pool is increased by the dollar amount of any transfers to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If a transfer is made in a currency other than the dollar, the amount of the currency is translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The $E pool is decreased by the dollar basis of any remittance made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the $E pool under paragraphs (c) and (d)(4) of these section. The $E pool is also reduced by the amount of a transfer (other than a remittance) from the QBU branch translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the spot rate must be applied consistently to all transfers to and from a QBU branch.

(ii) *Dollar basis of the post-86 profits pool.* The amount of a QBU branch's dollar basis in the post-86 profits pool (the $P pool) is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the $P pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The $P pool is increased by the functional currency amount of the QBU branch's profits (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate (as defined in §1.989 (b)–1) for the year. The $P pool is decreased by the functional currency amount of the QBU branch's losses (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate for the year and by the dollar basis of any remittances made by the QBU branch during the taxable year from the post-86 profits pool under paragraph (c)(1) of this section.

(iii) *Combination of the $E and the $P pools.* For taxable years beginning on or after October 25, 1991 the $P and the $E pools are combined into one pool called the basis pool. Additions to and subtractions from the basis pool shall be made utilizing the principles set forth in paragraphs (d)(3)(i) and (ii) of this section.

(4) *Step 3—Calculation of the dollar basis of a remittance.* For all taxable years beginning after December 31,

1986, the dollar basis of a remittance is calculated using the following formula:

$$\frac{\text{Amount of remittance (in QBC branch's functional currency) from the applicable pool (EQ, post-86 profits, or equity pool)}}{\text{Balance of the applicable pool (EQ, post-86 profits or equity pool) reduced by prior remittances}} \times \text{The dollar basis of the applicable pool (\$E, \$P, or basis pool) reduced by prior remittances}$$

(5) *Step 4—Calculation of the section 987 gain or loss on a remittance.* Section 987 gains or loss equals the difference between—

(i) The dollar amount of the remittance, and

(ii) The dollar basis of the remittance as calculated under paragraph (d)(4) of this section.

(e) *Functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987*—(1) *Basis of asset.* For taxable years beginning after December 31, 1986, the functional currency adjusted basis of a QBU branch asset acquired in a taxable year beginning before January 1, 1987, is the functional currency basis of the asset at the date of acquisition, as adjusted according to United States tax principles. The functional currency adjusted basis of an asset for which a functional currency basis was not determined at the date of acquisition is the nonfunctional currency basis of the asset at the date of acquisition multiplied by the spot exchange rate on the date of acquisition, as adjusted according to United States tax principles.

(2) *Adjustment to basis of asset.* Any future adjustments to the functional currency adjusted basis of such an asset are determined with respect to the appropriate functional currency adjusted basis of the asset as determined under this paragraph (e).

(f) *Functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987.* For the first taxable year beginning after December 31, 1986, the amount of a QBU branch liability incurred in a taxable year beginning before January 1, 1987, is the functional currency amount of the liability at the date incurred, as adjusted according to United States tax principles. The functional currency amount of a liability for which a functional currency amount was not determined at the date incurred is the nonfunctional currency amount of the liability at the date incurred multiplied by the spot exchange rate on the date incurred, as adjusted according to the United States tax principles.

(g) *Examples.* The provisions of this section are illustrated by the following examples.

*Example 1:* (i) *Facts.* U.S. is a domestic corporation. B, a QBU branch of U.S., operates in country X and was established in 1985. B's functional currency is the FC. U.S. is on a calendar taxable year and, prior to January 1, 1987, accounted for the operations of B by the profit and loss method of accounting as set forth in Rev. Rul. 75–107, 1975–1 C.B. 32. B's books and records were kept according to United States tax principles. B received a transfer of $2,000 in 1985, and had profits of $3,000 in 1985 and $5,000 in 1986. B made a remittance in 1986, the dollar basis of which was $1,000. As of December 31, 1986, the adjusted basis of B's functional currency assets exceeded the functional currency amount of its liabilities by 15,000 FC (the beginning pool of EQ). Under section 987, B has profits of 8,000 FC in 1987, which are worth $1,000 when translated at the weighted average exchange rate for 1987 as required by sections 987(2) and 989(b)(4). B has no profits or loss in 1988. There are no transfers to B in 1987 and 1988. B remits 18,000 FC in 1988. Under section 987, the appropriate exchange rate for the 1988 remittance is 10 FC/$1.

(ii) *Calculation of section 987 loss on remittance*—(A) *Post-86 profits.* Under paragraph (c)(i) of this section, the 18,000 FC remittance comes first out of the post-86 profits pool (8,000 FC) and second out of EQ (10,000 FC). The loss on the 1988 remittance out of the post-86 profits pool equals:

Dollar value of post-86 profits remitted − Dollar basis of post-86 profits remitted= (8,000 FC × 10 FC/$1) − $1,000 = $800 − $1,000 = ≤$200> loss.

(B) *EQ.* Under paragraph (d) of this section, U.S. calculates 987 gain or loss on the 10,000 FC remittance of EQ from B as follows:

*Step 1.* The total EQ pool equals 15,000 FC (the functional currency adjusted bases of its assets less the functional currency amount of its liabilities as of December 31, 1986). There are no adjustments necessary under paragraph (d)(2)(i)(B) of this section.

*Step 2.* The $E pool is $9,000 (the $2,000 transfer in 1985 plus profits of $3,000 in 1985 and $5,000 in 1986 and less than $1,000 basis of the 1986 remittance). There are no adjustments necessary under paragraph (d)(3)(i)(B) of this section.

*Step 3.* The entire 10,000 FC remittance is deemed to come out of EQ.

*Step 4.* The dollar basis of the EQ remitted equals: N × $E determined under paragraph (d)(3)(i)=

$$\frac{10{,}000\ \text{FC}}{15{,}000\ \text{FC}} \times \$9{,}000 = \$6{,}000$$

Where:

$$\text{N} = \frac{\text{Portion of remittance out of EQ}}{\text{EQ balance determined under paragraph (d)(2)(i) of this section}}$$

*Step 5.* Section 987 loss of U.S. on remittance equals:

Dollar value of the EQ remitted − Dollar basis of the EQ remitted = (10,000 FC × 10 FC/$1) − $6,000 = $1,000 − $6,000 = ≤$5,000> loss.

(C) *Total loss on remittance.* The total combined loss on the remittance is ≤$5,200>. The total of amounts determined in paragraphs (ii)(A) and (B) of this Example 1.

*Example 2:* (i) *Facts.* D is a domestic corporation. B, a QBU branch of D, operates in country X. B's functional currency is the FC. At the end of B's last taxable year beginning before October 25, 1991, B's EQ pool equals 15,000 FC and B's post-86 profits pool equals 8,000 FC. B's $E amount equals $9,000, and the $P pool equals $1,000. In B's first taxable year beginning on or after October 25, 1991, B remits 18,000 FC. Under section 987, the appropriate exchange rate for this remittance is 10FC:$1.

(ii) *Computation of the equity pool.*

15,000 FC (EQ pool) + 8,000 FC (post-86 profits pool) = 23,000 FC (equity pool)

(iii) *Computation of the basis pool.*

$$\$9{,}000\ (\$\text{E amount}) + \$1{,}000\ (\$\text{P amount}) = \$10{,}000$$

(iv) *Dollar basis in remittance.*

$$\frac{18{,}000\ \text{FC (amount of remittance)}}{23{,}000\ \text{FC (equity pool)}} \times \$10{,}000 = \$7{,}826$$

(v) *Computation of section 987 loss by U.S. on remittance.*

$$\$1{,}800\ (\text{dollar value of remittance}) - \$7{,}826\ (\text{dollar basis in remittance}) = < \$6{,}026 >$$

(loss on remittance)

(h) *Character and source of section 987 gain or loss.* Section 987 gain or loss is sourced and characterized as provided by section 987 and regulations issued under that section.

[T.D. 8367, 56 FR 48434, Sept. 25, 1991; 56 FR 65684, Dec. 18, 1991]

## § 1.988–0 Taxation of gain or loss from a section 988 transaction; Table of Contents.

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(18) Interaction of section 988 and §1.1275–2(g).
(c) Item of expense or gross income or receipts which is to be paid or received after the date accrued.
(1) In general.
(2) Determination of exchange gain or loss with respect to an item of gross income or receipts.
(3) Determination of exchange gain or loss with respect to an item of expense.
(4) Examples.
(d) Exchange gain or loss with respect to forward contracts, futures contracts and option contracts.
(1) Scope.
(2) Realization of exchange gain or loss.
(3) Recognition of exchange gain or loss.
(4) Determination of exchange gain or loss.
(5) Hyperinflationary contracts.
(e) Currency swaps and notional principal contracts.
(1) Notional principal contract denominated in a single nonfunctional currency.
(2) Special rules for currency swaps.
(3) Amortization of swap premium or discount in the case of off market swaps.
(4) Treatment of taxpayer disposing of a currency swap.
(5) Examples.
(6) Special effective date for rules regarding currency swaps.
(7) Special rules for currency swap contracts in hyperinflationary currencies.
(f) Substance over form.
(1) In general.
(2) Example.
(g) Effective date.
(h) Timing of income and deductions from notional principal contracts.

*§ 1.988–3 Character of exchange gain or loss.*

(a) In general.
(b) Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss.
(1) In general.
(2) Special rule for contracts that become part of a straddle after the election is made.
(3) Requirements for making the election.
(4) Verification.
(5) Independent verification.
(6) Effective date.
(c) Exchange gain or loss treated as interest.
(1) In general.
(2) Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.
(d) Effective date.

*§ 1.988–4 Source of gain or loss realized on a section 988 transaction.*

(a) In general.
(b) Qualified business unit.
(1) In general.
(2) Proper reflection on the books of the taxpayer or qualified business unit.
(c) Effectively connected exchange gain or loss.
(d) Residence.
(1) In general.
(2) Exception.
(3) Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).
(e) Special rule for certain related party loans.
(1) In general.
(2) United States person.
(3) Loans by related person.
(4) 10 percent owned foreign corporation.
(f) Exchange gain or loss treated as interest under § 1.988–3.
(g) Exchange gain or loss allocated in the same manner as interest under § 1.861–9T.
(h) Effective date.

*§ 1.988–5 Section 988(d) hedging transactions.*

(a) Integration of a nonfunctional currency debt instrument and a § 1.988–5(a) hedge.
(1) In general.
(2) Exception.
(3) Qualifying debt instrument.
(4) Section 1.988–5(a) hedge.
(5) Definition of integrated economic transaction.
(6) Special rules for legging in and legging out of integrated treatment.
(7) Transactions part of a straddle.
(8) Identification requirements.
(9) Taxation of qualified hedging transactions.
(10) Transition rules and effective dates.
(b) Hedged executory contracts.
(1) In general.
(2) Definitions.
(3) Identification rules.
(4) Effect of hedged executory contract.
(5) References to this paragraph (b).
(c) Hedges of period between trade date and settlement date on purchase or sale of publicly traded stock or security.
(d) [Reserved]
(e) Advance rulings regarding net hedging and anticipatory hedging systems.
(f) [Reserved]
(g) General effective date.

*§ 1.988–6 Nonfunctional Currency Contingent Payment Debt Instruments*

(a) In general.
(1) Scope.
(2) Exception for hyperinflationary currencies.
(b) Instruments described in paragraph (a)(1)(i) of this section.
(1) In general.
(2) Application of noncontingent bond method.
(3) Treatment and translation of amounts determined under noncontingent bond method.
(4) Determination of gain or loss not attributable to foreign currency.
(5) Determination of foreign currency gain or loss.
(6) Source of gain or loss.
(7) Basis different from adjusted issue price.
(8) Fixed but deferred contingent payments.
(c) Examples.
(d) Multicurrency debt instruments.
(1) In general.
(2) Determination of denomination currency.
(3) Issuer/holder consistency.
(4) Treatment of payments in currencies other than the denomination currency.
(e) Instruments issued for nonpublicly traded property.
(1) Applicability.
(2) Separation into components.
(3) Treatment of components consisting of one or more noncontingent payments in the same currency.
(4) Treatment of components consisting of contingent payments.
(5) Basis different from adjusted issue price.
(6) Treatment of holder on sale, exchange, or retirement.
(f) Rules for nonfunctional currency tax exempt obligations described in § 1.1275–4(d).
(g) Effective date.

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### § 1.988–1 Certain definitions and special rules.

(a) *Section 988 transaction*—(1) *In general.* The term ''section 988 transaction'' means any of the following transactions—

(i) A disposition of nonfunctional currency as defined in paragraph (c) of this section;

(ii) Any transaction described in paragraph (a)(2) of this section if any amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.

A transaction described in this paragraph (a) need not require or permit payment with a nonfunctional currency as long as any amount paid or received is determined by reference to the value of one or more nonfunctional currencies. The acquisition of nonfunctional currency is treated as a section 988 transaction for purposes of establishing the taxpayer's basis in such currency and determining exchange gain or loss thereon.

(2) *Description of transactions.* The following transactions are described in this paragraph (a)(2).

(i) *Debt instruments.* Acquiring a debt instrument or becoming an obligor under a debt instrument. The term ''debt instrument'' means a bond, debenture, note, certificate or other evidence of indebtedness.

(ii) *Payables, receivables, etc.* Accruing, or otherwise taking into account, for purposes of subtitle A of the Internal Revenue Code, any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account. A payable relating to cost of goods sold, or a payable or receivable relating to a capital expenditure or receipt, is within the meaning of this paragraph (a)(2)(ii). Generally, a payable relating to foreign taxes (whether or not claimed as a credit under section 901) is within the meaning of this paragraph (a)(2)(ii). However, a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of this paragraph (a)(2)(ii) if the QBU branch's functional currency is the U.S. dollar and the foreign taxes are claimed as a credit under section 901.

(iii) *Forward contract, futures contract, option contract, or similar financial instrument.* Except as otherwise provided in this paragraph (a)(2)(iii) and paragraph (a)(4)(i) of this section, entering into or acquiring any forward contract, futures contract, option, warrant, or similar financial instrument.

(A) *Limitation for certain derivative instruments.* A forward contract, futures contract, option, warrant, or similar financial instrument is within this paragraph (a)(2)(iii) only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or is otherwise described in paragraph (a)(1)(ii) of this section. Thus, if the underlying property of an instrument is another financial instrument (*e.g.*, an option on a futures contract), then the underlying property to which such other instrument (*e.g.*, the futures contract) ultimately relates must be a nonfunctional currency. For example, a forward contract to purchase wheat denominated in a nonfunctional currency, an option to enter into a forward contract to purchase wheat denominated in a nonfunctional currency, or a warrant to purchase stock denominated in a nonfunctional currency is not described in this paragraph (a)(2)(iii). On the other hand, a forward contract to purchase a nonfunctional currency, an option to enter into a forward contract to purchase a nonfunctional currency, an option to purchase a bond denominated in or the payments of which are determined by reference to the value of a nonfunctional currency, or a warrant to purchase nonfunctional currency is described in this paragraph (a)(2)(iii).

(B) *Nonfunctional currency notional principal contracts—(1) In general.* The term ''similar financial instrument'' includes a notional principal contract only if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency.

(*2*) *Definition of notional principal contract.* The term ''notional principal contract'' means a contract (*e.g.*, a swap, cap, floor or collar) that provides

for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this purpose, a ''notional principal contract'' shall only include an instrument where the underlying property to which the instrument ultimately relates is money (*e.g.*, functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate. Thus, the term ''notional principal contract'' includes a currency swap as defined in §1.988–2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.

(C) *Effective date with respect to certain contracts.* This paragraph (a)(2)(iii) does not apply to any forward contract, futures contract, option, warrant, or similar financial instrument entered into or acquired on or before October 21, 1988, if such instrument would have been marked to market under section 1256 if held on the last day of the taxable year.

(3)–(5) [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (a) of this section. The examples assume that X is a U.S. corporation on an accrual method with the calendar year as its taxable year. Because X is a U.S. corporation the U.S. dollar is its functional currency under section 985. The examples also assume that section 988(d) does not apply.

*Example 1.* On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The disposition of the 10,000 Canadian dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

*Example 2.* On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X converts the 10,000 Canadian dollars to U.S. dollars. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

*Example 3.* On January 1, 1989, X borrows 100,000 British pounds (£) for a period of 10 years and issues a note to the lender with a face amount of £100,000. The note provides for payments of interest at an annual rate of 10% paid quarterly in pounds and has a stated redemption price at maturity of £100,000. X's becoming the obligor under the note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(i) of this section. Because X is an accrual basis taxpayer, the accrual of interest expense under X's note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(ii) of this section. In addition, the acquisition of the British pounds to make payments under the note is a section 988 transaction for purposes of establishing X's basis in such pounds, and the disposition of such pounds is a section 988 transaction under paragraph (a)(1)(i) of this section. See §1.988–2(b) with respect to the translation of accrued interest expense and the determination of exchange gain or loss upon payment of accrued interest expense.

*Example 4.* On January 1, 1989, X purchases an original issue for 74,621.54 British pounds (£) a 3-year bond maturing on December 31, 1991, at a stated redemption price of £100,000. The bond provides for no stated interest. The bond has a yield to maturity of 10% compounded semiannually and has £25,378.46 of original issue discount. The acquisition of the bond is a section 988 transaction as provided in paragraphs (a)(1)(ii) and (2)(i) of this section. The accrual of original issue discount with respect to the bond is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. See §1.988–2(b) with respect to the translation of original issue discount and the determination of exchange gain or loss upon receipt of such amounts.

*Example 5.* On January 1, 1989, X sells and delivers inventory to Y for 10,000,000 Italian lira for payment on April 1, 1989. Under X's method of accounting, January 1, 1989 is the accrual date. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of gross receipts on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section.

*Example 6.* On January 1, 1989, X agrees to purchase a machine from Y for delivery on March 1, 1990 for 1,000,000 yen. The agreement calls for X to pay Y for the machine on June 1, 1990. Under X's method of accounting, the expenditure for the machine does not accrue until delivery on March 1, 1990. The agreement to purchase the machine is not a section 988 transaction. In particular, the agreement to purchase the machine is not described in paragraph (a)(2)(ii) of this section because the agreement is not an item of expense taken into account under subtitle A (but rather is an agreement to purchase a capital asset in the future). However, the

payable that will arise on the delivery date is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section even though the payable relates to a capital expenditure. In addition, the disposition of yen to satisfy the payable on June 1, 1990, is a section 988 transaction under paragraph (a)(1)(i) of this section.

*Example 7.* On January 1, 1989, X purchases and takes delivery of inventory for 10,000 French francs with payment to be made on April 1, 1989. Under X's method of accounting, the expense accrues on January 1, 1989. On January 1, 1989, X also enters into a forward contract with a bank to purchase 10,000 French francs for $2,000 on April 1, 1989. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of expense on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. Entering into the forward contract to purchase the 10,000 French francs is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(iii) of this section.

*Example 8.* On January 1, 1989, X acquires 100,000 Norwegian krone. On January 15, 1989, X purchases and takes delivery of 1,000 shares of common stock with the 100,000 krone acquired on January 1, 1989. On August 1, 1989, X sells the 1,000 shares of common stock and receives 120,000 krone in payment. On August 30, 1989, X converts the 120,000 krone to U.S. dollars. The acquisition of the 100,000 krone on January 1, 1989, and the acquisition of the 120,000 krone on August 1, 1989, are section 988 transactions for purposes of establishing the basis of such krone. The disposition of the 100,000 krone on January 15, 1989, and the 120,000 krone on August 30, 1989, are section 988 transactions as provided in paragraph (a)(1)(i) of this section. Neither the acquisition on January 15, 1989, nor the disposition on August 1, 1989, of the stock is a section 988 transaction.

*Example 9.* On May 11, 1989, X purchases a one year note at original issue for its issue price of $1,000. The note pays interest in dollars at the rate of 4 percent compounded semiannually. The amount of principal received by X upon maturity is equal to $1,000 plus the equivalent of the excess, if any, of (a) the Financial Times One Hundred Stock Index (an index of stocks traded on the London Stock Exchange hereafter referred to as the FT100) determined and translated into dollars on the last business day prior to the maturity date, over (b) £2,150, the ''stated value'' of the FT100, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the exchange rate of £1=$1.50. The purchase by X of the instrument described above is not a section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not nonfunctional currency.

*Example 10.* On April 9, 1989, X enters into an interest rate swap that provides for the payment of amounts by X to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. Pursuant to paragraphs (a)(1)(ii) and (2)(iii) of this section, this yen for yen interest rate swap is a section 988 transaction.

*Example 11.* On August 11, 1989, X enters into an option contract for sale of a group of stocks traded on the Japanese Nikkei exchange. The contract is not a section 988 transaction within the meaning of §1.988–1(a)(2)(iii) because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

(7) *Special rules for regulated futures contracts and non-equity options*—(i) *In general.* Except as provided in paragraph (a)(7)(ii) of this section, paragraph (a)(2)(iii) of this section shall not apply to any regulated futures contract or non-equity option which would be marked to market under section 1256 if held on the last day of the taxable year.

(ii) *Election to have paragraph (a)(2)(iii) of this section apply.* Notwithstanding paragraph (a)(7)(i) of this section, a taxpayer may elect to have paragraph (a)(2)(iii) of this section apply to regulated futures contracts and non-equity options as provided in paragraphs (a)(7)(iii) and (iv) of this section.

(iii) *Procedure for making the election.* A taxpayer shall make the election provided in paragraph (a)(7)(ii) of this section by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''Election to Treat Regulated Futures Contracts and Non-Equity Options as Section 988 Transactions Under Section 988 (c)(1)(D)(ii)'' that contains the following:

(A) The taxpayer's name, address, and taxpayer identification number;

(B) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(C) A statement that the taxpayer (including all members of such person's affiliated group as defined in section 1504 or in the case of an individual all persons filing a joint return with such individual) elects to have section

988(c)(1)(D)(i) and §1.988–1(a)(7)(i) not apply;

(D) The date of the beginning of the taxable year for which the election is being made;

(E) If the election is filed after the first day of the taxable year, a statement regarding whether the taxpayer has previously held a contract described in section 988(c)(1)(D)(i) or §1.988–1(a)(7)(i) during such taxable year, and if so, the first date during the taxable year on which such contract was held; and

(F) The signature of the person making the election (in the case of individuals filing a joint return, the signature of all persons filing such return).

The election shall be made by the following persons: in the case of an individual, by such individual; in the case of a partnership, by each partner separately; effective for taxable years beginning after March 17, 1992, in the case of tiered partnerships, each ultimate partner; in the case of an S corporation, by each shareholder separately; in the case of a trust (other than a grantor trust) or estate, by the fiduciary of such trust or estate; in the case of any corporation other than an S corporation, by such corporation (in the case of a corporation that is a member of an affiliated group that files a consolidated return, such election shall be valid and binding only if made by the common parent, as that term is used in §1.1502–77(a)); in the case of a controlled foreign corporation, by its controlling United States shareholders under §1.964–1(c)(3). With respect to a corporation (other than an S corporation), the election, when made by the common parent, shall be binding on all members of such corporation's affiliated group as defined in section 1504 that file a consolidated return. The election shall be binding on any income or loss derived from the partner's share (determined under the principles of section 702(a)) of all contracts described in section 988(c)(1)(D)(i) or paragraph (a)(7)(i) of this section in which the taxpayer holds a direct interest or indirect interest through a partnership or S corporation; however, the election shall not apply to any income or loss of a partnership for any taxable year if such partnership made an election under section 988(c)(1)(E)(iii)(V) for such year or any preceding year. Generally, a copy of the election must be attached to the taxpayer's income tax return for the first year it is effective. It is not required to be attached to subsequent returns. However, in the case of a partner, a copy of the election must be attached to the taxpayer's income tax return for every year during which the taxpayer is a partner in a partnership that engages in a transaction that is subject to the election.

(iv) *Time for making the election*—(A) *In general.* Unless the requirements for making a late election described in paragraph (a)(7)(iv)(B) of this section are satisfied, an election under section 988 (c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section. The election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section shall apply to contracts entered into or acquired after October 21, 1988, and held on or after the effective date of the election. The election shall be effective as of the beginning of the taxable year and shall be binding with respect to all succeeding taxable years unless revoked with the prior consent of the Commissioner. In determining whether to grant revocation of the election, recapture of the tax benefit derived from the election in previous taxable years will be considered.

(B) *Late elections.* A taxpayer may make an election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section within 30 days after the time prescribed in the first sentence of paragraph (a)(7)(iv)(A) of this section. Such a late election shall be effective as of the beginning of the taxable year; however, any losses recognized during the taxable year with respect to contracts described in section 988(c)(1)(D)(ii) or paragraph (a)(7)(ii) of this section which were entered into or acquired after October 21, 1988, and held on or before the date on which the

late election is mailed or otherwise delivered to the Internal Revenue Service Center shall not be treated as derived from a section 988 transaction. A late election must comply with the procedures set forth in paragraph (a)(7)(iii) of this section.

(v) *Transition rule.* An election made prior to September 21, 1989 which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of paragraphs (a)(7)(iii) and (iv) of this section.

(vi) *General effective date provision.* This paragraph (a)(7) shall apply with respect to futures contracts and options entered into or acquired after October 21, 1988.

(8) *Special rules for qualified funds*—(i) *Definition of qualified fund.* The term ''qualified fund'' means any partnership if—

(A) At all times during the taxable year (and during each preceding taxable year to which an election under section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 percent of the interests in the capital or profits of the partnership;

(B) The principa1 activity of such partnership for such taxable year (and each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;

(C) At least 90 percent of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains described in subparagraph (A), (B), or (G) of section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;

(D) No more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and

(E) An election under section 988 (c)(1)(E)(iii)(V) as provided in paragraph (a)(8)(iv) of this section applies to the taxable year.

(ii) *Special rules relating to paragraph (a)(8)(i)(A) of this section*—(A) *Certain general partners.* The interest of a general partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section for any taxable year of the partnership if, for the taxable year of the partner in which such partnership's taxable year ends, such partner (and each corporation filing a consolidated return with such partner) had no ordinary income or loss from a section 988 transaction (other than income from the partnership) which is exchange gain or loss (as the case may be).

(B) *Treatment of incentive compensation.* For purposes of paragraph (a)(8)(i)(A) of this section, any income allocable to a general partner as incentive compensation based on profits rather than capital shall not be taken into account in determining such partner's interest in the profits of the partnership.

(C) *Treatment of tax exempt partners.* The interest of a partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirements of paragraph (a)(5)(8)(A) of this section if none of the income of such partner from such partnership is subject to tax under chapter 1 of subtitle A of the Internal Revenue Code (whether directly or through one or more pass-through entities).

(D) *Look-through rule.* In determining whether the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section is met with respect to any partnership, any interest in such partnership held by another partnership shall be treated as held proportionately by the partners in such other partnership.

(iii) *Other special rules*—(A) *Related persons.* Interests in the partnership held by persons related to each other (within the meaning of section 267(b) or 707(b)) shall be treated as held by one person.

(B) *Predecessors.* Reference to any partnership shall include a reference to any predecessor thereof.

(C) *Treatment of certain debt instruments.* Solely for purposes of paragraph (a)(8)(i)(D) of this section, any debt instrument which is described in both paragraphs (a)(1)(ii) and (2)(i) of this section shall be treated as a commodity.

(iv) *Procedure for making the election provided in section 988(c)(1)(E)(iii)(V).* A

partnership shall make the election provided in section 988(c)(1)(E)(iii)(V) by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''QUALIFIED FUND ELECTION UNDER SECTION 988(c)(1)(E)(iii)(V)'' that contains the following:

(A) The partnership's name, address, and taxpayer identification number;

(B) The name, address and taxpayer identification number of the general partner making the election on behalf of the partnership;

(C) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(D) A brief description of the activity of the partnership;

(E) A statement that the partnership is making the election provided in section 988(c)(1)(E)(iii)(V);

(F) The date of the beginning of the taxable year for which the election is being made;

(G) If the election is filed after the first day of the taxable year, then a statement regarding whether the partnership previously held an instrument referred to in section 988(c)(1)(E)(i) during such taxable year and, if so, the first date during the taxable year on which such contract was held; and

(H) The signature of the general partner making the election.

The election shall be made by a general partner with management responsibility of the partnership's activities and a copy of such election shall be attached to the partnership's income tax return (Form 1065) for the first taxable year it is effective. It is not required to be attached to subsequent returns.

(v) *Time for making the election.* The election under section 988(c)(1)(E)(iii)(V) for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such year on which the partnership holds an instrument described in section 988(c)(1)(E)(i). The election under section 988(c)(1)(E)(iii)(V) shall apply to the taxable year for which made and all succeeding taxable years. Such election may only be revoked with the consent of the Commissioner. In determining whether to grant revocation of the election, recapture by the partners of the tax benefit derived from the election in previous taxable years will be considered.

(vi) *Operative rules applicable to qualified funds*—(A) *In general.* In the case of a qualified fund, any bank forward contract or any foreign currency futures contract traded on a foreign exchange which is not otherwise a section 1256 contract shall be treated as a section 1256 contract for purposes of section 1256.

(B) *Gains and losses treated as short-term.* In the case of any instrument treated as a section 1256 contract under paragraph (a)(8)(vi)(A) of this section, subparagraph (A) of section 1256(a)(3) shall be applied by substituting ''100 percent'' for ''40 percent'' (and subparagraph (B) of such section shall not apply).

(vii) *Transition rule.* An election made prior to September 21, 1989, which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of §1.988–1(a)(8)(iv) and (v).

(viii) *General effective date rules*—(A) The requirements of subclause (IV) of section 988(c)(1)(E)(iii) shall not apply to contracts entered into or acquired on or before October 21, 1988.

(B) In the case of any partner in an existing partnership, the 20 percent ownership requirements of subclause (I) of section 988(c)(1)(E)(iii) shall be treated as met during any period during which such partner does not own a percentage interest in the capital or profits of such partnership greater than 33⅓ percent (or, if lower, the lowest such percentage interest of such partner during any period after October 21, 1988, during which such partnership is in existence). For purposes of the preceding sentence, the term ''existing partnership'' means any partnership if—

(*1*) Such partnership was in existence on October 21, 1988, and principally engaged on such date in buying and selling options, futures, or forwards with respect to commodities; or

(*2*) A registration statement was filed with respect to such partnership with the Securities and Exchange Commission on or before such date and such registration statement indicated that

the principal activity of such partnership will consist of buying and selling instruments referred to in paragraph (a)(8)(viii)(B)(*1*) of this section.

(9) *Exception for certain transactions entered into by an individual*—(i) *In general.* A transaction entered into by an individual which otherwise qualifies as a section 988 transaction shall be considered a section 988 transaction only to the extent expenses properly allocable to such transaction meet the requirements of section 162 or 212 (other than the part of section 212 dealing with expenses incurred in connection with taxes).

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(9) of this section.

*Example 1.* X is a U.S. citizen who therefore has the U.S. dollar as his functional currency. On January 1, 1990, X enters into a spot contract to purchase 10,000 British pounds (£) for $15,000 for delivery on January 3, 1990. Immediately upon delivery, X acquires at original issue a pound denominated bond with an issue price of £10,000. The bond matures on January 3, 1993, pays interest in pounds at a rate of 10% compounded semiannually, and has no original issue discount. Assume that all expenses properly allocable to these transactions would meet the requirements of section 212. Under §1.988–2(d)(1)(ii), entering into the spot contract on January 1, 1990, is not a section 988 transaction. The acquisition of the pounds on January 3, 1990, under the spot contract is a section 988 transaction for purposes of establishing X's basis in the pounds. The disposition of the pounds and the acquisition of the bond by X are section 988 transactions. These transactions are not excluded from the definition of a section 988 transaction under paragraph (a)(9) of this section because expenses properly allocable to such transactions meet the requirements of section 212.

*Example 2.* X is a U.S. citizen who therefore has the dollar as his functional currency. In preparation for X's vacation, X purchases 1,000 British pounds (£) from a bank on June 1, 1989. During the period of X's vacation in the United Kingdom beginning June 10, 1989, and ending June 20, 1989, X spends £500 for hotel rooms, £300 for food and £200 for miscellaneous vacation expenses. The expenses properly allocable to such dispositions do not meet the requirements of section 162 or 212. Thus, the disposition of the pounds by X on his vacation are not section 988 transactions.

(10) *Intra-taxpayer transactions*—(i) *In general.* Except as provided in paragraph (a)(10)(ii) of this section, transactions between or among the taxpayer and/or qualified business units of that taxpayer (''intra-taxpayer transactions'') are not section 988 transactions. See section 987 and the regulations thereunder.

(ii) *Certain transfers.* Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon an intra-taxpayer transfer of such currency or item where as the result of the transfer the currency or other such item—

(A) Loses its character as nonfunctional currency or an item described in paragraph (a)(2) of this section; or

(B) Where the source of the exchange gain or loss could be altered absent the application of this paragraph (a)(10)(ii).

Such exchange gain or loss shall be computed in accordance with §1.988–2 (without regard to §1.988–2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use the translation rate that it uses for purposes of computing section 987 gain or loss with respect to the QBU branch that makes the transfer. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner, may defer such gain or loss.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(10).

*Example.* (A) X, a corporation with the U.S. dollar as its functional currency, operates through foreign branches Y and Z. Y and Z are qualified business units as defined in section 989(a) with the LC as their functional currency. X computes Y's and Z's income under section 987 (relating to branch transactions). On November 12, 1988, Y transfers $25 to the home office of X when the fair market value of such amount equals LC120. Y has a basis of LC100 in the $25. Under paragraph (a)(10)(ii) of this section, Y realizes foreign source exchange gain of LC20 (LC120—LC100) as the result of the $25 transfer. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(B) If instead Y transfers the $25 to Z, exchange gain is not realized because the $25 is nonfunctional currency with respect to Z and if Z were to immediately convert the $25 into LCs, the gain would be foreign source. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(11) *Authority to include or exclude transactions from section 988*—(i) *In general.* The Commissioner may recharacterize a transaction (or series of transactions) in whole or in part as a section 988 transaction if the effect of such transaction (or series of transactions) is to avoid section 988. In addition, the Commissioner may exclude a transaction (or series of transactions) which in form is a section 988 transaction from the provisions of section 988 if the substance of the transaction (or series of transactions) indicates that it is not properly considered a section 988 transaction.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(11).

*Example.* B is an individual with the U.S. dollar as its functional currency. B holds 500,000 Swiss francs which have a basis of $100,000 and a fair market value of $400,000 as of October 15, 1989. On October 16, 1989, B transfers the 500,000 Swiss francs to a newly formed U.S. corporation, X, with the dollar as its functional currency. On October 16, 1989, B sells the stock of X for $400,000. Assume the transfer to X qualified for nonrecognition under section 351. Because the sale of the stock of X is a substitute for the disposition of an asset subject to section 988, the Commissioner may recharacterize the sale of the stock as a section 988 transaction. The same result would obtain if B transferred the Swiss francs to a partnership and then sold the partnership interest.

(b) *Spot contract.* A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract. See §1.988–2 (d)(1)(ii) for operative rules regarding spot contracts.

(c) *Nonfunctional currency.* The term ''nonfunctional currency'' means with respect to a taxpayer or a qualified business unit (as defined in section 989 (a)) a currency (including the European Currency Unit) other than the taxpayer's or the qualified business unit's functional currency as defined in section 985 and the regulations thereunder. For rules relating to nonrecognition of exchange gain or loss with respect to certain dispositions of nonfunctional currency, see §1.988–2 (a)(1)(iii).

(d) *Spot rate*—(1) *In general.* Except as otherwise provided in this paragraph, the term ''spot rate'' means a rate demonstrated to the satisfaction of the District Director or the Assistant Commissioner (International) to reflect a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. In the absence of such a demonstration, the District Director or the Assistant Commissioner (International), in his or her sole discretion, shall determine the spot rate from a source of exchange rate information reflecting actual transactions conducted in a free market. For example, the taxpayer or the District Director or the Assistant Commissioner (International) may determine the spot rate by reference to exchange rates published in the pertinent monthly issue of ''International Financial Statistics'' or a successor publication of the International Monetary Fund; exchange rates published by the Board of Governors of the Federal Reserve System pursuant to 31 U.S.C. section 5151; exchange rates published in newspapers, financial journals or other daily financial news sources; or exchange rates quoted by electronic financial news services.

(2) *Consistency required in valuing transactions subject to section 988.* If the use of inconsistent sources of spot rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate spot rate.

(3) *Use of certain spot rate conventions for payables and receivables denominated in nonfunctional currency.* If consistent with the taxpayer's financial accounting, a taxpayer may utilize a spot rate convention determined at intervals of one quarter year or less for purposes of computing exchange gain or loss with respect to payables and receivables denominated in a nonfunctional currency that are incurred in the ordinary course of business with respect to the

acquisition or sale of goods or the obtaining or performance of services. For example, if consistent with the taxpayer's financial accounting, a taxpayer may accrue all payables and receivables incurred during the month of January at the spot rate on December 31 or January 31 (or at an average of any spot rates occurring between these two dates) and record the payment or receipt of amounts in satisfaction of such payables and receivables consistent with such convention. The use of a spot rate convention cannot be changed without the consent of the Commissioner.

(4) *Currency where an official government established rate differs from a free market rate*—(i) *In general.* If a currency has an official government established rate that differs from a free market rate, the spot rate shall be the rate which most clearly reflects the taxpayer's income. Generally, this shall be the free market rate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (d)(4).

*Example 1.* X is an accrual method U.S. corporation with the dollar as its functional currency. X owns all the stock of a Country L subsidiary, CFC. CFC has the currency of Country L, the LC, as its functional currency. Country L imposes restrictions on the remittance of dividends. On April 1, 1990, CFC pays a dividend to X in the amount of LC100. Assume that the official governnent established rate is $1=LC1 and the free market rate, which takes into account the remittance restrictions and which is the rate that most clearly reflects income, is $1=LC4. On April 1, 1990, X donates the LC100 in a transaction that otherwise qualifies as a charitable contribution under section 170 (c). Both the amount of the dividend income and the deduction under section 170 is $25 (LC100 × the free market rate, $.25).

*Example 2.* X, a corporation with the U.S. dollar as its functional currency, operates in foreign country L through branch Y. Y is a qualified business unit as defined in section 989 (a). X computes Y's income under the dollar approximate separate transactions method as described in § 1.985–3. The currency of L is the LC. X can purchase legally United States dollars ($) in L only from the L government. In order to take advantage of an arbitrage between the official and secondary dollar to LC exchange rates in L:

(i) X purchases LC100 for $60 in L on the secondary market when the official exchange rate is S1=LC1;

(ii) X transfers the LC100 to Y;

(iii) Y purchases $100 for LC100; and

(iv) Y transfers $65 ($100 less an L tax withheld of $35 on the transfer) to the home office of X.

Under paragraph (a)(7) of this section, the transfer of the LC100 by X to Y is a realization event. X has a basis of $60 in the LC100. Under these facts, the appropriate dollar to LC exchange rate for computing the amount realized by X is the official exchange rate. Therefore, X realizes $40 ($100–$60) of U.S. source gain from the transfer to Y. The same result would obtain if Y rather than X purchased the LC100 on the secondary market in L with $60 supplied by X, because the substance of this transaction is that X is performing the arbitrage.

(e) *Exchange gain or loss.* The term ''exchange gain or loss'' means the amount of gain or loss realized as determined in § 1.988–2 with respect to a section 988 transaction. Except as otherwise provided in these regulations (*e.g.*, § 1.98B–5), the amount of exchange gain or loss from a section 988 transaction shall be separately computed for each section 988 transaction, and such amount shall not be integrated with gain or loss recognized on another transaction (whether or not such transaction is economically related to the section 988 transaction). See § 1.988–2 (b)(8) for a special rule with respect to debt instruments.

(f) *Hyperinflationary currency*—(1) *Definition*—(i) *General rule.* For purposes of section 988, a hyperinflationary currency means a currency described in § 1.985–1(b)(2)(ii)(D). Unless otherwise provided, the currency in any example used in §§ 1.988–1 through 1.988–5 is not a hyperinflationary currency.

(ii) *Special rules for determining base period.* In determining whether a currency is hyperinflationary under § 1.985–1(b)(2)(ii)(D) for purposes of this paragraph (f), the following rules will apply:

(A) The base period means the thirty-six calendar month period ending on the last day of the taxpayer's (or qualified business unit's) current taxable year. Thus, for example, if for 1996, 1997, and 1998, a country's annual inflation rates are 6 percent, 11 percent, and 90 percent, respectively, the cumulative inflation rate for the three-year base period is 124% [((1.06 × 1.11 × 1.90) − 1.0 = 1.24) × 100 = 124%]. Accordingly, assuming the QBU has a calendar year

as its taxable year, the currency of the country is hyperinflationary for the 1998 taxable year. This change in the §1.985–1(b)(2)(ii)(D) base period shall not apply to any section 988 transaction of an entity described in section 851 (regulated investment company (RIC)) or section 856 (real estate investment trust (REIT)). The Service may, by notice, provide that the foregoing change in the §1.985–1(b)(2)(ii)(D) base period does not apply to any section 988 transaction of an entity with distribution requirements similar to a RIC or REIT.

(B) The last sentence of §1.985–1(b)(2)(ii)(D) shall not apply to alter the base period for purposes of this paragraph (f) in determining whether a currency is hyperinflationary for purposes of section 988. Accordingly, generally accepted accounting principles may not apply to alter the base period for purposes of this paragraph (f).

(2) *Effective date.* Paragraph (f)(1) of this section shall apply to transactions entered into after February 14, 2000.

(g) *Fair market value.* The fair market value of an item shall, where relevant, reflect an appropriate premium or discount for the time value of money (*e.g.*, the fair market value of a forward contract to buy or sell nonfunctional currency shall reflect the present value of the difference between the units of nonfunctional currency times the market forward rate at the time of valuation and the units of nonfunctional currency times the forward rate set forth in the contract). However, if consistent with the taxpayer's method of financial accounting (and consistently applied from year to year), the preceding sentence shall not apply to a financial instrument that matures within one year from the date of issuance or acquisition. Unless otherwise provided, the fair market value given in any example used in §§1.988–1 through 1.988–5 is deemed to reflect appropriately the time value of money. If the use of inconsistent sources of forward or other market rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate rate.

(h) *Interaction with sections 1092 and 1256.* Unless otherwise provided, it is assumed for purposes of §§1.988–1 through 1.988–5 that any contract used in any example is not a section 1256 contract and is not part of a straddle as defined in section 1092. No inference is intended regarding the application of section 1092 or 1256 unless expressly stated.

(i) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

[T.D. 8400, 57 FR 9178, Mar. 17, 1992, as amended by T.D. 8914, 66 FR 280, Jan. 3, 2001]

### §1.988–2 Recognition and computation of exchange gain or loss.

(a) *Disposition of nonfunctional currency*—(1) *Recognition of exchange gain or loss*—(i) *In general.* Except as otherwise provided in this section, §1.988–1(a)(7)(ii), and §1.988–5, the recognition of exchange gain or loss upon the sale or other disposition of nonfunctional currency shall be governed by the recognition provisions of the Internal Revenue Code which apply to the sale or disposition of property (*e.g.*, section 1001 or, to the extent provided in regulations, section 1092). The disposition of nonfunctional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the nonfunctional currency for purposes of the preceding sentence.

(ii) *Clarification of section 1031.* An amount of one nonfunctional currency is not ''property of like kind'' with respect to an amount of a different nonfunctional currency.

(iii) *Coordination with section 988(c)(1)(C)(ii).* No exchange gain or loss is recognized with respect to the following transactions—

(A) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency;

(B) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or

other financial institution if such instrument is denominated in such currency;

(C) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

(D) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

(E) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

The taxpayer's basis in the units of nonfunctional currency or other property received in the transaction shall be the adjusted basis of the units of nonfunctional currency or other property transferred. See paragraph (b) of this section with respect to the timing of interest income or expense and the determination of exchange gain or loss thereon.

(iv) *Example.* The following example illustrates the provisions of paragraph (a)(1)(iii) of this section.

*Example.* X is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 1989, X acquires 1,500 British pounds (£) for $2,250 (£1 = $1.50). On January 3, 1989, when the spot rate is £1 = $1.49, X deposits the £1,500 with a British financial institution in a non-interest bearing demand account. On February 1, 1989, when the spot rate is £1 = $1.45, X withdraws the £1,500. On February 5, 1989, when the spot rate is £1 = $1.42, X purchases inventory in the amount of £1,500. Pursuant to paragraph (a)(1)(iii) of this section, no exchange loss is realized until February 5, 1989, when X disposes of the £1,500 for inventory. At that time, X realizes exchange loss in the amount of $120 computed under paragraph (a)(2) of this section. The loss is not an adjustment to the cost of the inventory.

(2) *Computation of gain or loss*—(i) *In general.* Exchange gain realized from the sale or other disposition of nonfunctional currency shall be the excess of the amount realized over the adjusted basis of such currency, and exchange loss realized shall be the excess of the adjusted basis of such currency over the amount realized.

(ii) *Amount realized*—(A) *In general.* The amount realized from the disposition of nonfunctional currency shall be determined under section 1001(b). A taxpayer that uses a spot rate convention under §1.988–1(d)(3) to determine exchange gain or loss with respect to a payable shall determine the amount realized upon the disposition of nonfunctional currency paid in satisfaction of the payable in a manner consistent with such convention.

(B) *Exchange of nonfunctional currency for property.* For purpose of paragraph (a)(2) of this section, the exchange of nonfunctional currency for property (other than nonfunctional currency) shall be treated as—

(*1*) An exchange of the units of nonfunctional currency for units of functional currency at the spot rate on the date of the exchange, and

(*2*) The purchase or sale of the property for such units of functional currency.

(C) *Example.* The following example illustrates the provisions of paragraph (a)(2)(ii)(B) of this section.

*Example.* G is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1989, G enters into a contract to purchase a paper manufacturing machine for 10,000,000 British pounds (£) for delivery on January 1, 1991. On January 1, 1991, when G exchanges £10,000,000 (which G purchased for $12,000,000) for the machine, the fair market value of the machine is £17,000,000. On January 1, 1991, the spot exchange rate is £1 = $1.50. Under paragraph (a)(2)(ii)(B) of this section, the transaction is treated as an exchange of £10,000,000 for $15,000,000 and the purchase of the machine for $15,000,000. Accordingly, in computing G's exchange gain of $3,000,000 on the disposition of the £10,000,000, the amount realized is $15,000,000. G's basis in the machine is $15,000,000. No gain is recognized on the bargain purchase of the machine.

(iii) *Adjusted basis*—(A) *In general.* Except as provided in paragraph (a)(2)(iii)(B) of this section, the adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code

(*e.g.*, sections 1011 through 1023). A taxpayer that uses a spot rate convention under §1.988–1 (d)(3) to determine exchange gain or loss with respect to a receivable shall determine the basis of nonfunctional currency received in satisfaction of such receivable in a manner consistent with such convention.

(B) *Determination of the basis of nonfunctional currency withdrawn from an account with a bank or other financial institution—(1) In general.* The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution shall be determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method (as illustrated in the example below), or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first shall not be considered reasonable.

(*2*) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iii)(B).

*Example.* (i) X, a cash basis individual with the dollar as his functional currency, opens a demand account with a Swiss bank. Assume expenses associated with the demand account are deductible under section 212. The following chart indicates Swiss franc deposits to the account, Swiss franc interest credited to the account, the dollar basis of each deposit, and the determination of the aggregate dollar basis of all Swiss francs in the account. Assume that the taxpayer has properly translated all the amounts specified in the chart and that all transactions are subject to section 988.

| Date | Swiss francs deposited | Interest received | U.S. dollar basis | Aggregate U.S. dollar basis |
|---|---|---|---|---|
| 1/01/89 | 1000 Sf | | $500 | $500 |
| 3/31/89 | | 50 Sf | 25 | 525 |
| 6/30/89 | | 50 Sf | 24 | 549 |
| 9/30/89 | | 50 Sf | 25 | 574 |
| 12/31/89 | | 50 Sf | 26 | 600 |

(ii) On January 1, 1990, X withdraws 500 Swiss francs from the account. X may determine his basis in the Swiss francs by multiplying the aggregate U.S. dollar basis of Swiss francs in the account by a fraction the numerator of which is the number of Swiss francs withdrawn from the account and the denominator is the total number of Swiss francs in the account. Under this method, X's basis in the 500 Swiss francs is $250 computed as follows:

$$\frac{500\ \text{Sf}}{1200\ \text{Sf}} \times \$600 = \$250$$

(iii) X's basis in the Swiss francs remaining in the account is $350 ($600 − $250). X must use this method consistently from year to year with respect to withdrawals of nonfunctional currency from all of X's accounts.

(iv) Purchase and sale of stock or securities traded on an established securities market by cash basis taxpayer—

(A) *Amount realized.* If stock or securities traded on an established securities market are sold by a cash basis taxpayer for nonfunctional currency, the amount realized with respect to the stock or securities (as determined on the trade date) shall be computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. This rule applies notwithstanding that the stock or securities are treated as disposed of on a date other than the settlement date under another section of the Code. See section 453(k).

(B) *Basis.* If stock or securities traded on an established securities market are purchased by a cash basis taxpayer for nonfunctional currency, the basis of the stock or securities shall be determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase.

(C) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iv).

*Example.* On November 1, 1989 (the trade date), X, a calendar year cash basis U.S. individual, purchases stock for £100 for settlement on November 5, 1989. On November 1, 1989, the spot value of the £100 is $140. On November 5, 1989, X purchases £100 for $141 which X uses to pay for the stock. X's basis in the stock is $141. On December 30, 1990 (the

trade date), X sells the stock for £110 for settlement on January 5, 1991. On December 30, 1990, the spot value of £110 is $165. On January 5, 1991, X transfers the stock and receives £110 which, translated at the spot rate, equal $166. Under section 453(k), the stock is considered disposed of on December 30, 1990. The amount realized with respect to such disposition is the value of the £110 on January 5, 1991 ($166). Accordingly, X's gain realized on December 30, 1990, from the disposition of the stock is $25 ($166 amount realized less $141 basis). X's basis in the £110 received from the sale of the stock is $166.

(v) *Purchase and sale of stock or securities traded on an established securities market by accrual basis taxpayer.* For taxable years beginning after March 17, 1992, an accrual basis taxpayer may elect to apply the rules of paragraph (a)(2)(iv) of this section. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently from year to year and cannot be changed without the consent of the Commissioner.

(b) *Translation of interest income or expense and determination of exchange gain or loss with respect to debt instruments*—(1) *Translation of interest income received with respect to a nonfunctional currency demand account.* Interest income received with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency shall be translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year. No exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account subject to this paragraph (b)(1).

(2) *Translation of nonfunctional currency interest income or expense received or paid with respect to a debt instrument described in § 1.988–1(a)(1)(ii) and (2)(i)*—(i) *Scope*—(A) *In general.* Paragraph (b) of this section only applies to debt instruments described in § 1.988–1(a)(1)(ii) and (2)(i) where all payments are denominated in, or determined with reference to, a single nonfunctional currency. Except as provided in paragraph (b)(2)(i)(B) of this section, this paragraph (b) shall not apply to contingent payment debt instruments.

(B) *Nonfunctional currency contingent payment debt instruments*—(*1*) *Operative rules.* See § 1.988–6 for rules applicable to contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

(*2*) *Certain instruments are not contingent payment debt instruments.* For purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder, a debt instrument does not provide for contingent payments merely because the instrument is denominated in, or all payments of which are determined with reference to, a single nonfunctional currency. See § 1.988–6 for the treatment of nonfunctional currency contingent payment debt instruments.

(ii) *Determination and translation of interest income or expense*—(A) *In general.* Interest income or expense on a debt instrument described in paragraph (b)(2)(i) of this section (including original issue discount determined in accordance with sections 1271 through 1275 and 163(e) as adjusted for acquisition premium under section 1272(a)(7), and acquisition discount determined in accordance with sections 1281 through 1283) shall be determined in units of nonfunctional currency and translated into functional currency as provided in paragraphs (b)(2)(ii)(B) and (C) of this section. For purposes of sections 483, 1273(b)(5) and 1274, the nonfunctional currency in which an instrument is denominated (or by reference to which payments are determined) shall be considered money.

(B) *Translation of interest income or expense that is not required to be accrued prior to receipt or payment.* With respect

to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense received or paid that is not required to be accrued by the taxpayer prior to receipt or payment shall be translated at the spot rate on the date of receipt or payment. No exchange gain or loss is realized with respect to the receipt or payment of such interest income or expense (other than the exchange gain or loss that might be realized under paragraph (a) of this section upon the disposition of the nonfunctional currency so received or paid).

(C) *Translation of interest income or expense that is required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense that is required to be accrued prior to receipt or payment (*e.g.*, under section 1272, 1281 or 163(e) or because the taxpayer uses an accrual method of accounting) shall be translated at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the partial period within the taxable year. See paragraphs (b)(3) and (4) of this section for the determination of exchange gain or loss on the receipt or payment of accrued interest income or expense.

(iii) *Determination of average rate or other accrual convention*—(A) *In general.* For purposes of this paragraph (b), the average rate for an accrual period (or partial period) shall be a simple average of the spot exchange rates for each business day of such period or other average exchange rate for the period reasonably derived and consistently applied by the taxpayer.

(B) *Election to use spot accrual convention.* For taxable years beginning after March 17, 1992, a taxpayer may elect to translate interest income and expense at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently to all debt instruments from year to year and cannot be changed without the consent of the Commissioner.

(3) *Exchange gain or loss recognized by the holder with respect to accrued interest income.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest income shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest income received with respect to such accrual period (as determined under the ordering rules of paragraph (b)(7) of this section) into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of), and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the accrual period.

(4) *Exchange gain or loss recognized by the obligor with respect to accrued interest expense.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest expense on the date such

accrued interest expense is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest expense shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest expense is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest expense accrued with respect to the amount of interest paid into functional currency at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for such accrual period; and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest paid (or, if the obligation to make payments is extinguished or transferred, the units accrued) with respect to such accrual period (as determined under the ordering rules in paragraph (b)(7) of this section) into functional currency at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(5) *Exchange gain or loss recognized by the holder of a debt instrument with respect to principal.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the holder acquired the instrument in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal amount shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

(6) *Exchange gain or loss recognized by the obligor of a debt instrument with respect to principal.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the obligor became the obligor in

a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to such obligor shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the obligor is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date the obligor (or a transferor from whom the principal amount is carried over) became the obligor (or is deemed to have become the obligor); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(7) *Payment ordering rules*—(i) *Debt instruments subject to the rules of sections 163(e), or 1271 through 1288.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is subject to the rules of sections 163(e), or 1272 through 1288, units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument shall be treated first as a receipt or payment of periodic interest under the principles of section 1273 and the regulations thereunder, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal. Units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) treated as a receipt or payment of original issue discount under the preceding sentence are attributed to the earliest accrual period in which original issue discount has accrued and to which prior receipts or payments have not been attributed. No portion thereof shall be treated as prepaid interest. These rules are illustrated by *Example 10* of paragraph (b)(9) of this section.

(ii) *Other debt instruments.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is not subject to the rules of section 163(e) or 1272 through 1288, whether units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument are treated as interest or principal shall be determined under section 163 or other applicable section of the Code.

(8) *Limitation of exchange gain or loss on payment or disposition of a debt instrument.* When a debt instrument described in paragraph (b)(2)(i) of this section is paid or disposed of, or when the obligation to make payments thereunder is satisfied by another person, or extinguished or assumed by another person, exchange gain or loss is computed with respect to both principal and any accrued interest (including original issue discount), as provided in paragraph (b)(3) through (7) of this section. However, pursuant to section 988(b)(1) and (2), the sum of any exchange gain or loss with respect to the principal and interest of any such debt instrument shall be realized only to the extent of the total gain or loss realized on the transaction. The gain or loss realized shall be recognized in accordance with the general principles of the Code. See *Examples 3, 4* and *6* of paragraph (b)(9) of this section.

(9) *Examples.* The preceding provisions are illustrated in the following examples. The examples assume that any transaction involving an individual is a section 988 transaction.

*Example 1.* (i) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1992, X converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 1992, 1993, and 1994, and will repay X's £10,000 principal on December 31, 1994. Assume the spot rates for the pertinent dates are as follows:

| Date | Spot rate (pounds to dollars) |
|---|---|
| Jan. 1, 1992 | £1=$1.30 |
| Dec. 31, 1992 | £1=$1.35 |

| Date | Spot rate (pounds to dollars) |
|---|---|
| Dec. 31, 1993 | £1=$1.40 |
| Dec. 31, 1994 | £1=$1.45 |

(ii) Under paragraph (b)(2)(ii)(B) of this section, X will translate the £1,000 interest payments at the spot rate on the date received. Accordingly, X will have interest income of $1,350 in 1992, $1,400 in 1993, and $1,450 in 1994. Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of interest income.

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at the spot rate on the date it is received (£10,000×$1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000×$1.30 = $13,000). Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 1994.

*Example 2.* (i) Assume the same facts as in *Example 1* except that X is an accrual method taxpayer and that average rates are as follows:

| Accrual period | Average rate (pounds to dollars) |
|---|---|
| 1992 | £1=$1.32 |
| 1993 | £1=$1.37 |
| 1994 | £1=$1.42 |

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will accrue the £1,000 interest payments at the average rate for the accrual period. Accordingly, X will have interest income of $1,320 in 1992, $1,370 in 1993, and $1,420 in 1994. Because X is an accrual basis taxpayer, X determines exchange gain or loss for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting the amounts of interest income accrued for such period. Thus, X will realize $90 of exchange gain with respect to interest received under the loan, computed as follows:

| Year | Spot value interest received | Accrued interest @ average rate | Exch. gain |
|---|---|---|---|
| 1992 | $1,350 | $1,320 | $30 |
| 1993 | 1,400 | 1,370 | 30 |
| 1994 | 1,450 | 1,420 | 30 |
| Total | | | $90 |

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

*Example 3.* Assume the same facts as in *Example 1* except that X is a calendar year taxpayer on the accrual method of accounting that elects to use a spot rate convention to translate interest income as provided in §1.988–2(b)(2)(iii)(B). Interest income is received by X on the last day of each accrual period. Under paragraph (b)(2)(ii)(C), X will translate the interest income at the spot rate on the last day of each interest accrual period. Accordingly, X will have interest income of $1,350 in 1992, and $1,400 in 1993, $1,450 in 1994. Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income. Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

*Example 4.* Assume the same facts as in *Example 1* except that on December 31, 1993, X sells Y's note for 9,821.13 British pounds (£) after the interest payment. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 principal. The exchange gain is $1,000 [(£10,000×$1.40)−(£10,000×$1.30)]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X's total gain is $749.58 [(£9,821.13×$1.40)−(£10,000×$1.30)]. Thus, X will realize $749.58 of exchange gain (and will realize no market loss).

*Example 5.* (i) The facts are the same as in *Example 1* except that Y becomes insolvent and fails to repay the full £10,000 principal when due. Instead, X and Y agree to compromise the debt for a payment of £8,000 on December 31, 1994. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 originally booked. The exchange gain is $1,500 [(£10,000×$1.45)−(£10,000×$1.30) = $1,500]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X realizes an overall loss on the disposition of $1,400 [(£8,000×$1.45)−(£10,000×$1.30) = ($1,400)]. Thus, X will realize no exchange gain (and a $1400 market loss).

(ii) If the exchange rate on December 31, 1994, were £1 = $1.25, rather than £1 = $1.45, X would compute exchange loss under paragraph (b)(8) of this section, on the £10,000 originally booked. The exchange loss would be $500 [(£10,000×$1.25)−(£10,000×$1.30) = ($500)]. X's total loss on the disposition would be $3,000 [(£8,000×$1.25)–(£10,000×$1.30) =

($3,000)]. Thus, X would realize $500 of exchange loss and a $2,500 market loss on the disposition.

*Example 6.* (i) X is an individual with the dollar as his functional currency. X is on the cash method of accounting. On January 1, 1989, X borrows 10,000 British pounds (£) from Y, an unrelated person. The terms of the loan provide that X will make interest payments of £1,200 on December 31 of 1989 and 1990 and will repay Y's £10,000 principal on December 31, 1990. The spot rates for the pertinent dates are as follows:

| Date | Spot rate [1] |
|---|---|
| Jan. 1, 1989 | 1=$1.50 |
| Dec. 31, 1989 | 1=1.60 |
| Dec. 31, 1990 | 1=1.70 |

[1] Pounds to dollars.

Assume that the basis of the £1,200 paid as interest by X on December 31, 1989, is $2,000, the basis of the £1,200 paid as interest by X on December 31, 1990, is $2,020 and the basis of the £10,000 principal paid by X on December 31, 1990, is $16,000.

(ii) Under paragraph (b)(2)(ii)(B) of this section, X translates the £1,200 interest payments at the spot rate on the day paid. Thus, X paid $1,920 (£1,200×$1.60) of interest on December 31, 1989, and $2,040 (£1,200×$1.70) of interest on December 31, 1990. In addition, X will realize exchange gain or loss on the disposition of the £1,200 on December 31, 1989 and 1990, under paragraph (a) of this section. Pursuant to paragraph (a)(2) of this section, X will realize an exchange loss of $80 [(£1,200×$1.60)−$2,000] on December 31, 1989, and exchange gain of $20 [(£1,200×$1.70)−$2,020] on December 31, 1990.

(iii) Under paragraph (b)(6) of this section, X will realize exchange loss on December 31, 1990, upon repayment of the £10,000 principal amount determined by translating the £10,000 received at the spot rate on January 1, 1989 (£10,000×$1.50 = $15,000) and subtracting from such amount, the amount determined by translating the £10,000 paid at the spot rate on December 31, 1990 (£10,000×$1.70 = $17,000). Thus, under paragraph (b)(6) of this section, X has an exchange loss with respect to the £10,000 principal of $2,000. Further, under paragraph (a)(2) of this section, X will realize an exchange gain upon disposition of the £10,000 on December 31, 1990. Under paragraph (a)(2) of this section, X will subtract his adjusted basis in the £10,000 ($16,000) from the amount realized upon the disposition of the £10,000 (£10,000×$1.70 = $17,000) resulting in a gain of $1,000. Accordingly, X's combined exchange gain and loss realized on December 31, 1990, with respect to the repayment of the £10,000 is a $1,000 exchange loss.

*Example 7.* (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. On January 1, 1989, X purchases at original issue for 82.64 Canadian dollars (C$) M corporation's 2 year note maturing on December 31, 1990, at a stated redemption price of C$100. The yield to maturity in Canadian dollars is 10 percent and the accrual period is the one year period beginning January 1 and ending December 31. The note has C$17.36 of original issue discount. Assume that the spot rates are as follows: C$1 = U.S.$.72 on January 1, 1989; C$1 = U.S.$.80 on January 1, 1990; C$1 = U.S.$ .82 on December 31, 1990. Assume further that the average rate for 1989 is C$1 = U.S.$ .76 and for 1990 is C$1 = U.S. $.81.

(ii) Under paragraph (b)(2)(ii)(A) of this section, X will determine its interest income in Canadian dollars. Accordingly, under section 1272, X must take into account original issue discount in the amount of C$8.26 on December 31, 1989, and C$9.10 on December 31, 1990. Pursuant to paragraph (b)(2)(ii)(C) of this section, X will translate these amounts into U.S. dollars at the average exchange rate for the relevant accrual period. Thus, the amount of interest income taken into account in 1989 is U.S.$6.28 (C$8.26×U.S.$.76) and in 1990 is U.S.$7.37 (C$9.10×U.S.$.81). Pursuant to paragraph (b)(3)(ii) of this section, X will realize exchange gain or loss with respect to the accrued interest determined for each accrual period by translating the Canadian dollars received with respect to such accrual period into U.S. dollars at the spot rate on the date the interest is received and subtracting from that amount the amount accrued in U.S. dollars. Thus, the amount of exchange gain realized on December 31, 1990, is U.S.$.58 (U.S.$.49 from 1989+U.S.$.09 from 1990). Pursuant to paragraph (b)(5) of this section, X shall realize exchange gain or loss with respect to the principal (C$82.64) on December 31, 1990, computed by translating the C$82.64 at the spot rate on December 31, 1990 (U.S.$67.76) and subtracting the C$82.64 translated at the spot rate on January 1, 1989 (U.S.$59.50) for an exchange gain of U.S.$8.26. Thus, X's combined exchange gain is U.S.$8.84 (U.S.$.49+U.S.$.09+U.S.$8.26).

(iii) Assume instead that on January 1, 1990, X sells the note for C$86.95, which it immediately converts to U.S. dollars. X's exchange gain is computed under paragraph (b)(8) of this section with reference to the nonfunctional currency denominated principal amount (C$82.64) and the nonfunctional currency denominated accrued original issue discount (C$8.26). X will compute an exchange gain of U.S.$6.61 with respect to the issue price [(C$82.64×U.S.$.80)−(C$82.64×U.S.$.72)] and an exchange gain of U.S.$.33 with respect to the accrued original issue discount [(C$8.26×U.S.$.80)− (C$8.26×U.S.$ .76)]. Accordingly, prior to the application of paragraph (b)(8) of this section, X's total exchange gain is U.S.$6.94 (U.S.$6.61+U.S.$.33), and X's market loss is U.S.$3.16

[(C$90.90 − C$86.95)×U.S.$.80]. Pursuant to paragraph (b)(8) of this section, however, X's market loss on the note of U.S.$3.16 is netted against X's exchange gain of U.S.$6.94, resulting in a realized exchange gain of U.S.$3.78 and no market loss.

*Example 8.* (i) The facts are the same as in *Example 7* (i) except that on January 1, 1990, X contributes the M corporation note to Y, a wholly-owned U.S. subsidiary of X with the dollar as its functional currency, and Y collects C$100 from M corporation at maturity on December 31, 1990, when the spot rate is C$1 = U.S.$.82. The transfer of the note from X to Y qualifies for nonrecognition of gain under section 351(a). On December 31, 1990, Y includes C$9.10 of accrued interest in income which translated at the average exchange rate of C$1 = U.S.$.81 for the year results in U.S.$7.37 of interest income.

(ii) Y's exchange gain is computed under paragraph (b)(3) of this section with respect to accrued interest income and paragraph (b)(5) of this section with respect to the nonfunctional currency principal amount. Under paragraph (b)(3) of this section, Y will realize exchange gain or loss for each accrual period computed by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the day received and subtracting the amounts of interest income accrued for such period. Thus, Y will realize $.49 of exchange gain with respect to original issue discount accrued in 1989 [(C$8.26×U.S.$.82) − (C$8.26×U.S.$.76) = U.S. $.49] and $.09 of exchange gain with respect to original issue discount accrued in 1990 [(C$9.10×U.S.$.82) − (C$9.10×U.S.$.81) = $.09].

(iii) Pursuant to paragraph (b)(5) of this section, the nonfunctional currency principal amount of the M bond in the hands of Y is C$82.64, the amount carried over from X, the transferor. Y's exchange gain with respect to the nonfunctional currency principal amount is $8.26 [(C$82.64×U.S.$.82) − (C$82.64×U.S.$.72) = U.S. $8.26]. Accordingly, Y's combined exchange gain is U.S. $8.84 ($.49+$.09+$8.26). Because the amount realized in Canadian dollars equals the adjusted issue price (C$100) on retirement of the M note, there is no market loss, and the netting rule of paragraph (b)(8) of this section does not limit realization of the exchange gain.

*Example 9.* (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. X elects to use the spot rate convention to translate interest income as provided in paragraph (b)(2)(iii)(B) of this section. On January 31, 1992, X loans £1000 to Y, an unrelated person. Under the terms of the loan, Y will pay X interest of £50 on July 31, 1992, and January 31, 1993, and will repay the £1000 principal on January 31, 1993. Assume the following spot exchange rates:

| Date | Spot rate [1] |
|---|---|
| Jan. 31, 1992 | £1=$1.50 |
| July 31, 1992 | £1=$1.55 |
| Dec. 31, 1992 | £1=$1.60 |
| Jan. 31, 1993 | £1=$1.61 |

[1] Pounds to dollars.

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will translate the interest income at the spot rate on the last day of each interest accrual period (and in the case of a partial accrual period, at the spot rate on the last day of the taxable year). Accordingly, X will have interest income of $77.50 (£50×$1.55) on July 31, 1992. Assuming under X's method of accounting that interest is accrued daily, X will accrue $66.50 (153/184×£50)×$1.60) of interest income on December 31, 1992. On January 31, 1993, X will have interest income of $13.60 ((31/184×£50)×$1.61). Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income received on July 31, 1992. However, X will realize exchange gain on the £41.50 (153/184×£50) of accrued interest income of $.41 [(£41.50×$1.61) − (£41.50×$1.60) = $.41].

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £100 principal amount determined by translating the £100 at the spot rate on the date it is received (£100×$1.61 = $161.00) and subtracting from such amount, the amount determined by translating the £100 at the spot rate on the date the loan was made (£100×$1.50 = $150.00). Accordingly, X will realize an exchange gain of $11 on the repayment of the loan on January 31, 1993.

*Example 10.* (i) X, a cash basis taxpayer with the dollar as its functional currency, has the calendar year as its taxable year. On January 1, 1992, X purchases at original issue for 65.88 British pounds (£) M corporation's 5-year bond maturing on December 31, 1996, having a stated redemption price at maturity of £100. The bond provides for annual payments of interest in pounds of 1 pound per year on December 31 of each year. The bond has 34.12 British pounds of original issue discount. The yield to maturity is 10 percent in British pounds and the accrual period is the one year period beginning January 1 and ending December 31 of each calendar year. The amount of original issue discount is determined in pounds for each accrual period by multiplying the adjusted issue price expressed in pounds by the yield and subtracting from such amount the periodic interest payments expressed in pounds for such period. The periodic interest payments are translated at the spot rate on the payment date (December 31 of each year). The original issue discount is translated at the average rate for the accrual period (January 1 through December 31). The following

chart describes the determination of interest income with respect to the facts presented and provides other pertinent information.

TABLE 1

| Year (Dec. 31) | Periodic interest payments in pounds for the accrual period | Original issue discount in pounds for the accrual period | Issue price or adjusted issue price in pounds | Assumed spot rate on Dec. 31 (pounds to dollars) | Assumed average rate for accrual period (pounds to dollars) | Periodic interest payments in pounds multiplied by spot rate on the date of payment (column 2 times column 5) | Original issue discount in pounds multiplied by the average rate for the accrual period (column 3 times column 6) | Total interest income in dollars (column 7 plus column 8) | Adjusted issue price in dollars |
|---|---|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| Issue Date: | | | 65.88 | 1=$1.20 | ..... | ..... | ..... | ..... | $79.06 |
| 1992 | 1 | 5.59 | 71.47 | 1=1.30 | 1=$1.25 | $1.30 | $6.99 | $8.29 | 86.05 |
| 1993 | 1 | 6.15 | 77.62 | 1=1.40 | 1=1.35 | 1.40 | 8.30 | 9.70 | 94.35 |
| 1994 | 1 | 6.76 | 84.38 | 1=1.50 | 1=1.45 | 1.50 | 9.80 | 11.30 | 104.15 |
| 1995 | 1 | 7.44 | 91.82 | 1=1.60 | 1=1.55 | 1.60 | 11.53 | 13.13 | 115.68 |
| 1996 | 1 | 8.18 | 100.00 | 1=1.70 | 1=1.65 | 1.70 | 13.50 | 15.20 | 129.18 |

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1996 totaling $7.88 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the average rate for the period. The following chart illustrates this computation:

TABLE 2

| Year | OID accrued in pounds for each accrual period | Assumed spot rate on date payment received (pounds to dollars) | Interest received times spot rate on the date received (col. 2 times col. 3) | Assumed average rate for accrual period (pounds to dollars) | IOD in pounds times the average rate for the accrual period (col. 2 times col. 5) | Exchange gain or loss (col. 4 less col. 6) |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| 1992 | 5.59 | 1=$1.70 | $9.50 | 1=$1.25 | $6.99 | $2.51 |
| 1993 | 6.15 | 1=1.70 | 10.46 | 1=1.35 | 8.30 | 2.16 |
| 1994 | 6.76 | 1=1.70 | 11.49 | 1=1.45 | 9.80 | 1.69 |
| 1995 | 7.44 | 1=1.70 | 12.65 | 1=1.55 | 11.53 | 1.12 |
| 1996 | 8.18 | 1=1.70 | 13.90 | 1=1.65 | 13.50 | .40 |
| Total | ..... | ..... | ..... | ..... | ..... | $7.88 |

(iii) X will also realize exchange gain with respect to the principal of the loan (*i.e.*, the issue price of 65.88 British pounds) on December 31, 1996 computed by translating the units of nonfunctional currency principal received at the spot rate on the date principal is received (65.88 British pounds × $1.70 = $112.00) and subtracting from such amount, the units of nonfunctional currency principal received translated at the spot rate on the date the instrument was acquired (65.88 British pounds × $1.20 = $79.06). Accordingly, X's exchange gain on the principal is $32.94 and X's total exchange gain with respect to the accrued interest and principal is $40.82. It should be noted that, under this fact pattern, the total exchange gain may be determined in an alternative fashion. Exchange gain may be computed by subtracting the adjusted issue price in dollars at maturity ($129.18—see column 10 of Table 1) from the amount computed by multiplying the stated redemption price at maturity in pounds times the spot rate on the maturity date (£100×$1.70 = $170), which equals $40.82.

*Example 11.* (i) The facts are the same as in *Example 10* except that X makes an election under paragraph (b)(2)(iii) of this section to translate accrued interest on the last day of

the accrual period. Accordingly, columns 8, 9 and 10 in Table 1 would change as follows:

| Year (Dec. 31) | Original issue discount in pounds multiplied by the spot rate on last day of accrual period (Dec. 31) | Total interest income in dollars (column 7 plus column 8) | Adjusted issue price in dollars |
|---|---|---|---|
| 1 | 8 | 9 | 10 |
| | | | $79.06 |
| 1992 | $7.27 | $8.57 | 87.63 |
| 1993 | 8.61 | 10.01 | 97.64 |
| 1994 | 10.14 | 11.64 | 109.28 |
| 1995 | 11.90 | 13.50 | 122.78 |
| 1996 | 13.91 | 15.61 | 138.39 |

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1993 totaling $6.18 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the spot rate on the last day of the accrual period. Accordingly, columns 5, 6 and 7 of Table 2 would change as follows:

| Year | Spot rate on last day of accrual period | OID in pounds times the spot rate on the last day of the accrual period (col 2 times col. 3) | Exchange gain or loss (col. 4 less col. 6) |
|---|---|---|---|
| 1 | 5 | 6 | 7 |
| 1992 | $1.30 | $7.27 | $2.23 |
| 1993 | 1.40 | 8.61 | 1.85 |
| 1994 | 1.50 | 10.14 | 1.35 |
| 1995 | 1.60 | 11.90 | 0.75 |
| 1996 | 1.70 | 13.90 | 0.00 |
| | | | 6.18 |

(iii) X will realize exchange gain with respect to the principal amount of the loan as provided in the preceding example.

*Example 12.* (i) C is a corporation that is a calendar year accrual method taxpayer with the dollar as its functional currency. On January 1, 1989, C lends 100 British pounds (£) in exchange for a note under the terms of which C will receive two equal payments of £57.62 on December 31, 1989, and December 31, 1990. Each payment of £57.62 represents the annual payment necessary to amortize the £100 principal amount at a rate of 10% compounded annually over a two year period. The following tables reflect the amounts of principal and interest that compose each payment and assumptions as to the relevant exchange rates:

| Date | Principal | Interest |
|---|---|---|
| Dec. 31, 1989 | £47.62 | £10.00 |
| Dec. 12, 1990 | £52.38 | £5.24 |

| Date | Spot rate £1= | Average rate for year ending |
|---|---|---|
| Jan. 1, 1989 | $1.30 | |
| Dec. 31, 1989 | 1.40 | 1.35 |
| Dec. 31, 1990 | 1.50 | 1.45 |

(ii) Because each interest payment is equal to the product of the outstanding principal balance of the obligation and a single fixed rate of interest, each stated interest payment constitutes periodic interest under the principles of section 1273. Accordingly, there is no original issue discount.

(iii) Because C is an accrual basis taxpayer, C will translate the interest income at the average rate for the annual accrual period pursuant to paragraph (b)(2)(ii)(C) of this section. Thus, C's interest income is $13.50 (£10.00×$1.35) in 1989, and $7.60 (£5.24×$1.45) in 1990. C will realize exchange gain or loss upon receipt of accrued interest computed in accordance with paragraph (b)(3) of this section. Thus, C will realize exchange gain in the amount of $.50 [(£10.00×$1.40) − $13.50] in 1989, and $.26 [(£5.24×$1.50) − $7.60] in 1990.

(iv) In addition, C will realize exchange gain or loss upon the receipt of principal each year computed under paragraph (b)(5) of this section. Thus, C will realize exchange gain in the amount of $4.76 [(£47.62×$1.40) − (£47.62×$1.30)] in 1989, and $10.48 [(£52.38×$1.50) − (£52.38×$1.30)] in 1990.

(10) *Treatment of bond premium*—(i) *In general.* Amortizable bond premium on a bond described in paragraph (b)(2)(i) of this section shall be computed in the units of nonfunctional currency in which the bond is denominated (or in which the payments are determined). Amortizable bond premium properly taken into account under section 171 or §1.61–12 (or the successor provision thereof) shall reduce interest income or expense in units of nonfunctional currency. Exchange gain or loss is realized with respect to bond premium described in the preceding sentence by treating the portion of premium amortized with respect to any period as a return of principal. With respect to a holder that does not elect to amortize bond premium under section 171, the

amount of bond premium will constitute a market loss when the bond matures. See paragraph (b)(8) of this section. The principles set forth in this paragraph (b)(10) shall apply to determine the treatment of acquisition premium described in section 1272(a)(7).

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(10).

*Example.* (A) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1989, X purchases Y corporation's note for 107.99 British pounds (£) from Z, an unrelated party. The note has an issue price of £100, a stated redemption price at maturity of £100, pays interest in pounds at the rate of 10% compounded annually, and matures on December 31, 1993. X elects to amortize the bond premium of £7.99 under the rules of section 171. Pursuant to paragraph (b)(10)(i) of this section, bond premium is determined and amortized in British pounds. Assume the amortization schedule is as follows:

| Year ending 12/31 | Bond premium amortized | Unamortized premium plus principal | Interest |
|---|---|---|---|
| | | £107.99 | |
| 1989 | £1.36 | £106.63 | £8.64 |
| 1990 | £1.47 | £105.16 | £8.53 |
| 1991 | £1.59 | £103.57 | £8.41 |
| 1992 | £1.71 | £101.86 | £8.29 |
| 1993 | £1.85 | £100.00 | £8.15 |

(B) The bond premium reduces X's pound interest income under the note. For example, the £10 stated interest payment made in 1989 is reduced by £1.36 of bond premium, and the resulting £8.64 interest income is translated into dollars at the spot rate on December 31, 1989. Exchange gain or loss is realized on the £1.36 bond premium based on the difference between the spot rates on January 1, 1989, the date the premium is paid to acquire the bond, and December 31, 1989, the date the bond premium is returned as part of the stated interest. The £1.36 bond premium reduces the unamortized premium plus principal to £106.63 (£107.99 − £1.36). On December 31, 1993, when the bond matures and the £7.99 of bond premium has been fully amortized, X will realize exchange gain or loss with respect to the remaining purchase price of £100.

(11) *Market discount*—(i) *In general.* Market discount as defined in section 1278(a)(2) shall be determined in units of nonfunctional currency in which the market discount bond is denominated (or in which the payments are determined). Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) shall be translated into functional currency at the spot rate on the date the market discount bond is disposed of. No part of such accrued market discount is treated as exchange gain or loss. Accrued market discount currently includible in income pursuant to section 1278(b) shall be translated into functional currency at the average exchange rate for the accrual period. Exchange gain or loss with respect to accrued market discount currently includible in income under section 1278(b) shall be determined in accordance with paragraph (b)(3) of this section relating to accrued interest income.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(11).

*Example.* (A) X is a calendar year corporation with the U.S. dollar as its functional currency. On January 1, 1990, X purchases a bond of M corporation for 96,530 British pounds (£). The bond, which was issued on January 1, 1989, has an issue price of £100,000, a stated redemption price at maturity of £100,000, and provides for annual pound payments of interest at 8 percent. The bond matures on December 31, 1991. X purchased the bond at a market discount of 3,470 pounds and did not elect to include the market discount currently in income under section 1278(b). X holds the bond to maturity and on December 31, 1991, receives payment of £100,000 (plus £8,000 interest) when the exchange rate is £1 = $1.50.

(B) Pursuant to paragraph (b)(11) of this section, X computes market discount in units of nonfunctional currency. Thus, the market discount as defined under section 1278(a)(2) is £3,470. Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) is translated at the spot rate on the date the market discount bond is disposed of. Accordingly, X will translate the accrued market discount of £3,470 at the spot rate on December 31, 1991 (£3,470×$1.50 = $5,205). No exchange gain or loss is realized with respect to the £3,470 of accrued market discount. See paragraphs (b)(3) and (5) of this section for the realization and recognition of exchange gain or loss with respect to accrued interest and principal.

(12) *Tax exempt bonds.* See §1.988–3(c)(2), which characterizes exchange loss realized with respect to a nonfunctional currency tax exempt bond as a reduction of interest income.

(13) *Nonfunctional currency debt exchanged for stock of obligor*—(i) *In general.* Notwithstanding any other section of the Code other than section 267, 1091 or 1092, exchange gain or loss shall be realized and recognized by the holder and the obligor in accordance with the rules of paragraphs (b)(3) through (7) of this section with respect to the principal and accrued interest of a debt instrument described in paragraph (b)(2)(i) of this section that is acquired by the obligor in exchange for its stock, provided however, that such gain or loss shall be recognized only to the extent of the total gain or loss on the exchange (regardless of whether such gain or loss would otherwise be recognized). This rule shall apply whether the debt instrument is converted into stock according to its terms or exchanged pursuant to a separate agreement between the obligor and the holder. A debt instrument that is acquired by the obligor from a shareholder as a contribution to capital shall be treated for purposes of this section as exchanged for stock, whether or not additional stock is issued.

(ii) *Coordination with section 108.* Section 988 and this section shall apply before section 108. Exchange gain realized by the obligor on an exchange described in paragraph (b)(13)(i) of this section shall not be treated as discharge of indebtedness income, but shall be considered to reduce the amount of the liability for purposes of computing the obligor's income on the exchange under section 108(e)(4), section 108(e)(6) or section 108(e)(10).

(iii) *Effective date.* This paragraph (b)(13) shall be effective for exchanges of debt for stock effected after September 21, 1989.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (b)(13). In each such example, assume that sections 267, 1091 and 1092 do not apply.

*Example 1.* (i) X is a calendar year U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990 (the issue date), X acquired a convertible bond maturing on December 31, 1998, issued by Y corporation, a U.K. corporation with the British pound (£) as its functional currency. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. The terms of the bond also provide that at any time prior to December 31, 1998, the holder may surrender all of his interest in the bond in exchange for 20 shares of Y common stock. On January 1, 1994, X surrenders his interest in the bond for 20 shares of Y common stock. Assume the following: (a) The spot rate on January 1, 1990, is £1 = $1.30, (b) The spot rate on January 1, 1994, is £1 = $1.50, and (c) The 20 shares of Y common stock have a market value of £200,000 on January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange gain with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is converted to stock. X will compute exchange gain pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the conversion date (£100.000×$1.50 = $150,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000×$1.30 = $130,000). Thus, X will realize and recognize $20,000 of exchange gain. X's basis in the 20 shares of Y common stock is $150,000 ($130,000 substituted basis + $20,000 recognized gain).

*Example 2.* (i) X, a foreign corporation with the British pound (£) as its functional currency, lends £100 at a market rate of interest to Y, its wholly-owned U.S. subsidiary, on January 1, 1990, on which date the spot exchange rate is £1 = $1. Y's functional currency is the U.S. dollar. On January 1, 1992, when the spot exchange rate is £1 = $.50, X cancels the debt as a contribution to capital. Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the £100 issue price of the debt instrument on January 1, 1992. Y will compute exchange gain pursuant to paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100×$1 = $100) and subtracting from such amount the issue price translated at the spot rate on the date of extinguishment (£100×$.50 = $50). Thus, Y will realize and recognize $50 of exchange gain.

(ii) Under section 108(e)(6), on the acquisition of its indebtedness from X as a contribution to capital Y is treated as having satisfied the debt with an amount of money equal to X's adjusted basis in the debt (£100). For purposes of section 108(e)(6), X's adjusted basis is translated into United States dollars at the spot rate on the date Y acquires the debt (£1 = $.50). Therefore, Y is treated as having satisfied the debt for $50. Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the exchange gain from $100 to $50. Accordingly, Y recognizes $50 of exchange gain and no discharge of indebtedness income on the extinguishment of its debt to X.

(iii) If X were a United States taxpayer with a dollar functional currency and a $100 basis in Y's obligation. X would realize and recognize an exchange loss of $50 under paragraph (b)(5) of this section on the contribution of the debt to Y. The recognized loss would reduce X's adjusted basis in the debt from $100 to $50, so that for purposes of applying section 108(e)(6) Y is treated as having satisfied the debt for $50. Accordingly, under these facts as well Y would recognize $50 of exchange gain and no discharge of indebtedness income.

*Example 3.* (i) X and Y are unrelated calendar year U.S. corporations with the U.S. dollar as their functional currency. On January 1, 1990 (the issue date), X acquires Y's bond maturing on December 31, 1999. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. On January 1, 1994, X and Y agree that Y will redeem its bond from X in exchange for 20 shares of Y common stock. Assume the following:

(a) The spot rate on January 1, 1990, is £1 = $1.00,

(b) The spot rate on January 1, 1994, is £1 = $.50,

(c) Interest rates on equivalent bonds have increased so that as of January 1, 1994, the value of Y's bond has declined to £90,000, and

(d) The 20 shares of Y common stock have a market value of £90,000 as of January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange loss with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is exchanged for stock. X will compute exchange loss pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the exchange date (£100,000×$.50 = $50,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000×$1.00 = $100,000). Thus, X will compute $50,000 of exchange loss, all of which will be realized and recognized because it does not exceed the total $55,000 realized loss on the exchange ($45,000 worth of stock received less $100,000 basis in the exchanged bond).

(iii) Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the issue price, computed under paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100,000×$1.00 = $100,000) and subtracting from such amount the issue price translated at the spot rate on the exchange date (£100,000×$.50 = $50,000). Thus, Y will realize and recognize $50,000 of exchange gain. Under section 108(e)(10), on the transfer of stock to X in satisfaction of its indebtedness Y is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock (£90,000×$.50 = $45,000). Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $50,000. Accordingly, Y recognizes an additional $5,000 of discharge of indebtedness income on the exchange.

*Example 4.* (i) The facts are the same as in *Example 3* except that interest rates on equivalent bonds have declined, rather than increased, so that the value of Y's bond on January 1, 1994, has risen to £112,500; and X and Y agree that Y will redeem its bond from X on that date in exchange for 25 shares of Y common stock worth £112,500. Pursuant to paragraphs (b)(13) and (b)(5) of this section, X will compute $50,000 of exchange loss on the exchange with respect to the £100,000 issue price of the bond. See Example 3. However, because X's total loss on the exchange is only $43,750 ($56,250 worth of stock received less $100,000 basis in the exchanged bond), under the netting rule of paragraph (b)(13) of this section the realized exchange loss is limited to $43,750.

(ii) Pursuant to paragraphs (b)(13) and (b)(6) of this section, Y will compute $50,000 of exchange gain with respect to the issue price. See *Example 3*. Under section 108(e)(10), Y is treated as having satisfied the $100,000 indebtedness with an amount of money equal to the fair market value of the stock (£112,500×$.50 = $56,250), resulting in a total gain on the exchange of $43,750. Accordingly, under paragraph (b)(13) of this section Y's realized (and recognized) exchange gain on the exchange is limited to $43,750. Also pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $56,250. Accordingly, Y recognizes no discharge of indebtedness income on the exchange.

(14) [Reserved]

(15) *Debt instruments and deposits denominated in hyperinflationary currencies*—(i) *In general.* If a taxpayer issues, acquires, or otherwise enters into or holds a hyperinflationary debt instrument (as defined in paragraph (b)(15)(vi)(A) of this section) or a hyperinflationary deposit (as defined in paragraph (b)(15)(vi)(B) of this section) on which interest is paid or accrued that is denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such instrument or deposit for its taxable year determined

by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (or an amount deposited); and

(B) The earlier of the last day of the taxable year, or the date the instrument (or deposit) is disposed of or otherwise terminated.

(ii) *Only exchange gain or loss is realized.* No gain or loss is realized under paragraph (b)(15)(i) by reason of factors other than movement in exchange rates, such as the creditworthiness of the debtor.

(iii) *Special rule for synthetic, non-hyperinflationary currency debt instruments*—(A) *General rule.* Paragraph (b)(15)(i) does not apply to a debt instrument that has interest and principal payments that are to be made by reference to a currency or item that does not reflect hyperinflationary conditions in a country (within the meaning of §1.988–1(f)).

(B) *Example.* Paragraph (b)(15)(iii)(A) is illustrated by the following example:

*Example.* When the Turkish lira (TL) is a hyperinflationary currency, A, a U.S. corporation with the U.S. dollar as its functional currency, makes a 5 year, 100,000 TL-denominated loan to B, an unrelated corporation, at a 10% interest rate when 1,000 TL equals $1. Under the terms of the debt instrument, B must pay interest annually to A in amount of Turkish lira that is equal to $100. Also under the terms of the debt instrument, B must pay A upon maturity of the debt instrument an amount of Turkish lira that is equal to $1,000. Although the principal and interest are payable in a hyperinflationary currency, the debt instrument is a synthetic dollar debt instrument and is not subject to paragraph (b)(15)(i) of this section.

(iv) *Source and character of gain or loss*—(A) *General rule for hyperinflationary conditions.* The rules of this paragraph (b)(15)(iv)(A) shall apply to any taxpayer that is either an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency gain on such debt instrument or deposit, or a holder of a hyperinflationary debt instrument or deposit and has currency loss on such debt instrument or deposit. For purposes of subtitle A of the Internal Revenue Code, any exchange gain or loss realized under paragraph (b)(15)(i) of this section is directly allocable to the interest expense or interest income, respectively, from the debt instrument or deposit (computed under this paragraph (b)), and therefore reduces or increases the amount of interest income or interest expense paid or accrued during that year with respect to that instrument or deposit. With respect to a debt instrument or deposit during a taxable year, to the extent exchange gain realized under paragraph (b)(15)(i) of this section exceeds interest expense of an issuer, or exchange loss realized under paragraph (b)(15)(i) of this section exceeds interest income of a holder or depositor, the character and source of such excess amount shall be determined under §§1.988–3 and 1.988–4.

(B) *Special rule for subsiding hyperinflationary conditions.* If the taxpayer is an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency loss, or if the taxpayer is a holder of a hyperinflationary debt instrument or deposit and has currency gain, then for purposes of subtitle A of the Internal Revenue Code, the character and source of the currency gain or loss is determined under §§1.988–3 and 1.988–4. Thus, if an issuer has both interest expense and currency loss, the currency loss is sourced and characterized under section 988, and does not affect the determination of interest expense.

(v) *Adjustment to principal or basis.* Any exchange gain or loss realized under paragraph (b)(15)(i) of this section is an adjustment to the functional currency principal amount of the issuer, functional currency basis of the holder, or the functional currency amount of the deposit. This adjusted amount or basis is used in making subsequent computations of exchange gain or loss, computing the basis of assets for purposes of allocating interest under §§1.861–9T through 1.861–12T and 1.882–5, or making other determinations that may be relevant for computing taxable income or loss.

(vi) *Definitions*—(A) *Hyperinflationary debt instrument.* A hyperinflationary debt instrument is a debt instrument that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the debt instrument; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the instrument provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation. For example, a debt instrument providing for a variable interest rate based on local conditions and generally responding to changes in the local consumer price index will reflect hyperinflation.

(B) *Hyperinflationary deposit.* A hyperinflationary deposit is a demand or time deposit or similar instrument issued by a bank or other financial institution that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the deposit; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the deposit provide for the adjustment of the deposit amount or interest payments in a manner that reflects hyperinflation.

(vii) *Interaction with other provisions*—(A) *Interest allocation rules.* In determining the amount of interest expense, this paragraph (b)(15) applies before §§1.861–9T through 1.861–12T, and 1.882–5.

(B) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, paragraph (b)(15)(i) of this section does not apply.

(C) *Interaction with section 988(a)(3)(C).* Section 988(a)(3)(C) does not apply to a debt instrument subject to the rules of paragraph (b)(15)(i) of this section.

(D) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, the rules of paragraph (b)(15)(i) of this section will not apply. This paragraph (b)(15)(vii)(D) does not apply if the application of §1.988–5 results in hyperinflationary debt instrument or deposit described in paragraph (b)(15)(vi)(A) or (B) of this section.

(viii) *Effective date.* This paragraph (b)(15) applies to transactions entered into after February 14, 2000.

(16) *Coordination with section 267 regarding debt instruments*—(i) *Treatment of a creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see §1.267(f)–1(h).

(ii) *Treatment of a debtor.* [Reserved]

(17) *Coordination with installment method under section 453.* [Reserved]

(18) *Interaction of section 988 and §1.1275–2(g)*—(i) *In general.* If a principal purpose of structuring a debt instrument subject to section 988 and any related hedges is to achieve a result that is unreasonable in light of the purposes of section 163(e), section 988, sections 1271 through 1275, or any related section of the Internal Revenue Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (b)(18) applies to a multicurrency debt instrument and a hedge or hedges, the Commissioner can wholly or partially integrate transactions or treat portions of the debt instrument as separate instruments where appropriate. See also §1.1275–2(g).

(ii) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. Another significant fact is whether the result is obtainable without the application of §1.988–6 and any related provisions (*e.g.*, if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(iii) *Effective date.* This paragraph (b)(18) shall apply to debt instruments issued on or after October 29, 2004.

(c) *Item of expense or gross income or receipts which is to be paid or received after the date accrued*—(1) *In general.* Except as provided in §1.988–5, exchange gain or loss with respect to an item described in §1.988–1(a)(1)(ii) and (2)(ii) (other than accrued interest income or expense subject to paragraph (b) of this section) shall be realized on the date payment is made or received. Except as provided in the succeeding sentence, such exchange gain or loss shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. If the taxpayer's right to receive income, or obligation to pay an expense, is transferred or modified in a transaction in which gain or loss would otherwise be recognized, exchange gain or loss shall be realized and recognized only to the extent of the total gain or loss on the transaction.

(2) *Determination of exchange gain or loss with respect to an item of gross income or receipts.* Exchange gain or loss realized on an item of gross income or receipts described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency received by the spot rate on the payment date, and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency received by the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is received or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of gross income or receipts is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date.

(3) *Determination of exchange gain or loss with respect to an item of expense.* Exchange gain or loss realized on an item of expense described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency paid by the spot rate on the booking date and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency paid by the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of expense is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is made or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the date.

(4) *Examples.* The following examples illustrate the application of paragraph (c) of this section.

*Example 1.* X is a calendar year corporation with the dollar as its functional currency. X is on the accrual method of accounting. On January 15, 1989, X sells inventory for 10,000 Canadian dollars (C$). The spot rate on January 15, 1989, is C$1 = U.S. $.55. On February 23, 1989, when X receives payment of the C$10,000, the spot rate is C$1 = U.S. $.50. On February 23, 1989, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate on the date the C$10,000 are received (C$10,000×.50 = U.S. $5,000) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate on the booking date (C$10,000×.55 = U.S. $5,500). Thus, X's exchange loss on the transaction is U.S. $500 (U.S. $5,000 − U.S. $5,500).

*Example 2.* The facts are the same as in *Example 1* except that X uses a spot rate convention to determine the spot rate as provided in §1.988–1(d)(3). Pursuant to X's spot rate convention, the spot rate at which a payable or receivable is booked is determined monthly for each nonfunctional currency payable or receivable by adding the spot rate at the beginning of the month and the spot rate at the end of the month and dividing by two. All payables and receivables in a nonfunctional currency booked during the month are translated into functional currency at the rate described in the preceding sentence. Further, the translation of nonfunctional currency paid with respect to a payable, and nonfunctional currency received with respect to a receivable, is also performed pursuant to the spot rate convention. Assume the spot rate determined under the spot rate convention for the month of

January is C$1 = U.S. $.54 and for the month of February is C$1 = U.S. $.51. On the last date in February, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate convention for the month of February (C$10,000×U.S. $.51 = U.S. $5,100) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate convention for the month of January (C$10,000×U.S. $.54 = $5,400). Thus, X's exchange loss on the transaction is U.S. $300 (U.S. $5,100–U.S. $5,400). X's basis in the C$10,000 is U.S. $5,400.

*Example 3.* The facts are the same as in *Example 2* except that X has a standing order with X's bank for the bank to convert any nonfunctional currency received in satisfaction of a receivable into U.S. dollars on the day received and to deposit those U.S. dollars in X's U.S. dollar bank account. X may use its convention to translate the amount booked into U.S. dollars, but must use the U.S. dollar amounts received from the bank with respect to such receivables to determine X's exchange gain or loss. Thus, if X receives payment of the C$10,000 on February 23, 1989, when the spot rate is C$1 = U.S.$ .50, X determines exchange gain or loss by subtracting the amount booked under X's convention (U.S.$5,400) from the amount of U.S. dollars received from the bank under the standing conversion order (assume $5,000). X's exchange loss is U.S.$400.

(d) *Exchange gain or loss with respect to forward contracts, futures contracts and option contracts*—(1) *Scope*—(i) *In general.* This paragraph (d) applies to forward contracts, futures contracts and option contracts described in §1.988–1(a)(1)(ii) and (2)(iii). For rules applicable to currency swaps and notional principal contracts described in §1.988–1(a) (1)(ii) and (2)(iii), see paragraph (e) of this section.

(ii) *Treatment of spot contracts.* Solely for purposes of this paragraph (d), a spot contract as defined in §1.988–1(b) to buy or sell nonfunctional currency is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii) unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency. For example, if a taxpayer with the dollar as its functional currency enters into a spot contract to purchase British pounds, and takes delivery of such pounds under the contract, the delivery of the pounds is not a realization event under section 988(c)(5) and paragraph (e)(4)(ii) of this section because the contract is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii). However, if the taxpayer sells or otherwise terminates the contract before taking delivery of the pounds, exchange gain or loss shall be realized and recognized in accordance with paragraphs (d)(2) and (3) of this section.

(2) *Realization of exchange gain or loss*—(i) *In general.* Except as provided in §1.988–5, exchange gain or loss on a contract described in §1.988–2(d)(1) shall be realized in accordance with the applicable realization section of the Internal Revenue Code (*e.g.*, sections 1001, 1092, and 1256). See also section 988(c)(5). For purposes of determining the timing of the realization of exchange gain or loss, sections 1092 and 1256 shall take precedence over section 988(c)(5).

(ii) *Realization by offset*—(A) *In general.* Except as provided in paragraphs (d)(2)(ii)(B) and (C) of this section, exchange gain or loss with respect to a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) shall not be realized solely because such transaction is offset by another transaction (or transactions).

(B) *Exception where economic benefit is derived.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is offset by another transaction or transactions, exchange gain shall be realized to the extent the taxpayer derives, by pledge or otherwise, an economic benefit (*e.g.*, cash, property or the proceeds from a borrowing) from any gain inherent in such offsetting positions. Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain taken into account by reason of the preceding sentence. This paragraph (d)(2)(ii)(B) shall apply to transactions creating an offset after September 21, 1989.

(C) *Certain contracts traded on an exchange.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is traded on an exchange and it is the general practice of the exchange to terminate offsetting contracts, entering into an offsetting contract shall be considered a termination of the contract being offset.

(iii) *Clarification of section 988(c)(5).* If the delivery date of a contract subject

to section 988(c)(5) and paragraph (d)(4)(ii) of this section is different than the date the contract expires, then for purposes of determining the date exchange gain or loss is realized, the term delivery date shall mean expiration date.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(1) and (2).

*Example 1.* On August 1, 1989, X, a calendar year corporation with the dollar as its functional currency, enters into a forward contract with Bank A to buy 100 New Zealand dollars for $80 for delivery on January 31, 1990. (The forward purchase contract is not a section 1256 contract.) On November 1, 1989, the market price for the purchase of 100 New Zealand dollars for delivery on January 31, 1990, is $76. On November 1, 1989, X cancels its obligation under the forward purchase contract and pays Bank A $3.95 (the present value of $4 discounted at 12% for the period) in cancellation of such contract. Under section 1001 (a), X realizes an exchange loss of $3.95 on November 1, 1989, because cancellation of the forward purchase contract for cash results in the termination of X's contract.

*Example 2.* X is a corporation with the dollar as its functional currency. On January 1, 1989, X enters into a currency swap contract with Bank A under which X is obligated to make a series of Japanese yen payments in exchange for a series of dollar payments. On February 21, 1992, X has a gain of $100,000 inherent in such contract as a result of interest rate and exchange rate movements. Also on February 21, 1992, X enters into an offsetting swap with Bank A to lock in such gain. If on February 21, 1992, X pledges the gain inherent in such offsetting positions as collateral for a loan, X's initial swap contract is treated as being terminated on February 21, 1992, under paragraph (d)(2)(ii)(B) of this section. Proper adjustment is made in the amount of any gain or loss subsequently realized for the gain taken into account by reason of paragraph (d)(2)(ii)(B) of this section.

*Example 3.* X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, X enters into a forward contract to buy 100,000 Swiss francs (Sf) for delivery on March l, 1990, for $51,220. Assume that the contract is a section 1256 contract under section 1256(g)(2) and that section 1256(e) does not apply. Pursuant to section 1256(a)(1), the forward contract is treated as sold for its fair market value on December 31, 1989. Assume that the fair market value of the contract is $1,000 determined under §1.988–1(g). Thus X will realize an exchange gain of $1,000 on December 31, 1989. Such gain is subject to the character rules of §1.988–3 and the source rules of §1.988–4.

(v) *Extension of the maturity date of certain contracts.* An extension of time for making or taking delivery under a contract described in paragraph (d)(1) of this section (*e.g.*, a historical rate rollover as defined in §1.988–5(b)(2)(iii)(C)) shall be considered a sale or exchange of the contract for its fair market value on the date of the extension and the establishment of a new contract on such date. If, under the terms of the extension, the time value of any gain or loss recognized pursuant to the preceding sentence adjusts the price of the currency to be bought or sold under the new contract, the amount attributable to such time value shall be treated as interest income or expense for all purposes of the Code. However, the preceding sentence shall not apply and the amount attributable to the time value of any gain or loss recognized shall be treated as exchange gain or loss if the period beginning on the first date the contract is rolled over and ending on the date payment is ultimately made or received with respect to such contract does not exceed 183 days.

(3) *Recognition of exchange gain or loss.* Except as provided in §1.988–5 (relating to section 988 hedging transactions), exchange gain or loss realized with respect to a contract described in paragraph (d)(1) of this section shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. For example, a loss realized with respect to a contract described in paragraph (d)(1) of this section which is part of a straddle shall be recognized in accordance with the provisions of section 1092 to the extent such section is applicable.

(4) *Determination of exchange gain or loss*—(i) *In general.* Exchange gain or loss with respect to a contract described in §1.988–2(d)(1) shall be determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of

the contract). Any gain or loss determined according to the preceding sentence shall be treated as exchange gain or loss.

(ii) *Special rules where taxpayer makes or takes delivery.* If the taxpayer makes or takes delivery in connection with a contract described in paragraph (d)(1) of this section, any gain or loss shall be realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) on the date on which he took or made delivery for its fair market value on such date. See paragraph (d)(2)(iii) of this section regarding the definition of the term ''delivery date.'' This paragraph (d)(4)(ii) shall not apply in any case in which the taxpayer makes or takes delivery before June 11, 1987.

(iii) *Examples.* The following examples illustrate the application of paragraph (d)(4) of this section.

*Example 1.* X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, when the six month forward rate is $.4907, X enters into a forward contract to buy 100,000 New Zealand dollars (NZD) for delivery on March 1, 1990. On March 1, 1990, when X takes delivery of the 100,000 NZD, the spot rate is 1NZD equals $.48. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery of nonfunctional currency under a forward contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract on March 1, 1990, the transferee would require a payment of $1,070 [($.48×100,000NZD)−($.4907×100,000NZD)] to compensate him for the loss in value of the 100,000NZD. Therefore, X realizes an exchange loss of $1,070. X has a basis in the 100,000NZD of $48,000.

*Example 2.* Assume the same facts as in *Example 1* except that the contract is for Swiss francs and is a section 1256 contract. Assume further that on December 31, 1989, the value to X of the contract as marked to market is $1,000. Pursuant to section 1256(a), X realizes an exchange gain of $1,000. Such gain, however, is characterized as ordinary income under §1.988–3 and will be sourced under §1.988–4.

*Example 3.* X is a calendar year corporation with the dollar as its functional currency. On May 2, 1989, X enters into an option contract with Bank A to purchase 50,000 Canadian dollars (C$) for U.S. $42,500 (C$1 = U.S. $.85) for delivery on or before September 18, 1989. X pays a $285 premium to Bank A to obtain the option contract. On September 18, 1989, when X exercises the option and takes delivery of the C$50,000, the spot rate is C$1 equals U.S. $.90. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery under an option contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract for its fair market value on September 18, 1989, X would receive U.S. $2,500 [(C$50,000×U.S. $.90)−(C$50,000×U.S. $.85)]. Accordingly, X is deemed to have received U.S. $2,500 on the sale of the contract at its fair market value. X will realize U.S. $2,215 ($2,500 deemed received less $285 paid) of exchange gain with respect to the delivery of Canadian dollars under the option contract. X's basis in the 50,000 Canadian dollars is U.S. $45,000.

(5) *Hyperinflationary contracts*—(i) *In general.* If a taxpayer acquires or otherwise enters into a hyperinflationary contract (as defined in paragraph (d)(5)(ii) of this section) that has payments to be made or received that are denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such contract for its taxable year determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the contract was acquired or entered into; and

(B) The earlier of the last day of the taxable year, or the date the contract is disposed of or otherwise terminated.

(ii) *Definition of hyperinflationary contract.* A hyperinflationary contract is a contract described in paragraph (d)(1) of this section that provides for payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer acquires or otherwise enters into the contract.

(iii) *Interaction with other provisions*—(A) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (d)(5) does not apply.

(B) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, this paragraph (d)(5) does not apply.

(C) *Adjustment for subsequent transactions.* Proper adjustments must be made in the amount of any gain or loss

subsequently realized for gain or loss taken into account by reason of this paragraph (d)(5).

(iv) *Effective date.* This paragraph (d)(5) is applicable to transactions acquired or otherwise entered into after February 14, 2000.

(e) *Currency swaps and other notional principal contracts*—(1) *In general.* Except as provided in paragraph (e)(2) of this section or in §1.988–5, the timing of income, deduction and loss with respect to a notional principal contract that is a section 988 transaction shall be governed by section 446 and the regulations thereunder. Such income, deduction and loss is characterized as exchange gain or loss (except as provided in another section of the Internal Revenue Code (or regulations thereunder), §1.988–5, or in paragraph (f) of this section).

(2) *Special rules for currency swaps*—(i) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section, the provisions of this paragraph (e)(2) shall apply solely for purposes of determining the realization, recognition and amount of exchange gain or loss with respect to a currency swap contract, and not for purposes of determining the source of such gain or loss, or characterizing such gain or loss as interest. Except as provided in §1.988–3(c), any income or loss realized with respect to a currency swap contract shall be characterized as exchange gain or loss (and not as interest income or expense). Any exchange gain or loss realized in accordance with this paragraph (e)(2) shall be recognized unless otherwise provided in an applicable section of the Code. For purposes of this paragraph (e)(2), a currency swap contract is a contract defined in paragraph (e)(2)(ii) of this section. With respect to a contract which requires the payment of swap principal prior to maturity of such contract, see paragraph (f) of this section. For purposes of this paragraph (e), the rules of paragraph (d)(2)(ii) of this section (regarding realization by offset) apply. See Example 2 of paragraph (d)(2)(iv) of this section.

(ii) *Definition of currency swap contract*—(A) *In general.* A currency swap contract is a contract involving different currencies between two or more parties to—

(*1*) Exchange periodic interim payments, as defined in paragraph (e)(2)(ii)(C) of this section, on or prior to maturity of the contract; and

(*2*) Exchange the swap principal amount upon maturity of the contract.

A currency swap contract may also require an exchange of the swap principal amount upon commencement of the agreement.

(B) *Swap principal amount.* The swap principal amount is an amount of two different currencies which, under the terms of the currency swap contract, is used to determine the periodic interim payments in each currency and which is exchanged upon maturity of the contract. If such amount is not clearly set forth in the contract, the Commissioner may determine the swap principal amount.

(C) *Exchange of periodic interim payments.* An exchange of periodic interim payments is an exchange of one or more payments in one currency specified by the contract for one or more payments in a different currency specified by the contract where the payments in each currency are computed by reference to an interest index applied to the swap principal amount. A currency swap contract must clearly indicate the periodic interim payments, or the interest index used to compute the periodic interim payments, in each currency.

(iii) *Timing and computation of periodic interim payments*—(A) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section and §1.988–5, the timing and computation of the periodic interim payments provided in a currency swap agreement shall be determined by treating—

(*1*) Payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made (or are determined with reference to) under the swap, and

(*2*) Payments received under the swap as payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received (or are determined with reference to) under the swap.

Except as provided in paragraph (e)(2)(v) of this section, the hypothetical issue price of such hypothetical borrowing and loan shall be the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (excluding any exchange of the swap principal amount at the inception of the contract) provided under the hypothetical borrowing or loan other than periodic interest payments under the principles of section 1273. For purposes of determining economic accrual under the currency swap, the number of hypothetical interest compounding periods of such hypothetical borrowing and loan shall be determined pursuant to a semiannual compounding convention unless the currency swap contract indicates otherwise. For purposes of determining the timing and amount of the periodic interim payments, the principles regarding the amortization of interest (see generally, sections 1272 through 1275 and 163(e)) shall apply to the hypothetical interest expense and income of such hypothetical borrowing and loan. However, such principles shall not apply to determine the time when principal is deemed to be paid on the hypothetical borrowing and loan. See paragraph (d)(2)(iii) of this section and *Example 2* of paragraph (d)(5) of this section with respect to the time when principal is deemed to be paid. With respect to the translation and computation of exchange gain or loss on any hypothetical interest income or expense, see §1.988–2(b). The amount treated as exchange gain or loss by the taxpayer with respect to the periodic interim payments for the taxable year shall be the amount of hypothetical interest income and exchange gain or loss attributable to such interest income from the hypothetical borrowing and loan for such year less the amount of hypothetical interest expense and exchange gain or loss attributable to the interest expense from such hypothetical borrowing and loan for such year.

(B) *Effect of prepayment for purposes of section 956.* For purposes of section 956, the Commissioner may treat any prepayment of a currency swap as a loan.

(iv) *Timing and determination of exchange gain or loss with respect to the swap principal amount.* Exchange gain or loss with respect to the swap principal amount shall be realized on the day the units of swap principal in each currency are exchanged. (See paragraph (e)(2)(ii)(A)(*2*) of this section which requires that the entire swap principal amount be exchanged upon maturity of the contract.) Such gain or loss shall be determined on the date of the exchange by subtracting the value (on such date) of the units of swap principal paid from the value of the units of swap principal received. This paragraph (e)(2)(iv) does not apply to an equal exchange of the swap principal amount at the commencement of the agreement at a market exchange rate.

(v) *Anti-abuse rules*—(A) *Method of accounting does not clearly reflect income.* If the taxpayer's method of accounting for income, expense, gain or loss attributable to a currency swap does not clearly reflect income, or if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may apply principles analogous to those of section 1274 or such other rules as the Commissioner deems appropriate to clearly reflect income. For example, in order to clearly reflect income the Commissioner may determine the hypothetical issue price, the hypothetical stated redemption price at maturity, and the amounts required to be taken into account within a taxable year. Further, if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may integrate the swap with another transaction (or transactions) in order to clearly reflect income.

(B) *Terms must be clearly stated.* If the currency swap contract does not clearly set forth the swap principal amount in each currency, and the periodic interim payments in each currency (or the interest index used to compute the

periodic interim payments in each currency), the Commissioner may defer any income, deduction, gain or loss with respect to such contract until termination of the contract.

(3) *Amortization of swap premium or discount in the case of off-market currency swaps*—(i) *In general.* An ''off-market currency swap'' is a currency swap contract under which the present value of the payments to be made is not equal to that of the payments to be received on the day the taxpayer enters into or acquires the contract (absent the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section). Generally, such present values may not be equal if the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) is not the spot rate, or the interest indices used to compute the periodic interim payments do not reflect current values, on the day the taxpayer enters into or acquires the currency swap.

(ii) *Treatment of taxpayer entering into or acquiring an off-market currency swap.* If a taxpayer that enters into or acquires a currency swap makes a payment (that is, the taxpayer pays a premium, ''swap premium,'' to enter into or acquire the currency swap) or receives a payment (that is, the taxpayer enters into or acquires the currency swap at a discount, ''swap discount'') in order to make the present value of the amounts to be paid equal the amounts to be received, such payment shall be amortized in a manner which places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap contract under which the present value of the amounts to be paid equal the amounts to be received (absent any swap premium or discount). Thus, swap premium or discount shall be amortized as follows—

(A) The amount of swap premium or discount that is attributable to the difference between the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) and the spot rate on the date the contract is entered into or acquired shall be taken into account as income or expense on the date the swap principal amounts are taken into account; and

(B) The amount of swap premium or discount attributable to the difference in values of the periodic interim payments shall be amortized in a manner consistent with the principles of economic accrual. *Cf.*, section 171.

Any amount taken into account pursuant to this paragraph (e)(3)(ii) shall be treated as exchange gain or loss.

(iii) *Definition of swap exchange rate.* The swap exchange rate is the single exchange rate set forth in the contract at which the swap principal amounts are determined. If the swap exchange rate is not clearly set forth in the contract, the Commissioner may determine such rate.

(iv) *Coordination with § 1.446–3(g)(4) regarding swaps with significant nonperiodic payments.* The rules of § 1.446–3(g)(4) apply to any currency swap with a significant nonperiodic payment. Section 1.446–3(g)(4) applies before this paragraph (e)(3). Thus, if § 1.446–3(g)(4) applies, currency gain or loss may be realized on the loan. This paragraph (e)(3)(iv) applies to transactions entered into after February 14, 2000.

(4) *Treatment of taxpayer disposing of a currency swap.* Any gain or loss realized on the disposition or the termination of a currency swap is exchange gain or loss.

(5) *Examples.* The following examples illustrate the application of this paragraph (e).

*Example 1.* (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, C enters into a currency swap with J with the following terms:

(1) the principal amount is $150 and 100 British pounds (£) (the equivalent of $150 on the effective date of the contract assuming a spot rate of £1 = $1.50 on January 1, 1989);

(2) C will make payments equal to 10% of the dollar principal amount on December 31, 1989, and December 31, 1990;

(3) J will make payments equal to 12% of the pound principal amount on December 31, 1989, and December 31, 1990; and

(4) on December 31, 1990, C will pay to J the $150 principal amount and J will pay to C the £100 principal amount.

Assume that the spot rate is £1 = $1.50 on January 1, 1989, £1 = $1.40 on December 31, 1989, and £1 = $1.30 on December 31, 1990. Assume further that the average rate for 1989 is £1 = $1.45 and for 1990 is £1 = $1.35.

(ii) Solely for determining the realization of gain or loss in accordance with paragraph

(e)(2) of this section (and not for purposes of determining whether any payments are treated as interest), C will treat the dollar payments made by C as payments made pursuant to a dollar borrowing with an issue price of $150, a stated redemption price at maturity of $150, and yield to maturity of 10%. C will treat the pound payments received as payments received pursuant to a pound loan with an issue price of £100, a stated redemption price at maturity of £100, and a yield of 12% to maturity. Pursuant to §1.988–2(b), C is required to compute hypothetical accrued pound interest income at the average rate for the accrual period and then determine exchange gain or loss on the day payment is received with respect to such accrued amount. Accordingly, C will accrue $17.40 (£12×$1.45) in 1989 and $16.20 (£12×$1.35) in 1990. C also will compute hypothetical exchange loss of $.60 on December 31, 1989 [(£12×$1.40)−(£12×$1.45)] and hypothetical exchange loss of $.60 on December 31, 1990 [(£12×$1.30)−(£12×$1.35)]. All such hypothetical interest income and exchange loss are characterized and sourced as exchange gain and loss. Further, C is treated as having paid $15 ($150×10%) of hypothetical interest on December 31, 1989, and again on December 31, 1990. Such hypothetical interest expense is characterized and sourced as exchange loss. Thus, C will have a net exchange gain of $1.80 ($17.40−$.60−$15.00) with respect to the periodic interim payments in 1989 and a net exchange gain of $.60 ($16.20−$.60−$15.00) with respect to the periodic interim payments in 1990. Finally, C will realize an exchange loss on December 31, 1990, with respect to the exchange of the swap principal amount. This loss is determined by subtracting the value of the units of swap principal paid ($150) from the value of the units of swap principal received (£100×$1.30 = $130) resulting in a $20 exchange loss.

*Example 2.* (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, when the spot rate is £1 = $1.50, C enters into a currency swap contract with J under which C agrees to make and receive the following payments:

| Date | C pays | J pays |
|---|---|---|
| December 31, 1989 | $15.00 | £12.00 |
| December 31, 1990 | 41.04 | 12.00 |
| December 31, 1991 | 0.00 | 12.00 |
| December 31, 1992 | 150.00 | 112.00 |

(ii) Under paragraph (e)(2)(iii) of this section, C must treat the dollar periodic interim payments under the swap as made pursuant to a hypothetical dollar borrowing. The hypothetical issue price is $150 and the stated redemption price at maturity is $206.04. The amount of hypothetical interest expense must be amortized in accordance with economic accrual. Thus J must include and C must deduct periodic interim payment amounts as follows:

| | Amount taken into account | Adjusted issue price |
|---|---|---|
| December 31, 1989 | $15.00 | 150.00 |
| December 31, 1990 | $15.00 | 123.96 |
| December 31, 1991 | $12.40 | 136.36 |
| December 31, 1992 | $13.64 | |

(iii) Gain or loss with respect to the periodic interim payments of the currency swap is determined under paragraph (e)(2)(iii)(A) of this section with respect to the dollar cash flow amortized as set forth above and the corresponding pound cash flow as stated in the currency swap contract. Gain or loss with respect to the principal payments (*i.e.*, $150 and £100) exchanged on December 31, 1992, is determined under paragraph (e)(2)(iv) of this section on December 31, 1992, notwithstanding that under the principles regarding amortization of interest $26.04 would have been regarded as a payment of principal on December 31, 1990.

*Example 3.* (i) X is a corporation on the accrual method of accounting with the dollar as its functional currency and the calendar year as its taxable year. On January 1, 1989, X enters into a three year currency swap contract with Y with the following terms. The swap principal amount is $100 and the Swiss franc (Sf) equivalent of such amount which equals Sf200 translated at the swap exchange rate of $1 = Sf2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10% compounded annually for U.S. dollar payments and 5% compounded annually for Swiss franc payments. Thus, under the currency swap, X agrees to pay Y $10 (10%×$100) on December 31st of 1989, 1990 and 1991 and to pay Y the swap principal amount of $100 on December 31, 1991. Y agrees to pay X Sf10 (5%×Sf200) on December 31st of 1989, 1990 and 1991 and to pay X the swap principal amount of Sf200 on December 31, 1991. Assume that the average rate for 1989 and the spot rate on December 31, 1989, is $1 = Sf2.5.

(ii) Under paragraph (e)(2)(iii) of this section, on December 31, 1989, X will realize an exchange loss of $6 (the sum of $10 of loss by reason of the $10 periodic interim payment paid to Y and $4.00 of gain, the value of Sf10 on December 31, 1989, from the receipt of Sf10 on such date).

(iii) On January 1, 1990, X transfers its rights and obligations under the swap contract to Z, an unrelated corporation. Z has the dollar as its functional currency, is on the accrual method of accounting, and has the calendar year as its taxable year. On January 1, 1990, the exchange rate is $1 = Sf2.50. The relevant dollar interest rate is 8% compounded annually and the relevant Swiss

franc interest rate is 5% compounded annually. Because of the movement in exchange and interest rates, the agreement between X and Z to transfer the currency swap requires X to pay Z $23.56 (the swap discount as determined under paragraph (e)(3) of this section).

(iv) Pursuant to paragraph (e)(4) of this section, X may deduct the loss of $23.56 in 1990. The loss is characterized under §1.988–3 and sourced under §1.988–4.

(v) Pursuant to paragraph (e)(3)(ii) of this section, Z is required to amortize the $23.56 received as follows. The amount of the $23.56 payment that is attributable to movements in exchange rates ($20) is taken into account on December 31, 1991, the date the swap principal amounts are exchanged, under paragraph (e)(3)(ii)(A) of this section. This amount is the present value (discounted at 10%, the rate under the currency swap contract used to compute the dollar periodic interim payments) of the financial asset required to compensate Z for the loss in value of the hypothetical Swiss franc loan resulting from movements in exchange rates between January 1, 1989, and January 1, 1990. This amount is determined by assuming that interest rates did not change from the date the swap originally was entered into (January 1, 1989), but that the exchange rate is $1 = Sf2.50. Under this assumption, a taxpayer undertaking the obligation to pay dollars under the currency swap on January 1, 1990, would only agree to pay $8 for Sf10 on December 31, 1990, and $88 for Sf210 on December 31, 1991, because the exchange rates have moved from $1 = Sf2 to $1 = Sf2.50. Thus, Z requires $2 on December 31, 1990, and $22 on December 31, 1991, to compensate for the amount of dollar payments Z is required to make in exchange for the Swiss francs received on December 31, 1990 and 1991. The present value of $2 on December 31, 1990, and $22 on December 31, 1991, discounted at the rate for U.S. dollar payments of 10% is $20 ($1.82+$18.18). This amount is discounted at the rate for U.S. dollar payments (i.e., at the historic rate) because the amount of the $23.56 payment received by Z that is attributable to movements in interest rates is computed and amortized separately as provided in the following paragraph.

(vi) Pursuant to paragraph (e)(3)(ii)(B) of this section, Z is required to amortize the portion of the $23.56 payment attributable to movements in interest rates under principles of economic accrual over the term of the currency swap agreement. The amount of the $23.56 payment that is attributable to movements in interest rates (assuming that exchange rates have not changed) is the present value ($3.56) of the excess ($2.00 in 1990 and $2.00 in 1991) of the periodic interim payments Z is required to pay under the currency swap agreement ($10 in 1990 and $10 in 1991) over the amount Z would be required to pay if the currency swap agreement reflected current interest rates on the day Z acquired the swap contract ($8 in 1990 and $8 in 1991) discounted at the appropriate dollar interest rate on January 1, 1990. Thus, under principles of economic accrual (e.g., see section 171 of the Code), Z will include in income $1.72 on December 31, 1990, the amount that, when added to the interest ($.28) on the $3.56 computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1989, and January 1, 1990. Z also will include in income $1.85 on December 31, 1991, the amount that, when added to the interest ($.15) on the $1.85 (the remaining balance of the $3.56 payment) computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1990, and January 1, 1991. This amount is computed assuming exchange rates have not changed because the amount attributable to movements in exchange rates is computed and amortized separately under the preceding paragraph.

(6) *Special effective date for rules regarding currency swaps.* Paragraph (e)(3) of this section regarding amortization of swap premium or discount in the case of off-market currency swaps shall be effective for transactions entered into after September 21, 1989, unless such swap premium or discount was paid or received pursuant to a binding contract with an unrelated party that was entered into prior to such date. For transactions entered into prior to this date, see Notice 89–21, 1989–8 I.R.B. 23.

(7) *Special rules for currency swap contracts in hyperinflationary currencies*—(i) *In general.* If a taxpayer enters into a hyperinflationary currency swap (as defined in paragraph (e)(7)(iv) of this section), then the taxpayer realizes exchange gain or loss for its taxable year with respect to such instrument determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (by the taxpayer); and

(B) The earlier of the last day of the taxable year, or the date the instrument is disposed of or otherwise terminated.

(ii) *Adjustment to principal or basis.* Proper adjustments are made in the amount of any gain or loss subsequently realized for gain or loss taken

into account by reason of this paragraph (e)(7).

(iii) *Interaction with DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (e)(7) does not apply.

(iv) *Definition of hyperinflationary currency swap contract.* A hyperinflationary currency swap contract is a currency swap contract that provides for—

(A) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the currency swap; or

(B) Payments that are adjusted to take into account the fact that the currency is hyperinflationary (as defined in §1.988–1(f)) during the current taxable year. A currency swap contract that provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local consumer price index is an example of this latter type of currency swap contract.

(v) *Special effective date for nonfunctional hyperinflationary currency swap contracts.* This paragraph (e)(7) applies to transactions entered into after February 14, 2000.

(f) *Substance over form*—(1) *In general.* If the substance of a transaction described in §1.988–1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance. For example, if a taxpayer enters into a transaction that it designates a ''currency swap contract'' that requires the prepayment of all payments to be made or to be received (but not both), the Commissioner may recharacterize the contract as a loan. In applying the substance over form principle, separate transactions may be integrated where appropriate. See also §1.861–9T(b)(1).

(2) *Example.* The following example illustrates the provisions of this paragraph (f).

*Example.* (i) On January 1, 1990, X, a U.S. corporation with the dollar as its functional currency, enters into a contract with Y under which X will pay Y $100 and Y will pay X LC100 on January 1, 1990, and X will pay Y LC109.3 and Y will pay X $133 on December 31, 1992. On January 1, 1990, the spot exchange rate is LC1 = $1 and the 3 year forward rate is LC1 = $.8218. X's cash flows are summarized below:

| Date | Dollar | LC |
|---|---|---|
| 1/1/90 | (100) | 100 |
| 12/31/90 | 0 | 0 |
| 12/31/91 | 0 | 0 |
| 12/31/92 | 133 | (109.3) |

(ii) X and Y designate this contract as a ''currency swap.'' Notwithstanding this designation, for purposes of determining the timing, source, and character with respect to the transaction, the transaction is characterized by the Commissioner in accordance with its substance. Thus, the January 1, 1990, exchange by X of $100 for LC 100 is treated as a spot purchase of LCs by X and the December 31, 1992, exchange by X at 109.3LC for $133 is treated as a forward sale of LCs by X. Under such treatment there would be no tax consequences to X under paragraph (e)(2) of this section in 1990, 1991, and 1992 with respect to this transaction other than the realization of exchange gain or loss on the sale of the LC109.3 on December 31, 1992. Calculation of such gain or loss would be governed by the rules of paragraph (d) of this section.

(g) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(h) *Timing of income and deductions from notional principal contracts.* Except as otherwise provided (e.g., in §1.988–5 or 1.446–3(g)), income or loss from a notional principal contract described in §1.988–1(a)(2)(iii)(B) (other than a currency swap) is exchange gain or loss. For the rules governing the timing of income and deductions with respect to notional principal contracts, see §1.446–3. See paragraph (e)(2) of this section with respect to currency swaps.

[T.D. 8400, 57 FR 9183, Mar. 17, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8860, 65 FR 2028, Jan. 13, 2000; T.D. 9157, 69 FR 52819, Aug. 30, 2004]

**§ 1.988–3 Character of exchange gain or loss.**

(a) *In general.* The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, § 1.988–5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) *Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements of paragraph (b)(3) of this section, to treat any gain or loss recognized on a contract described in § 1.988–2(d)(1) as capital gain or loss, but only if the contract—

(i) Is a capital asset in the hands of the taxpayer;

(ii) Is not part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)); and

(iii) Is not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect.

If a valid election under this paragraph (b) is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.

(2) *Special rule for contracts that become part of a straddle after an election is made.* If a contract which is the subject of an election under paragraph (b)(1) of this section becomes part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)) after the date of the election, the election shall be invalid with respect to gains from such contract and the Commissioner, in his sole discretion, may invalidate the election with respect to losses.

(3) *Requirements for making the election.* A taxpayer elects to treat gain or loss on a transaction described in paragraph (b)(1) of this section as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to the section 988(a)(1)(B) election. The Commissioner, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.

(4) *Verification.* A taxpayer that has made an election under § 1.988–3(b)(3) must attach to his income tax return a statement which sets forth the following:

(i) A description and the date of each election made by the taxpayer during the taxpayer's taxable year;

(ii) A statement that each election made during the taxable year was made before the close of the date the transaction was entered into;

(iii) A description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;

(iv) A statement that the contract was never part of a straddle as defined in section 1092; and

(v) A statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

In addition to any penalty that may otherwise apply, the Commissioner, in his sole discretion, may invalidate any or all elections made during the taxable year under § 1.988–3(b)(1) if the taxpayer fails to verify each election as provided in this § 1.988–3(b)(4). The preceding sentence shall not apply if the taxpayer's failure to verify each election was due to reasonable cause or bona fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

(5) *Independent verification*—(i) *Effect of independent verification.* If the taxpayer receives independent verification of the election in paragraph (b)(3) of this section, the taxpayer shall be presumed to have satisfied the requirements of paragraphs (b)(3) and (4) of this section. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.

(ii) *Requirements for independent verification.* A taxpayer receives independent verification of the election in paragraph (b)(3) of this section if—

(A) The taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified pursuant to this paragraph (b)(5) are conducted and reported.

(B) Only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account.

(C) Transactions subject to the election of paragraph (b)(3) of this section are entered into such account on the date such transactions are entered into.

(D) The broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following: ''Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B).''

(iii) *Special effective date for independent verification.* The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) *Effective date.* Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) *Exchange gain or loss treated as interest*—(1) *In general.* Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, §1.988–2(e)(2)(ii)(B), §1.988–5, and in administrative pronouncements. See §1.861–9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) *Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.* Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to the extent of total interest income, no exchange loss shall be recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

[T.D. 8400, 57 FR 9197, Mar. 17, 1992]

### § 1.988–4 Source of gain or loss realized on a section 988 transaction.

(a) *In general.* Except as otherwise provided in §1.988–5 and this section, the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer. This rule applies even if the taxpayer has made an election under §1.988–3(b) to characterize exchange gain or loss as capital gain or loss. This section takes precedence over section 865.

(b) *Qualified business unit*—(1) *In general.* The source of exchange gain or loss shall be determined by reference to the residence of the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense giving rise to such gain or loss is properly reflected.

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general.* Whether an asset, liability, or item of income or expense is properly reflected on the books of a qualified business unit is a question of fact.

(ii) *Presumption if booking practices are inconsistent.* It shall be presumed that an asset, liability, or item of income or expense is not properly reflected on the books of the qualified business unit if the taxpayer and its qualified business units employ inconsistent booking practices with respect to the same or similar assets, liabilities, or items of income or expense. If not properly reflected on the books, the Commissioner may allocate any asset, liability, or item of income or expense between or among the taxpayer and its qualified business units to properly reflect the source (or realization) of exchange gain or loss.

(c) *Effectively connected exchange gain or loss.* Notwithstanding paragraphs (a) and (b) of this section, exchange gain or loss 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 gain or loss 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).

(d) *Residence*—(1) *In general.* Except as otherwise provided in this paragraph (d), for purposes of sections 985 through 989, the residence of any person shall be—

(i) In the case of an individual, the country in which such individual's tax home (as defined in section 911(d)(3)) is located;

(ii) In the case of a corporation, partnership, trust or estate which is a United States person (as defined in section 7701(a)(30)), the United States; and

(iii) In the case of a corporation, partnership, trust or estate which is not a United States person, a country other than the United States.

If an individual does not have a tax home (as defined in section 911(d)(3)), the residence of such individual shall be the United States if such individual is a United States citizen or a resident alien and shall be a country other than the United States if such individual is not a United States citizen or resident alien. If the taxpayer is a U.S. person and has no principal place of business outside the United States, the residence of the taxpayer is the United States. Notwithstanding paragraph (d)(1)(ii) of this section, if a partnership is formed or availed of to avoid tax by altering the source of exchange gain or loss, the source of such gain or loss shall be determined by reference to the residence of the partners rather than the partnership.

(2) *Exception.* In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

(3) *Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).* The determination of residence shall be made at the partner level (without regard to whether the partnership is a qualified business unit of the partners) in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2).

(e) *Special rule for certain related party loans*—(1) *In general.* In the case of a loan by a United States person or a related person to a 10 percent owned foreign corporation, or a corporation that meets the 80 percent foreign business requirements test of section 861(c)(1), other than a corporation subject to §1.861–11T(e)(2)(i), which is denominated in, or determined by reference to, a currency other than the U.S. dollar and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate (as determined under section 1274(d)) at the time such loan is entered into, the following rules shall apply—

(i) For purposes of section 904 only, such loan shall be marked to market annually on the earlier of the last business day of the United States person's

(or related person's) taxable year or the date the loan matures; and

(ii) Any interest income earned with respect to such loan for the taxable year shall be treated as income from sources within the United States to the extent of any notional loss attributable to such loan under paragraph (d)(1)(i) of this section.

(2) *United States person.* For purposes of this paragraph (e), the term ''United States person'' means a person described in section 7701(a)(30).

(3) *Loans by related foreign persons*—(i) *In general.* [Reserved]

(ii) *Definition of related person.* For purposes of this paragraph (e), the term ''related person'' has the meaning given such term by section 954(d)(3) except that such section shall be applied by substituting ''United States person'' for ''controlled foreign corporation'' each place such term appears.

(4) *10 percent owned foreign corporation.* For purposes of this paragraph (e), the term ''10 percent owned foreign corporation'' means any foreign corporation in which the United States person owns directly or indirectly (within the meaning of section 318(a)) at least 10 percent of the voting stock.

(f) *Exchange gain or loss treated as interest under §1.988–3.* Notwithstanding the provisions of this section, any gain or loss realized on a section 988 transaction that is treated as interest income or expense under §1.988–3(c)(1) shall be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e) as the case may be.

(g) *Exchange gain or loss allocated in the same manner as interest under §1.861–9T.* The allocation and apportionment of exchange gain or loss under §1.861–9T shall not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049.

(h) *Effective date.* This section shall be effective for taxable years beginning after December 31, 1986. Thus, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

## §1.988–5 Section 988(d) hedging transactions.

(a) *Integration of a nonfunctional currency debt instrument and a §1.988–5(a) hedge*—(1) *In general.* This paragraph (a) applies to a qualified hedging transaction as defined in this paragraph (a)(1). A qualified hedging transaction is an integrated economic transaction, as provided in paragraph (a)(5) of this section, consisting of a qualifying debt instrument as defined in paragraph (a)(3) of this section and a §1.988–5(a) hedge as defined in paragraph (a)(4) of this section. If a taxpayer enters into a transaction that is a qualified hedging transaction, no exchange gain or loss is recognized by the taxpayer on the qualifying debt instrument or on the §1.988–5(a) hedge for the period that either is part of a qualified hedging transaction, and the transactions shall be integrated as provided in paragraph (a)(9) of this section. However, if the qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of §1.988–2(b).

(2) *Exception.* This paragraph (a) does not apply with respect to a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the U.S. dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher than the Federal short term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.

(3) *Qualifying debt instrument*—(i) *In general.* A qualifying debt instrument is a debt instrument described in §1.988–1(a)(2)(i), regardless of whether denominated in, or determined by reference to, nonfunctional currency (including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments). A qualifying debt instrument does not include accounts payable, accounts receivable or similar items of expense or income.

(ii) *Special rule for debt instrument of which all payments are proportionately hedged.* If a debt instrument satisfies

the requirements of paragraph (a)(3)(i) of this section, and all principal and interest payments under the instrument are hedged in the same proportion, then for purposes of this paragraph (a), that portion of the instrument that is hedged is eligible to be treated as a qualifying debt instrument, and the rules of this paragraph (a) shall apply separately to such qualifying debt instrument. See Example 8 in paragraph (a)(9)(iv) of this section.

(4) *Section 1.988–5(a) hedge*—(i) *In general.* A §1.988–5(a) hedge (hereinafter referred to in this paragraph (a) as a ''hedge'') is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section).

(ii) *Retroactive application of definition of currency swap contract.* A taxpayer may apply the definition of currency swap contract set forth in §1.988–2(e)(2)(ii) in lieu of the definition of swap agreement in section 2(e)(5) of Notice 87–11, 1987–1 C.B. 423 to transactions entered into after December 31, 1986 and before September 21, 1989.

(5) *Definition of integrated economic transaction.* A qualifying debt instrument and a hedge are an integrated economic transaction if all of the following requirements are satisfied—

(i) All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction under paragraph (a) of this section as a qualified hedging transaction such that a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section) can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument. See Examples 6 and 7 of paragraph (a)(9)(iv) of this section.

(ii) The hedge is identified in accordance with paragraph (a)(8) of this section on or before the date the acquisition of the financial instrument (or instruments) constituting the hedge is settled or closed.

(iii) None of the parties to the hedge are related. The term ''related'' means the relationships defined in section 267(b) or section 707(b).

(iv) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.

(v) Subject to the limitations of paragraph (a)(5) of this section, both the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the qualifying debt instrument and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(vi) With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying debt instrument or hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge (other than interest expense that is subject to §1.882–5), would have been effectively connected with such U.S. trade or business throughout the term of the qualified hedging transaction had this paragraph (a) not applied.

(6) *Special rules for legging in and legging out of integrated treatment*—(i) *Legging in.* ''Legging in'' to integrated treatment under this paragraph (a) means that a hedge is entered into after the date the qualifying debt instrument is entered into or acquired, and the requirements of this paragraph (a) are satisfied on the date the hedge is entered into (''leg in date''). If a taxpayer legs into integrated treatment, the following rules shall apply—

(A) Exchange gain or loss shall be realized with respect to the qualifying debt instrument determined solely by reference to changes in exchange rates between—

(*1*) The date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument; and

(*2*) The leg in date.

(B) The recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of.

(C) The source and character of such gain or loss shall be determined on the leg in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.

(ii) *Legging out.* With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, ''legging out'' of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (*e.g.*, exercises an option to change the interest rate or index, or the maturity date) or hedge (*e.g.*, changes the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction. A taxpayer that disposes of or terminates a qualified hedging transaction (*i.e.*, disposes of or terminates both the qualifying transaction and the hedge on the same day) shall be considered to have disposed of or otherwise terminated the synthetic debt instrument rather than as legging out. If a taxpayer legs out of integrated treatment, the following rules shall apply—

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If the hedge is disposed of or otherwise terminated, the qualifying debt instrument shall be treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the ''leg-out date''), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment to the principal amount of the debt instrument must be made to reflect any gain or loss taken into account. The netting rule of §1.988–2(b)(8) shall apply.

(C) If the qualifying debt instrument is disposed of or otherwise terminated, the hedge shall be treated as sold for its fair market value on the date the qualifying debt instrument is disposed of or otherwise terminated (the ''leg-out date''), and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the hedge for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(D) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), that part of the qualified hedging transaction that has not been terminated (*i.e.*, the remaining debt instrument in its entirety even if partially hedged, or hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

(E) If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, then paragraph (a)(6)(ii)(B) or (C) of this section, as appropriate, shall not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that hedges at least 50% of the remaining currency flow with respect to the qualifying debt instrument which was part of the qualified hedging transaction (or, if appropriate, an equivalent amount under the §1.988–5 hedge which was part of the qualified hedging transaction).

(7) *Transactions part of a straddle.* At the discretion of the Commissioner, a transaction shall not satisfy the requirements of paragraph (a)(5) of this section if the debt instrument making up the qualified hedging transaction is part of a straddle as defined in section 1092(c) prior to the time the qualified hedging transaction is identified.

(8) *Identification requirements*—(i) *Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the following information—

(A) The date the qualifying debt instrument and hedge were entered into;

(B) The date the qualifying debt instrument and the hedge are identified as constituting a qualified hedging transaction;

(C) The amount that must be deferred, if any, under paragraph (a)(6) of this section and the source and character of such deferred amount;

(D) A description of the qualifying debt instrument and the hedge; and

(E) A summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.

(ii) *Identification by trustee on behalf of beneficiary.* A trustee of a trust that enters into a qualified hedging transaction may satisfy the identification requirements described in paragraph (a)(8)(i) of this section on behalf of a beneficiary of such trust.

(iii) *Identification by the Commissioner.* If—

(A) A taxpayer enters into a qualifying debt instrument and a hedge but fails to comply with one or more of the requirements of this paragraph (a), and

(B) On the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction,

then the Commissioner may treat the qualifying debt instrument and the hedge as a qualified hedging transaction. The Commissioner may identify a qualifying debt instrument and a hedge as a qualified hedging transaction regardless of whether the qualifying debt instrument and the hedge are held by the same taxpayer.

(9) *Taxation of qualified hedging transactions*—(i) *In general*—(A) *General rule.* If a transaction constitutes a qualified hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction during the period that the transaction qualifies as a qualified hedging transaction. Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to section 263(g), 1092 or 1256 for the period such transactions are integrated. However, the qualified hedging transaction may be subject to section 263(g) or 1092 if such transaction is part of a straddle.

(B) *Special rule for income or expense of foreign persons effectively connected with a U.S. trade or business.* Interest income of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be treated as effectively connected with a U.S. trade or business. Interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be allocated and apportioned under § 1.882–5 of the regulations.

(C) *Special rule for foreign persons that enter into qualified hedging transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into a qualified hedging transaction that gives rise to U.S. source interest income (determined under the source rules for synthetic asset transactions as provided in this section) not effectively connected with a U.S. trade or business of such foreign person, for purposes of sections 871(a), 881, 1441, 1442 and 6049, the provisions of this paragraph (a) shall not apply and such sections of the Internal Revenue Code shall be applied separately to the qualifying debt instrument and the hedge. To the extent relevant to any foreign person, if the requirements of

this paragraph (a) are otherwise met, the provisions of this paragraph (a) shall apply for all other purposes of the Internal Revenue Code (*e.g.*, for purposes of calculating the earnings and profits of a controlled foreign corporation that enters into a qualified hedging transaction through a qualified business unit resident outside the United States, income or expense with respect to such qualified hedging transaction shall be calculated under the provisions of this paragraph (a)).

(ii) *Income tax effects of integration.* The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes, which is subject to the original issue discount provisions of sections 1272 through 1288 and 163(e), the terms of which are determined as follows:

(A) *Denomination of synthetic debt instrument.* In the case where the qualifying debt instrument is a borrowing, the denomination of the synthetic debt instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. For example, if the hedge is a forward contract to acquire British pounds for dollars, and the qualifying debt instrument is a borrowing denominated in British pounds, the synthetic debt instrument is considered a borrowing in dollars.

(B) *Term and accrual periods.* The term of the synthetic debt instrument shall be the period beginning on the identification date and ending on the date the qualifying debt instrument matures or such earlier date that the qualifying debt instrument or hedge is disposed of or otherwise terminated. Unless otherwise clearly indicated by the payment interval under the hedge, the accrual period shall be a six month period which ends on the dates determined under section 1272(a)(5).

(C) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.

(D) *Stated redemption price at maturity.* In the case where the qualifying debt instrument is a borrowing, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

(iii) *Source of interest income and allocation of expense.* Interest income from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be sourced by reference to the source of income under sections 861(a)(1) and 862(a)(1) of the qualifying debt instrument. The character for purposes of section 904 of interest income from a synthetic debt instrument shall be determined by reference to the character of the interest income from qualifying debt instrument. Interest expense from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be allocated and apportioned under §§1.861–8T through 1.861–12T or the successor sections thereof or under §1.882–5.

(iv) *Examples.* The following examples illustrate the application of this paragraph (a)(9).

*Example 1.* (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1989, K agrees to close the following transaction on December 31, 1989. K will borrow from an unrelated party on December 31, 1989, 100 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(a) K will swap, on December 31, 1989, the £100 obtained from the borrowing for $100; and

(b) K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make payments on the pound borrowing:

| Date | U.S. dollars | Pounds |
|---|---|---|
| December 31, 1990 | 8 | 10 |
| December 31, 1991 | 8 | 10 |
| December 31, 1992 | 108 | 110 |

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1989. On December 31, 1989, K borrows the £100 and swaps such pounds for $100. Assume x has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1990, $8 in 1991, and $108 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense with respect to the synthetic dollar borrowing under the rules of §§ 1.861–8T through 1.861–12T.

*Example 2.* (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On December 24, 1989, when the spot rate for Swiss francs (Sf) is Sf1 = $1, K enters into a forward contract to purchase Sf100 in exchange for $100.04 for delivery on December 31, 1989. The Sf100 are to be used for the purchase of a franc denominated debt instrument on December 31, 1989. The instrument will have a term of 3 years, an issue price of Sf100, and will bear interest at 6 percent, payable annually, with no repayment of principal until the final installment. On December 24, 1989, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

| Date | U.S. dollars | Francs |
|---|---|---|
| December 31, 1990 | 6.12 | 6 |
| December 31, 1991 | 6.23 | 6 |
| December 31, 1992 | 112.16 | 106 |

(ii) On December 31, 1989, K takes delivery of the Sf100 and purchases the franc denominated debt instrument. Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated and treated as one transaction with the following consequences:

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument in an amount equal to the dollars exchanged under the forward contract to purchase the francs necessary to acquire the franc debt instrument. Accordingly, the issue price is $100.04 (section 1273(b)(2) of the Code).

(B) The total amount of interest and principal received by K with respect to the synthetic dollar debt instrument is equal to the dollars received under the forward sales contracts (i.e., $6.12 in 1990, $6.23 in 1991, and $112.16 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $106.15 (i.e., $6.12 of the payments in 1990, 1991, and 1992 are treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $6.11.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 1990 (of which $1.88 constitutes OID), $8.15 in 1991 (of which $2.03 constitutes OID), and $8.32 in 1992 (of which $2.20 constitutes OID). The amount of the final payment received by K in excess of the interest income includible is a return of principal and a payment of previously accrued OID.

(E) The source of the interest income shall be determined by applying sections 861(a)(1)

and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

*Example 3.* (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. On January 1, 1993, when the spot rate is £1 = $1.60, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

| Date | U.S. dollars | Pounds |
|---|---|---|
| December 31, 1993 | 12.80 | 10 |
| December 31, 1994 | 12.80 | 10 |
| December 31, 1994 | 160.00 | 100 |

(ii) Assume that British pound interest rates are still 10% and that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(8) of this section. Under paragraph (a)(6)(i) of this section, K must realize exchange gain or loss with respect to the pound borrowing determined solely by reference to changes in exchange rates between January 1, 1992 and January 1, 1993. (Thus, gain or loss from other factors such as movements in interest rates or changes in credit quality of K are not taken into account). Recognition of such gain or loss is deferred until K terminates its pound borrowing. Accordingly, K must defer exchange loss in the amount of $10 [(£100×1.50) − (£100×1.60)].

(iii) Additionally, the qualified hedging transaction is treated as a synthetic U.S. dollar debt instrument with an issue date of January 1, 1993, and a maturity date of December 31, 1994. The issue price of the synthetic debt instrument is $160 (£100×1.60, the spot rate on January 1, 1993) and the total amount of interest and principal is $185.60. The accrual period is the one year period beginning on January 1 and ending December 31 of each year. The stated redemption price at maturity is $160. Thus, K is treated as paying $12.80 of interest in 1993, $12.80 of interest in 1994, and $160 of principal in 1994. The interest expense from the synthetic instrument is allocated and apportioned in accordance with the rules of §§ 1.861–8T through 1.861–12T. Sections 263(g), 1092, and 1256 do not apply to the positions comprising the synthetic dollar borrowing.

*Example 4.* (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1990, is £1 = $1.50. Also on January 1, 1990, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

| Date | U.S. dollars | Pounds |
|---|---|---|
| December 31, 1990 | 12.00 | 10 |
| December 31, 1991 | 12.00 | 10 |
| December 31, 1992 | 162.00 | 110 |

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $12 in 1990, $12 in 1991, and $162 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $12 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§ 1.861–8T through 1.861–12T.

(iv) Assume that on January 1, 1991, the spot exchange rate is £1 = $1.60, interest rates have not changed since January 1, 1990, (accordingly, assume that the market value of K's bond in pounds has not changed) and that K transfers its rights and obligations under the currency swap contract in exchange for $10. Under § 1.988–2(e)(3)(iii), K will include in income as exchange gain $10 on January 1, 1991. Pursuant to paragraph (a)(6)(ii) of this

section, the pound borrowing and the currency swap contract are treated as a qualified hedging transaction for 1990. The loss inherent in the pound borrowing from January 1, 1990, to January 1, 1991, is realized and recognized on January 1, 1991. Such loss is exchange loss in the amount of $10.00 [(£100×$1.50, the spot rate on January 1, 1990)—(£100×$1.60, the spot rate on January 1, 1991)]. For purposes of determining exchange gain or loss on the £100 principal amount of the debt instrument for the period January 1, 1991, to December 31, 1992, the spot rate on January 1, 1991 is used rather than the spot rate on the issue date. Thus, assuming that the spot rate on December 31, 1992, the maturity date, is £1 = $1.80, K realizes exchange loss in the amount of $20 [(£100×$1.60) − (£100×$1.80)]. Except as provided in paragraph (a)(8)(iii) (regarding identification by the Commissioner), the pound borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

*Example 5.* (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On January 1, 1990, when the spot rate for Swiss francs (Sf) is Sf1 = $.50, K converts $100 to Sf200 and purchases a franc denominated debt instrument. The instrument has a term of 3 years, an adjusted issue price of Sf200, and will bear interest at 5 percent, payable annually, with no repayment of principal until the final installment. The U.S. dollar interest rate on an equivalent instrument is 8% on January 1, 1990, compounded annually. On January 1, 1990, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

| Date | U.S. dollars | Francs |
|---|---|---|
| December 31, 1990 | 5.14 | 10 |
| December 31, 1991 | 5.29 | 10 |
| December 31, 1992 | 114.26 | 210 |

(ii) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. Assume further that on January 1, 1991, the spot exchange rate is Sf1 = U.S.$.5143, the U.S. dollar interest rate is 10%, compounded annually, and the Swiss franc interest rate is the same as on January 1, 1990 (5%, compounded annually). On January 1, 1991, K disposes of the forward contracts that were to mature on December 31, 1991, and December 31, 1992 and incurs a loss of $3.62 (the present value of $.10 with respect to the 1991 contract and $4.27 with respect to the 1992 contract).

(iii) The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated for the period beginning January 1, 1990, and ending January 1, 1991.

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument with an issue price of $100.

(B) The total amount of interest and principal to be received by K with respect to the synthetic dollar debt instrument is equal to the dollars to be received under the forward sales contracts (i.e., $5.14 in 1990, $5.29 in 1991, and $114.26 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $109.27 (i.e., $5.14 of the payments in 1990, 1991, and 1992 is treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $9.27.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 1990 (of which $2.86 constitutes OID).

(E) The source of the interest income is determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

(iv) Because K disposed of the forward contracts on January 1, 1991, the rules of paragraph (a)(6)(ii) of this section shall apply. Accordingly, the $3.62 loss from the disposition of the forward contracts is realized and recognized on January 1, 1991. Additionally, K is deemed to have sold the franc debt instrument for $102.86, its fair market value in dollars on January 1, 1991. K will compute gain or loss with respect to the deemed sale of the franc debt instrument by subtracting its adjusted basis in the instrument ($102.86—the value of the Sf200 issue price at the spot rate on the identification date plus $2.86 of original issue discount accrued on the synthetic dollar debt instrument for 1990) from the amount realized on the deemed sale of $102.86. Thus K realizes and recognizes no gain or loss from the deemed sale of the debt instrument. The dollar amount used to determine exchange gain or loss with respect to the franc debt instrument is the Sf200 issue price on January 1, 1991, translated into dollars at the spot rate on January 1, 1991, of Sf1 = U.S.$.5143. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the franc borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

*Example 6.* (i) K is a U.S. corporation with the dollar as its functional currency. On January 1, 1992, K issues a debt instrument with the following terms: the issue price is $1,000, the instrument pays interest annually at a rate of 8% on the $1,000 principal amount, the instrument matures on December 31, 1996, and the amount paid at maturity is the greater of zero or $2,000 less the U.S. dollar value (determined on December 31, 1996) of 150,000 Japanese yen.

(ii) Also on January 1, 1992, K enters into the following hedges with respect to the instrument described in the preceding paragraph: a forward contract under which K will sell 150,000 yen for $1,000 on December 31, 1996 (note that this forward rate assumes that interest rates in yen and dollars are equal); and an option contract that expires on December 31, 1996, under which K has the right (but not the obligation) to acquire 150,000 yen for $2,000. K will pay for the option by making payments to the writer of the option equal to $5 each December 31 from 1992 through 1996.

(iii) The net economic effect of these transactions is that K has created a liability with a principal amount and amount paid at maturity of $1,000, with an interest cost of 8.5% (8% on debt instrument, 0.5% option price) compounded annually. For example, if on December 31, 1996, the spot exchange rate is $1 = 100 yen, K pays $500 on the bond [$2,000 − (150,000 yen/$100)], and $500 in satisfaction of the forward contract [$1,000 − (150,000 yen/$100)]. If instead the spot exchange rate on December 31, 1996 is $1 = 200 yen, K pays $1,250 on the bond [$2,000 − (150,000 yen/$200)] and K receives $250 in satisfaction of the forward contract [$1,000 − (150,000 yen/$200)]. Finally, if the spot exchange rate on December 31, 1996 is $1 = 50 yen, K pays $0 on the bond [$2,000 − (150,000 yen/$50), but the bond holder is not required under the terms of the instrument to pay additional principal]; K exercises the option to buy 150,000 yen for $2,000; and K then delivers the 150,000 yen as required by the forward contract in exchange for $1,000.

(iv) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The debt instrument described in paragraph (i) of this *Example 6* (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the forward contract and option contract described in paragraph (ii) of this example (which constitute a hedge under paragraph (a)(4) of this section and are collectively referred to hereafter as ''the contracts'') together are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to K, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.5% compounded annually (with no original issue discount). K must allocate and apportion its annual interest expense of $85 under the rules of §§1.861–8T through 1.861–12T.

*Example 7.* (i) R is a U.S. corporation with the dollar as its functional currency. On January 1, 1995, R issues a debt instrument with the following terms: the issue price is 504 British pounds (£), the instrument pays interest at a rate of 3.7% (compounded semi-annually) on the £504 principal amount, the instrument matures on December 31, 1999, with a repayment at maturity of the £504 principal plus the proportional gain, if any, in the ''Financial Times'' 100 Stock Exchange (FTSE) index (determined by the excess of the value of the FTSE index on the maturity date over the value of the FTSE on the issue date, divided by the value of the FTSE index on the issue date, multiplied by the number of FTSE index contracts that could be purchased on the issue date for £504).

(ii) Also on January 1, 1995, R enters into a contract with a bank under which on January 1, 1995, R will swap the £504 for $1,000 (at the current spot rate). R will make U.S. dollar payments to the bank equal to 8.15% on the notional principal amount of $1,000 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. R will receive pound payments from the bank equal to 3.7% on the notional principal amount of £504 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. On December 31, 1999, R will swap with the bank $1,000 for £504 plus the proportional gain, if any, in the FTSE index (computed as provided above).

(iii) Economically, both the indexed debt instrument and the hedging contract are hybrid instruments with the following components. The indexed debt instrument is composed of a par pound debt instrument that is assumed to have a 10.85% coupon (compounded semi-annually) plus an embedded FTSE equity index option for which the investor pays a premium of 7.15% (amortized semi-annually) on the pound principal amount. The combined effect is that the premium paid by the investor partially offsets the coupon payments resulting in a return of 3.7% (10.85% − 7.15%). Similarly, the dollar payments under the hedging contract to be made by R are computed by multiplying the dollar notional principal amount by an 8.00% rate (compounded semi-annually) which the facts assume would be the rate paid on a conventional currency swap plus a premium of 0.15% (amortized semi-annually) on the dollar notional principal amount for an embedded FTSE equity index option.

(iv) Assume R satisfies the identification requirements of paragraph (a)(8) of this section. The indexed debt instrument described in paragraph (i) of this *Example 7* constitutes

a qualifying debt instrument under paragraph (a)(3) of this section. The hedging contract described in paragraph (ii) of this *Example 7* constitutes a hedge under paragraph (a)(4) of this section. Since both the pound exposure of the indexed debt instrument and the exposure to movements of the FTSE embedded in the indexed debt instrument are hedged such that a yield to maturity can be determined in dollars, the transaction satisfies the requirement of paragraph (a)(5)(i) of this section. Assuming the transactions satisfy the other requirements of paragraph (a)(5) of this section, the indexed debt instrument and hedge are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to R, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.15% compounded semi-annually (with no original issue discount). K must allocate and apportion its interest expense from the synthetic instrument under the rules §§1.861–8T through 1.861–12T.

*Example 8.* (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1992, K agrees to close the following transaction on December 31, 1992. K will borrow from an unrelated party on December 31, 1992, 200 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(A) K will swap, on December 31, 1992, £100 obtained from the borrowing for $100; and

(B) K will exchange dollars for pounds pursuant to the following table:

| Date | U.S. dollars | Pounds |
|---|---|---|
| December 31, 1993 | 8 | 10 |
| December 31, 1994 | 8 | 10 |
| December 31, 1995 | 108 | 110 |

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1992. On December 31, 1992, K borrows the £200 and swaps £100 for $100. Assume K has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The £200 debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section. Because all principal and interest payments under the instrument are hedged in the same proportion (50% of all interest and principal payments are hedged), 50% of the payments under the £200 instrument (principal amount of £100 and annual interest of £10) are treated as a qualifying debt instrument for purposes of paragraph (a) of this section. Thus, the distinct £100 borrowing and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, £100 of the pound borrowing and the swap are integrated and treated as one synthetic dollar transaction with the following consequences:

(A) The integration of £100 of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1993, $8 in 1994, and $108 in 1995).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1995.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

That portion of the £200 pound debt instrument that is not hedged (*i.e.*, £100) is treated as a separate debt instrument subject to the rules of §1.988–2 (b) and §§1.861–8T through 1.861–12T.

*Example 9.* (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. On the same day, K enters into a currency swap agreement with an unrelated bank under which K agrees to the following:

(A) On January 1, 1992, K will exchange the £100 borrowed for $150.

(B) For the period beginning January 1, 1992 and ending December 31, 1994, K will pay at the end of each month an amount determined by multiplying $150 by one month LIBOR less 65 basis points and receive from the bank on December 31st of 1992, 1993, and 1994, £10.

(C) On December 31, 1994, K will exchange $150 for £100.

Assume K satisfies the identification requirements of paragraph (a)(8) of this section.

(ii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section)

are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract.

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the monthly variable interest payments under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 1994.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

*Example 10.* (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K loans 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. Also on January 1, 1992, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange pounds for dollars pursuant to the following table:

| Date | Pounds | Dollars |
|---|---|---|
| December 31, 1992 | 10 | 12 |
| December 31, 1993 | 10 | 12 |
| December 31, 1994 | 110 | 162 |

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound loan (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound loan and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound loan and the swap results in a synthetic dollar loan with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar loan is equal to the dollar payments received by K under the currency swap contract (i.e., $12 in 1992, $12 in 1993, and $162 in 1994).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar loan.

(D) K must include in income as interest $12 in 1992, 1993, and 1994.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the pound interest income that would have been received had the transaction not been integrated.

(iv) On January 1, 1993, K transfers both the pound loan and the currency swap to B, its wholly owned U.S. subsidiary, in exchange for B stock in a transfer that satisfies the requirements of section 351. Under paragraph (a)(6) of this section, the transfer of both instruments is not ''legging out.'' Rather, K is considered to have transferred the synthetic dollar loan to B in a transaction in which gain or loss is not recognized. B's basis in the loan under section 362 is $100.

(10) *Transition rules and effective dates for certain provisions*—(i) *Coordination with Notice 87–11.* Any transaction entered into prior to September 21, 1989, which satisfied the requirements of Notice 87–11, 1987–1 C.B. 423, shall be deemed to satisfy the requirements of paragraph (a) of this section.

(ii) *Prospective application to contingent payment debt instruments.* In the case of a contingent payment debt instrument, the definition of qualifying debt instrument set forth in paragraph (a)(3)(i) of this section applies to transactions entered into after March 17, 1992.

(iii) *Prospective application of partial hedging rule.* Paragraph (a)(3)(ii) of this section is effective for transactions entered into after March 17, 1992.

(iv) *Effective date for paragraph (a)(6)(i) of this section.* The rules of paragraph (a)(6)(i) of this section are effective for qualified hedging transactions that are legged into after March 17, 1992.

(b) *Hedged executory contracts*—(1) *In general.* If the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2) of this section, the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of this section.

(2) *Definitions*—(i) *Hedged executory contract.* A hedged executory contract is an executory contract as defined in

paragraph (b)(2)(ii) of this section that is the subject of a hedge as defined in paragraph (b)(2)(iii) of this section, provided that the following requirements are satisfied—

(A) The executory contract and the hedge are identified as a hedged executory contract as provided in paragraph (b)(3) of this section.

(B) The hedge is entered into (*i.e.*, settled or closed, or in the case of nonfunctional currency deposited in an account with a bank or other financial institution, such currency is acquired and deposited) on or after the date the executory contract is entered into and before the accrual date as defined in paragraph (b)(2)(iv) of this section.

(C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3) of this section and ending on or after the accrual date.

(D) None of the parties to the hedge are related. The term related means the relationships defined in section 267(b) and section 707(c)(1).

(E) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the executory contract and the hedge are properly reflected on the books of the same qualified business unit.

(F) Subject to the limitations of paragraph (b)(2)(i)(E) of this section, both the executory contract and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the executory contract and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(G) With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract or hedge through such trade or business, all items of income and expense associated with the executory contract and the hedge would have been effectively connected with such U.S. trade or business throughout the term of the hedged executory contract had this paragraph (b) not applied.

(ii) *Executory contract*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future. Notwithstanding the preceding sentence, a contract to buy or sell stock shall be considered an executory contract. (Thus, for example, a contract to sell stock of an affiliate is an executory contract for this purpose.) On the accrual date, such agreement ceases to be considered an executory contract and is treated as an account payable or receivable.

(B) *Exceptions.* An executory contract does not include a section 988 transaction. For example, a forward contract to purchase nonfunctional currency is not an executory contract. An executory contract also does not include a transaction described in paragraph (c) of this section.

(C) *Effective date for contracts to buy or sell stock.* That part of paragraph (b)(2)(ii)(A) of this section which provides that a contract to buy or sell stock shall be considered an executory contract applies to contracts to buy or sell stock entered into on or after March 17, 1992.

(iii) *Hedge*—(A) *In general.* For purposes of this paragraph (b), the term hedge means a deposit of nonfunctional currency in a hedging account (as defined paragraph (b)(3)(iii)(D) of this section), a forward or futures contract described in §1.988–1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract. The term hedge also includes an option contract described in §1.988–

1(a)(1)(ii) and (2)(iii), but only if the option's expiration date is on or before the accrual date. The premium paid for an option that lapses shall be integrated with the executory contract.

(B) *Special rule for series of hedges.* A series of hedges as defined in paragraph (b)(3)(iii)(A) of this section shall be considered a hedge if the executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3)(i) of this section and ending on or after the accrual date. A taxpayer that enters into a series of hedges will be deemed to have satisfied the preceding sentence if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following such termination.

(C) *Special rules for historical rate rollovers—(1) Definition.* A historical rate rollover is an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date to reflect the taxpayer's gain or loss on the contract as of the rollover date plus the time value of such gain or loss through the new maturity date.

(*2*) *Certain historical rate rollovers considered a hedge.* A historical rate rollover is considered a hedge if the rollover date is before the accrual date.

(*3*) *Treatment of time value component of certain historical rate rollovers that are hedges.* Interest income or expense determined under §1.988–2(d)(2)(v) with respect to a historical rate rollover shall be considered part of a hedge if the period beginning on the first date a hedging contract is rolled over and ending on the date payment is made or received under the executory contract does not exceed 183 days. Such interest income or expense shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract. For the treatment of such interest income or expense that is not considered part of a hedge, see §1.988–2(d)(2)(v).

(D) *Special rules regarding deposits of nonfunctional currency in a hedging account.* A hedging account is an account with a bank or other financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts. For purposes of determining the basis of units in such account that comprise the hedge, only those units in the account as of the accrual date shall be taken into consideration. A taxpayer may adopt any reasonable convention (consistently applied to all hedging accounts) to determine which units comprise the hedge as of the accrual date and the basis of the units as of such date.

(E) *Interest income on deposit of nonfunctional currency in a hedging account.* Interest income on a deposit of nonfunctional currency in a hedging account may be taken into account for purposes of determining the amount of a hedge if such interest is accrued on or before the accrual date. However, such interest income shall be included in income as provided in section 61. For example, if a taxpayer with the dollar as its functional currency enters into an executory contract for the purchase and delivery of a machine in one year for 100 British pounds (£), and on such date deposits £90.91 in a properly identified bank account that bears interest at the rate of 10%, the interest that accrues prior to the accrual date shall be included in income and may be considered a hedge.

(iv) *Accrual date.* The accrual date is the date when the item of income or expense (including a capital expenditure) that relates to an executory contract is required to be accrued under the taxpayer's method of accounting.

(v) *Payment date.* The payment date is the date when payment is made or received with respect to an executory contract or the subsequent corresponding account payable or receivable.

(3) *Identification rules*—(i) *Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with paragraph (b)(3) of this section.

(ii) *Identification by the Commissioner.* If a taxpayer enters into an executory contract and a hedge but fails to satisfy one or more of the requirements of paragraph (b) of this section and, based on the facts and circumstances, the Commissioner concludes that the executory contract in substance is hedged, then the Commissioner may apply the provisions of paragraph (b) of this section as if the taxpayer had satisfied all of the requirements therein, and may make appropriate adjustments. The Commissioner may apply the provisions of paragraph (b) of this section regardless of whether the executory contract and the hedge are held by the same taxpayer.

(4) *Effect of hedged executory contract*—(i) *In general.* If a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on such payable or receivable for the period covered by the hedge.

(ii) *Partially hedged executory contracts.* The effect of integrating an executory contract and a hedge that partially hedges such contract is to treat the amounts paid or received under the hedge as paid or received under the portion of the executory contract being hedged, or any subsequent account payable or receivable. The income or expense of services performed or received under the executory contract, or the amount realized or basis of property sold or purchased under the executory contract, that is attributable to that portion of the executory contract that is not hedged shall be translated into functional currency on the accrual date. Exchange gain or loss shall be realized when payment is made or received with respect to any payable or receivable arising on the accrual date with respect to such unhedged amount.

(iii) *Disposition of a hedge or executory contract prior to the accrual date*—(A) *In general.* If a taxpayer identifies an executory contract as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of (or otherwise terminates) the executory contract prior to the accrual date, the hedge shall be treated as sold for its fair market value on the date the executory contract is disposed of and any gain or loss shall be realized and recognized on such date. Such gain or loss shall be an adjustment to the amount received or expended with respect to the disposition or termination, if any. The spot rate on the date the hedge is treated as sold shall be used to determine subsequent exchange gain or loss on the hedge. If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge prior to the accrual date, any gain or loss realized on such disposition shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract.

(B) *Certain events in a series of hedges treated as a termination of the hedged executory contract.* If the rules of paragraph (b)(2)(iii)(B) of this section are not satisfied, the hedged executory contract shall be terminated and the provisions of paragraph (b)(4)(iii)(A) of this section shall apply to any gain or loss previously realized with respect to such hedge. Any subsequent hedging contracts entered into to reduce the risk of exchange rate movements with respect to such executory contract shall not be considered a hedge as defined in paragraph (b)(2)(iii) of this section.

(C) *Executory contracts between related persons.* If an executory contract is between related persons as defined in sections 267(b) and 707(b), and the taxpayer disposes of the hedge or terminates the executory contract prior to the accrual date, the Commissioner may redetermine the timing, source, and character of gain or loss from the hedge or the executory contract if he determines that a significant purpose for disposing of the hedge or terminating the executory contract prior to

the accrual date was to affect the timing, source, or character of income, gain, expense, or loss for Federal income tax purposes.

(iv) *Disposition of a hedge on or after the accrual date.* If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge on or after the accrual date, no gain or loss is recognized on the hedge and the booking date as defined in §1.988–2(c)(2) of the payable or receivable for purposes of computing exchange gain or loss shall be the date such hedge is disposed of. See *Example 3* of paragraph (b)(4)(iv) of this section.

(v) *Sections 263(g), 1092, and 1256 do not apply.* Sections 263(g), 1092, and 1256 do not apply with respect to an executory contract or hedge which comprise a hedged executory contract as defined in paragraph (b)(2) of this section. However, sections 263(g), 1092 and 1256 may apply to the hedged executory contract if such transaction is part of a straddle.

(vi) *Examples.* The principles set forth in paragraph (b) of this section are illustrated in the following examples. The examples assume that K is an accrual method, calendar year U.S. corporation with the dollar as its functional currency.

*Example 1.* (i) On January 1, 1992, K enters into a contract with JPF, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Also on January 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on June 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3)(i) of this section. On June 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to JPF in exchange for the machine. Assume that the accrual date is June 1, 1993.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore, K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. K's basis in the machine is $250,000. Section 1256 does not apply to the forward contract.

*Example 2.* (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of machine. Assume that under K's method of accounting the delivery date is the accrual date. On September 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. Thus K's basis in the machine is $250,000. In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1993, to September 1, 1993. Section 1256 does not apply to the forward contract.

*Example 3.* The facts are the same as in *Example 2* except that K disposed of the forward contract on August 1, 1993 for $10,000. Pursuant to paragraph (b)(4)(iv) of this section, K does not recognize the $10,000 gain. K's basis in the machine is $250,000 (the amount fixed by the forward contract), regardless of the amount in dollars that K actually pays to acquire the Sf500,000 when K pays for the machine. K has a payable with a booking date of August 1, 1993, payable on September 1, 1993 for 500,000 Swiss francs. Thus, K will realize exchange gain or loss on the difference between the amount booked on August 1, 1993 and the amount paid on September 1, 1993 under §1.988–2(c).

*Example 4.* (i) On January 1, 1992, K enters into a contract with S, a Swiss machine repair firm, to pay 500,000 Swiss francs for repairs to be performed on June 1, 1992. Under the contract, K is not obligated to pay for the repairs until September 1, 1992. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on August 1, 1992. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1992, S performs the repair services. Assume that under K's method of accounting this date is the accrual date. On August 1, 1992, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract. On the same day, K deposits the Sf500,000 in a separate account with a bank and properly identifies the transaction as a continuation of the hedged executory contract. On September 1, 1992, K makes payment of the Sf500,000 in the account to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory

contract. Therefore K is deemed to have paid $250,000 for the services and there is no exchange gain or loss on the foreign currency forward contract or on the disposition of Sf500,000 in the account. Any interest on the Swiss francs in the account is included in income but is not considered part of the hedge (because the amount paid for the services must be set on or before the accrual date). In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1992, to September 1, 1992. Section 1256 does not apply to the forward contract.

*Example 5.* (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 250,000 Swiss francs for $125,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of the machine. Assume that under K's method of accounting the delivery date is the accrual date. Assume further that the exchange rate is Sf1 = $.50 on June 1, 1993. On August 30, 1993, K purchases Sf250,000 for $135,000. On September 1, 1993, K takes delivery of the 250,000 Swiss francs (in exchange for $125,000) under the forward contract and makes payment of 500,000 Swiss francs (the Sf250,000 received under the contract plus the Sf250,000 purchased on August 30, 1993) to S. Assume the spot rate on September 1, 1993, is 1 Sf = $.5420 (Sf250,000 equal $135,500).

(ii) Under paragraph (b)(1) of this section, the partial hedge is integrated with the executory contract. K is deemed to have paid $250,000 for the machine [$125,000 on the hedged portion of the Sf500,000 and $125,000 ($.50, the spot rate on June 1, 1993, times Sf250,000) on the unhedged portion of the Sf500,000]. K's basis in the machine therefore is $250,000. K recognizes no exchange gain or loss on the foreign currency forward contract but K will realize exchange gain of $500 on the disposition of the Sf250,000 purchased on August 30, 1993 under §1.988–2(a). In addition, exchange loss is realized on the unhedged portion of the payable in existence from June 1, 1993, to September 1, 1993. Thus, K will realize exchange loss of $10,500 ($125,000 booked less $135,500 paid) under §1.988–2(c) on the payable. Section 1256 does not apply to the forward contract.

*Example 6.* (i) On January 1, 1990, K enters into a contract with S, a Swiss steel manufacturer, to buy steel for 1,000,000 Swiss francs (Sf) for delivery and payment on December 31, 1990. On January 1, 1990, the spot rate is Sf1 = $.50, the U.S. dollar interest rate is 10% compounded annually, and the Swiss franc rate is 5% compounded annually. Under K's method of accounting, the delivery date is the accrual date.

(ii) Assume that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $523,800 for delivery on December 31, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract constitutes a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward contract are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $523,800 for the steel and will have a basis in the steel of $523,800. No gain or loss is realized with respect to the forward contract and section 1256 does not apply to such contract.

(iii) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K cancels the forward contract in exchange for $17,800 ($530,000 − $512,200). On July 1, 1990, K enters into a second forward agreement to buy Sf1,000,000 for $542,900 for delivery on December 31, 1990. K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $525,100 for the steel (the forward price in the second forward agreement of $542,900 less the gain on the first forward agreement of $17,800) and will have a basis in the steel of $525,100. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(iv) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K enters into a historical rate rollover of its $17,800 gain ($530,000 − $512,200) on the forward agreement. Thus, K enters into a second foreign currency forward agreement to buy Sf1,000,000 for $524,210 for delivery on December 31, 1990. (The forward price of $524,210 is the market forward price on July 1, 1990, for the purchase of Sf1,000,000 for delivery on December 31, 1990, of $542,900 less

the $17,800 gain on January 1, 1990, contract and less the time value of such gain of $890.) K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. On December 31, 1990, when the spot rate is Sf1 = $.54, K takes delivery of the Sf1,000,000 (in exchange for $524,210) and purchases the steel for Sf1,000,000. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, which incorporates the rollover of K's gain on the January 1, 1990, contract, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Because the period from the rollover date to the date payment is made under the executory contract does not exceed 183 days, the $890 of interest income is considered part of the hedge and is not recognized. Thus, K is deemed to have paid $524,210 for the steel and will have a basis in the steel of $524,210. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(v) Assume instead that on January 1, 1990, K purchases Sf952,380.95 (the present value of Sf1,000,000 to be paid on December 31, 1990) for $476,190.48 and on the same day deposits the Swiss francs in a separate bank account that bears interest at a rate of 5%, compounded annually. K properly identifies the transaction as a hedged executory contract. Over the period beginning January 1, 1990, and ending December 31, 1990, K receives Sf47,619.05 in interest on the account that is included in income and that has a basis of $25,714.29. (Assume that under §1.988–2(b)(1), K uses the spot rate of Sf1 = $.54 to translate the interest income). On December 31, 1990, K makes payment of the Sf1,000,000 principal and accrued interest in the account to S. Pursuant to paragraph (b)(2)(iii) of this section, the principal in the bank account and the interest constitute a hedge. Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $501,904.77 (the basis of the principal deposited plus the basis of the interest) for the steel and there is no exchange gain or loss on the disposition of the Sf1,000,000. K's basis in the steel therefore is $501,904.77.

(5) *References to this paragraph (b).* If the rules of this paragraph (b) are referred to in another paragraph of this section (*e.g.*, paragraph (c) of this section), then the rules of this paragraph (b) shall be applied for purposes of such other paragraph by substituting terms appropriate for such other paragraph. For example, paragraph (c)(2) of this section refers to the identification rules of paragraph (b)(3) of this section. Accordingly, for purposes of paragraph (c)(2), the rules of paragraph (b)(3) will be applied by substituting the term ''stock or security'' for ''executory contract''.

(c) *Hedges of period between trade date and settlement date on purchase or sale of publicly traded stock or security.* If a taxpayer purchases or sells stocks or securities which are traded on an established securities market and—

(1) Hedges all or part of such purchase or sale for any part of the period beginning on the trade date and ending on the settlement date; and

(2) Identifies the hedge and the underlying stock or securities as an integrated transaction under the rules of paragraph (b)(3) of this section;

then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and shall not be taken into account as exchange gain or loss). The term hedge means a deposit of nonfunctional currency in a hedging account (within the meaning of paragraph (b)(2)(iii)(D) of this section), or a forward or futures contract described in §1.988–1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations for any portion of the period beginning on the trade date and ending on the settlement date. The provisions of paragraphs (b)(2)(i)(D) through (G), and (b)(2)(iii)(D) and (E) of this section shall apply. Sections 263(g), 1092, and 1256 do not apply with respect to stock or securities and a hedge which are subject to this paragraph (c).

(d) [Reserved]

(e) *Advance rulings regarding net hedging and anticipatory hedging systems.* In his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures

for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

(f) [Reserved]

(g) *General effective date.* Except as otherwise provided in this section, the rules of this section shall apply to qualified hedging transactions, hedged executory contracts and transactions described in paragraph (c) of this section entered into on or after September 21, 1989. This section shall apply even if the transaction being hedged (*e.g.*, the debt instrument) was entered into or acquired prior to such date. The effective date regarding advance rulings for net and anticipatory hedging shall be governed by such revenue procedures that the Commissioner may publish.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

### § 1.988–6 Nonfunctional currency contingent payment debt instruments.

(a) *In general*—(1) *Scope.* This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1) and to which §1.1275–4(a) would otherwise apply if the debt instrument were denominated in the taxpayer's functional currency. Except as provided by the rules in this section, the rules in §1.1275–4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275–4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1) (*e.g.*, the instrument is issued for non-publicly traded property).

(2) *Exception for hyperinflationary currencies*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985–1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) *Discretion as to method.* If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988–2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) *Instruments described in paragraph (a)(1)(i) of this section*—(1) *In general.* Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275–4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument.

Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) *Application of noncontingent bond method*—(i) *Accrued interest.* Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275–4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275–4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275–4(b)(4)(i) shall be the rate described in §1.1274–4(d) with respect to the denomination currency.

(ii) *Net positive and negative adjustments.* Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(6) (and §1.1275–4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C), in the denomination currency.

(iii) *Adjusted issue price.* The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) *Adjusted basis.* The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) *Amount realized.* The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) *Treatment and translation of amounts determined under noncontingent bond method*—(i) *Accrued interest.* The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988–2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988–2(b)(2)(iii)(B).

(ii) *Net positive and negative adjustments*—(A) *Net positive adjustments.* A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under §1.1275–4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) *Net negative adjustments.* A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(*1*) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(*2*) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275–4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(*3*) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(*1*) and (*2*) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(*4*) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(*1*), (*2*) and (*3*) of this section is a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to

interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275–4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) *Adjusted basis*—(A) *In general.* Except as otherwise provided in this paragraph and paragraph (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275–4(b)(7)(iii) into functional currency as follows:

(*1*) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(*2*) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(*3*) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275–4(b)(7)(iii) are translated as follows:

(*i*) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(*ii*) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(*3*)(*i*) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) *Exception for interest reduced by a negative adjustment carryforward.* Solely for purposes of this §1.988–6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) *Amount realized*—(A) *Instrument held to maturity*—(*1*) *In general.* With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(*2*) *Subsequent purchases at discount and fixed but deferred contingent payments.* For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) *Sale, exchange, or unscheduled retirement*—(*1*) *Holder.* In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's

amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (*i.e.*, any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(*2*) *Issuer*. In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) *Effect of negative adjustment carryforward with respect to the issuer*. Any amount of negative adjustment carryforward treated as ordinary income under §1.1275–4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) *Determination of gain or loss not attributable to foreign currency*. A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in §1.1275–4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) *Determination of foreign currency gain or loss*—(i) *In general*. Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of §1.988–2(b).

(ii) *Foreign currency gain or loss attributable to accrued interest*. The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) *Principal*. The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists

of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) *Payment ordering rules*—(A) *In general.* Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(*1*) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(*2*) Any amount remaining after applying paragraph (b)(5)(iv)(A)(*1*) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(*3*) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(*1*) and (*2*) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) *Special rule for sale or exchange or unscheduled retirement.* Payments made or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) *Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest.* A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) *Source of gain or loss.* The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988–4. Consistent with the rules of §1.1275–4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275–4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865–1(b)(2).

(7) *Basis different from adjusted issue price*—(i) *In general.* The rules of §1.1275–4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) *Determination of basis.* If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) *Purchase price greater than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the

date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) *Purchase price less than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) *Fixed but deferred contingent payments.* In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275–4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275–4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

*Example 1. Treatment of net positive adjustment*—(i) *Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275–4(b), provides for a single payment of £1210 on December 31, 2006 (consisting of a noncontingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

| Date | Spot rate (pounds to dollars) |
|---|---|
| Dec. 31, 2004 | £1.00 = $1.00 |
| Dec. 31, 2005 | £1.00 = $1.10 |
| Dec. 31, 2006 | £1.00 = $1.20 |

| Accrual period | Average rate (pounds to dollars) |
|---|---|
| 2005 | £1.00 = $1.05 |
| 2006 | £1.00 = $1.15 |

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($1.05 × £100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 × £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ($1.15 × £110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) *Effect of net positive adjustment.* The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 × £90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210. The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [£100 × ($1.20 − $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [£110 × ($1.20 − $1.15)]. With respect to principal, the foreign currency gain is $200 [£1000 × ($1.20 − $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) *Source.* Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States.

Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 2. Treatment of net negative adjustment.* (i) *Facts.* Assume the same facts as in *Example 1*, except that Z receives £975 at maturity instead of £1300.

(ii) *Treatment in 2005.* The treatment of the debt instrument in 2005 is the same as in *Example 1*. Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 × £110 = $126.50).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 − £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 + $126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 − $1231.50 = − $25).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [£975 × ($1.20 − $1.00)].

(F) *Source.* In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 3. Negative adjustment and periodic interest payments*—(i) *Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument

with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

| Date | Spot rate (pounds to dollars) |
|---|---|
| Dec. 31, 2004 | £1.00 = $1.00 |
| June 30, 2005 | £1.00 = $1.20 |
| Dec. 31, 2005 | £1.00 = $1.40 |
| June 30, 2006 | £1.00 = $1.60 |
| Dec. 31, 2006 | £1.00 = $1.80 |

| Accrual period | Average rate (pounds to dollars) |
|---|---|
| Jan.-June 2005 | £1.00 = $1.10 |
| July-Dec. 2005 | £1.00 = $1.30 |
| Jan.-June 2006 | £1.00 = $1.50 |
| July-Dec. 2006 | £1.00 = $1.70 |

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 × 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($1.10 × £50 = $55.00). Similarly, Z accrues £51 of interest in the July-December accrual period [(£1000 + £50 − £30) × 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 × £51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 − £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 × £50 = $55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.10 × £30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 − $33).

(*2*) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 − £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 × £51 = $66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.30 × £30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 − $39).

(C) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [£30 × ($1.20 − $1.10)], and $3 of foreign currency gain on the July-December interest payment [£30 × ($1.40 − $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) *Source.* Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of

this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is £52.05 (adjusted issue price of £1041 × 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($1.50 × £52.05 = $78.08). Similarly, Z accrues £53.15 of interest in the July-December accrual period [(£1041 + £52.05 − £30) × 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 × £53.15 = $90.35). Accordingly, Z accrues £105.20, or $168.43, of interest income in 2006.

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *Adjusted issue price and basis*—(1) *January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is £1063.05 (£1041 + £52.05 − £30 = £1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the £52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 × £52.05 = $78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.50 × £30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 − $45).

(2) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is £1086.20 (£1063.05 + £53.15 − £30 = £1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the £53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 × £53.15 = $90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.70 × £30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 − $51).

(D) *Amount realized.* Even though Z receives £981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £20 of the £1086.20 (representing the interest accrued in the January-June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.10), resulting in an amount realized of $22; £21 of the £1086.20 (representing the interest accrued in the July-December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.30), resulting in an amount realized of $27.30; £22.05 of the £1086.20 (representing the interest accrued in the January-June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1–December 31, 2006 accrual period, less the £30 interest payment) is translated into dollars at the rate at which it was accrued (£1 = $1.70), resulting in an amount realized of $39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(*3*) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference

between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [£30 × ($1.60 − $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [£30 × ($1.80 − $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the £30 payments), the foreign currency gain is $14 [£20 × ($1.80 − $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the £30 payments), the foreign currency gain is $10.50 [£21 × ($1.80 − $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [£940 × ($1.80 − $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two £30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) *Source.* Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 4. Purchase price greater than adjusted issue price.* (i) *Facts.* On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of §1.1275-4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

| Date | Spot rate (pounds to dollars) |
|---|---|
| July 1, 2005 | £1.00 = $1.00 |
| Dec. 31, 2006 | £1.00 = $2.00 |

| Accrual period | Average rate (pounds to dollars) |
|---|---|
| July 1–Dec. 31, 2005 | £1.00 = $1.50 |
| Jan. 1–June 30, 2006 | £1.00 = $1.50 |
| July 1–Dec. 31, 2006 | £1.00 = $1.50 |

(ii) *Initial basis.* Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is $1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = $1).

(iii) *Allocation of purchase price differential.* Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($1.50 × £59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is

£1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (£59.54 × $1.50)].

(v) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 × £62.59 = $93.89). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [(£1221.30 + £62.59) × 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 × £65.80 = $98.70). Accordingly, Z accrues £128.39, or $192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments*—(*1*) *Offset of positive adjustment.* The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 (£50.30 − £243.24 = £192.94) for 2006.

(*2*) *Offset of accrued interest.* Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining £5.01 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*—(*1*) *January-June accrual period.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89 (£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(*2*) *July-December accrual period.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(*3*) *Adjustment to basis upon contingent payment.* Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = $1). Accordingly, Z's adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 − $243.24).

(D) *Amount realized.* Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 − £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $89.31; £62.59 of the £1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $93.89; £65.80 of the £1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1156.76. Z's amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 − $1443.66 = −$5).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain under section 988

on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [£1400 × ($2.00 − $1.00)].

(F) *Source.* Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 5. Sale of an instrument with a negative adjustment carryforward.* (i) *Facts.* On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British poundsunder §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

| Date | Spot rate (pounds to dollars) |
|---|---|
| Dec. 31, 2003 | £1.00 = $1.00 |
| Dec. 31, 2005 | £1.00 = $2.00 |
| Dec. 30, 2006 | £1.00 = $2.00 |

| Accrual period | Average rate (pounds to dollars) |
|---|---|
| Jan. 1–Dec. 31, 2004 | £1.00 = $2.00 |
| Jan. 1–Dec. 31, 2005 | £1.00 = $2.00 |
| Jan. 1–Dec. 31, 2006 | £1.00 = $2.00 |

(ii) *Treatment in 2004*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($2.00 × £100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 × £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 × 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 × £110 = $220).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section, the net negative adjustment which

reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006 is £900, *i.e.*, the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis on January 1, 2006 is Z's adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z's adjusted basis on January 1, 2006 is therefore, $900.

(D) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the £50 payment. [($2.00—$1.00) × £50 =$50]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2006 (adjusted issue price of £900 × 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ($2.00 × £90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) *Effect of net negative adjustment.* The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue $80 of interest income. [(£90 − £50) × $2.00 = $80]

(C) *Adjusted issue price.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis.* For purposes of determining Z's dollar basis in the debt instrument, Z's $900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) of this section the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*, £1.00 =$1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) *Amount realized.* Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(*1*) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also translated by reference to the

principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is $940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis − $940 amount realized). Under paragraph (b)(4) of this section and §1.1275–4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under §§1.988–6(b)(6) and 1.1275–4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§1.988–6(b)(6) and 1.865–1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00 − $1.00) × £940]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments*—(1) *In general.* Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency*—(i) *In general.* The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. Except as otherwise provided in paragraph (d)(2)(ii) of this section, the predominant currency of the instrument shall be the currency with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies).

(ii) *Difference in discount rate of greater than 10 percentage points.* This §1.988–6(d)(2)(ii) applies if no currency has a value determined under paragraph (d)(2)(i) of this section that is greater than 50% of the total value of all payments. In such a case, if the difference between the discount rate in the denomination currency otherwise determined under (d)(2)(i) of this section and the discount rate determined under paragraph (d)(2)(i) of this section with respect to any other currency in which payments are made (or determined by reference to) pursuant to the instrument is greater than 10 percentage points, then the Commissioner may determine the predominant currency under any reasonable method.

(3) *Issuer/holder consistency.* The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to

the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency.* For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as noncurrency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275–4(b) rather than under this section.

(e) *Instruments issued for nonpublicly traded property—(1) Applicability.* This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1). For example, this paragraph (e) generally applies to a contingent payment debt instrument denominated in a nonfunctional currency that is issued for nonpublicly traded property. Generally the rules of §1.1275–4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components.* An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275–4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency.* The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274–2(c)(2), and the test rate shall be determined under §1.1274–4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the *de minimis* rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in §1.988–2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) *Treatment of components consisting of contingent payments*—(i) *General rule.* A component consisting of a contingent payment shall generally be treated in the manner provided in §1.1275–4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) *Certain delayed contingent payments*—(A) *Separate debt instrument relating to the fixed component.* The rules of §1.1275–4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be

made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988–2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) *Contingent component.* With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275–4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) *Basis different from adjusted issue price.* The rules of §1.1275–4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) *Treatment of a holder on sale, exchange, or retirement.* The rules of §1.1275–4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) *Rules for nonfunctional currency tax exempt obligations described in §1.1275–4(d)*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, section 1.988–6 shall not apply to a debt instrument the interest on which is excluded from gross income under section 103(a).

(2) *Operative rules.* [Reserved].

(g) *Effective date.* This section shall apply to debt instruments issued on or after October 29, 2004.

[T.D. 9157, 69 FR 52819, Aug. 30, 2004]

### § 1.989(a)–1 Definition of a qualified business unit.

(a) *Applicability*—(1) *In general.* This section provides rules relating to the definition of the term ''qualified business unit'' (QBU) within the meaning of section 989.

(2) *Effective date.* These rules shall apply to taxable years beginning after December 31, 1986. However, any person may apply on a consistent basis §1.989(a)–1T (c) of the Temporary Income Tax Regulations in lieu of §1.989(a)–1 (c) to all taxable years beginning after December 31, 1986, and on or before February 5, 1990. For the text of the temporary regulation, see 53 FR 20612 (June 8, 1988).

(b) *Definition of a qualified business unit*—(1) *In general.* A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.

(2) *Application of the QBU definition*—(i) *Persons.* A corporation is QBU. An individual is not a QBU. A partnership, trust, or estate is a QBU of a partner or beneficiary.

(ii) *Activities.* Activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if—

(A) The activities constitute a trade or business; and

(B) A separate set of books and records is maintained with respect to the activities.

(3) *Special rule.* Any activity (wherever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States shall be treated as a separate QBU, provided the books and records requirement of paragraph (d)(2) of this section is satisfied.

(c) *Trade or business.* The determination as to whether activities constitute a trade or business is ultimately dependent upon an examination of all the facts and circumstances. Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes). To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. Such group of activities must ordinarily include the collection of income and the payment of expenses. It is not necessary that the activities carried out by a QBU constitute a different trade or business from those carried out by other QBUs of the taxpayer. A vertical, functional, or geographic division of the same trade or business

may be a trade or business for this purpose provided that the activities otherwise qualify as trade or business under this paragraph (c). However, activities that are merely ancillary to a trade or business will not constitute a trade or business under this paragraph (c). Activities of an individual as an employee are not considered by themselves to constitute a trade or business under this paragraph (c).

(d) *Separate books and records*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, a separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records. For example, in the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal where each receipt and each disbursement is recorded. Similarly, in the case of a taxpayer using an accrual method of accounting, the books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses incurred (accounts payable). In general, a journal represents a chronological account of all transactions entered into by an entity for an accounting period. A ledger account, on the other hand, chronicles the impact during an accounting period of the specific transactions recorded in the journal for that period upon the various items shown on the entity's balance sheet (*i.e.*, assets, liabilities, and capital accounts) and income statement (*i.e.*, revenues and expenses).

(2) *Special rule.* For purposes of paragraph (b)(3) of this section, books and records include books and records used to determine income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

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

*Example 1.* Corporation X is a domestic corporation. Corporation X manufactures widgets in the U.S. for export. Corporation X sells widgets in the United Kingdom through a branch office in London. The London office has its own employees and solicits and processes orders. Corporation X maintains in the U.S. a separate set of books and records for all transactions conducted by the London office. Corporation X is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. The London branch office is a QBU under paragraph (b)(2)(ii) of this section because (1) the sale of widgets is a trade or business as defined in paragraph (c) of this section; and (2) a complete and separate set of books and records (as described in paragraph (d) of this section) is maintained with respect to its sales operations.

*Example 2.* A domestic corporation incorporates a wholly-owned subsidiary in Switzerland. The domestic corporation is a manufacturer that markets its product abroad primarily through the Swiss subsidiary. To facilitate sales of the parent's product in Europe, the Swiss subsidiary has branch offices in France and West Germany that are responsible for all marketing operations in those countries. Each branch has its own employees, solicits and processes orders, and maintains a separate set of books and records. The domestic corporation and the Swiss subsidiary are both QBUs under paragraph (b)(2)(i) of this section because of their corporate status. The French and West German branches are QBUs of the Swiss subsidiary. They satisfy paragraph (b)(2)(ii) because each constitutes a trade or business (as defined in paragraph (c) of this section) and because separate sets of books and records (as described in paragraph (d) of this section) of their respective operations is maintained. Each branch is considered to have a trade or business although each is a geographical division of the same trade or business.

*Example 3.* W is a domestic corporation that manufactures product X in the United States for sale worldwide. All of W's sales functions are conducted exclusively in the United States. W employs individual Q to work in France. Q's sole function is to act as a courier to deliver sales documents to customers in France. With respect to Q's activities in France, a separate set of books and records as described in paragraph (d) is maintained. Under paragraph (c) of this section, Q's activities in France do not constitute a QBU since they are merely ancillary to W's manufacturing and selling business. Q is not considered to have a QBU because an individual's activities as an employee are not considered to constitute a trade or business of the individual under paragraph (c).

*Example 4.* The facts are the same as in example (3) except that the courier function is the sole activity of a wholly-owned French subsidiary of W. Under paragraph (b)(2)(i) of this section, the French subsidiary is considered to be a QBU.

*Example 5.* A corporation incorporated in the Netherlands is a subsidiary of a domestic corporation and a holding company for the

stock of one or more subsidiaries incorporated in other countries. The Dutch corporation's activities are limited to paying its directors and its administrative expenses, receiving capital contributions from its United States parent corporation, contributing capital to its subsidiaries, receiving dividend distributions from its subsidiaries, and distributing dividends to its domestic parent corporation. Under paragraph (b)(2)(i) of this section, the Netherlands corporation is considered to be a QBU.

*Example 6.* Taxpayer A, an individual resident of the United States, is engaged in a trade or business wholly unrelated to any type of investment activity. A also maintains a portfolio of foreign currency-denominated investments through a foreign broker. The broker is responsible for all activities necessary to the management of A's investments and maintains books and records as described in paragraph (d) of this section, with respect to all investment activities of A. A's investment activities qualify as a QBU under paragraph (b)(2)(ii) of this section to the extent the activities engaged in by A generate expenses that are deductible under section 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes).

*Example 7.* Taxpayer A, an individual resident of the United States, is the sole shareholder of foreign corporation (FC) whose activities are limited to trading in stocks and securities. FC is a QBU under paragraph (b)(2)(i) of this section.

*Example 8.* Taxpayer A, an individual resident of the United States, markets and sells in Spain and in the United States various products produced by other United States manufacturers. A has an office and employs a salesman to manage A's activities in Spain, maintains a separate set of books and records with respect to his activities in Spain, and is engaged in a trade or business as defined in paragraph (c) of this section. Therefore, under paragraph (b)(2)(ii) of this section, the activities of A in Spain are considered to be a QBU.

*Example 9.* Foreign corporation FX is incorporated in Mexico and is wholly owned by a domestic corporation. The domestic corporation elects to treat FX as a domestic corporation under section 1504(d). FX operates entirely in Mexico and maintains a separate set of books and records with respect to its activities in Mexico. FX is a QBU under paragraph (b)(2)(i) of this section. The activities of FX in Mexico also constitute a QBU under paragraph (b)(2)(ii) of this section.

*Example 10.* F, a foreign corporation, computes a gain of $100 from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business in the United States and as if such gain were effectively connected with such trade or business. F is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. F's disposition activity constitutes a separate QBU under paragraph (b)(3) of this section.

[T.D. 8279, 55 FR 284, Jan. 4, 1990]

### § 1.989(b)–1 Definition of weighted average exchange rate.

For purposes of section 989(b)(3) and (4), the term ''weighted average exchange rate'' means the simple average of the daily exchange rates (determined by reference to a qualified source of exchange rates within the meaning of § 1.964–1(d)(5)), excluding weekends, holidays and any other nonbusiness days for the taxable year.

[T.D. 8263, 54 FR 38664, Sept. 20, 1989. Redesignated by T.D. 8367, 56 FR 48437, Sept. 25, 1991; 57 FR 6060, Feb. 18, 1992]

### § 1.989(c)–1 Transition rules for certain branches of United States persons using a net worth method of accounting for taxable years beginning before January 1, 1987.

(a) *Applicability*—(1) *In general.* This section applies to qualified business units (QBU) branches of United States persons, whose functional currency (as defined in section 985 of the Code and regulations issued thereunder) is other than the United States dollar (dollar) and that used a net worth method of accounting for their last taxable year beginning before January 1, 1987. Generally, a net worth method of accounting is any method of accounting under which the taxpayer calculates the taxable income of a QBU branch based on the net change in the dollar value of the QBU branch's equity over the course of a taxable year, taking into account any remittance made during the year. QBU branch equity is the excess of QBU branch assets over QBU branch liabilities. For all taxable years beginning after December 31, 1986, such QBU branches must use the profit and loss method of accounting as described in section 987, except to the extent otherwise provided in regulations under section 985 or any other provision of the Code.

(2) *Insolvent QBU branches.* A taxpayer may apply the principles of this section to a QBU branch that used a net worth method of accounting for its

last taxable year beginning before January 1, 1987, whose $E pool (as defined in paragraph (d)(3)(i) of this section) is negative. For taxable years beginning on or after October 25, 1991, the principles of this section shall apply to insolvent QBU branches.

(b) *General rules.* For the general rules, see §1.987–5(b).

(c) *Determining the pool(s) from which a remittance is made.* To determine from which pool(s) a remittance is made, see §1.987–5(c).

(d) *Calculation of section 987 gain or loss*—(1) *In general.* See §1.987–5(d)(1) for rules to make this calculation.

(2) *Step 1—Calculate the amount of the functional currency pools.* For calculation of the amount of the functional currency pools, see §1.987–5(d)(2).

(3) *Step 2—Calculate the dollar basis pools*—(i) *Dollar basis of the EQ pool*—(A) *Beginning dollar basis.* The beginning dollar basis of the EQ pool (hereinafter referred to as the $E pool) equals the final net worth of the QBU branch. Final net worth of the QBU branch equals the QBU branch's equity value (assets less liabilities) measured in dollars at the end of the taxpayer's last taxable year beginning before January 1, 1987, determined on the basis of the QBU branch's books and records as adjusted according to United States tax principles.

(B) *Adjusting the $E pool.* For adjustments to be made to the $E pool, see §1.987–5(d)(3)(i)(B).

(ii) *Dollar basis of the post-86 profits pool.* To calculate the dollar basis of the post-86 profits pool, see §1.987–5(d)(3)(ii).

(iii) *Dollar basis of the equity pool.* To calculate the dollar basis of the equity pool, see §1.987–5(d)(3)(iii).

(4) *Step 3—Calculation of the dollar basis of a remittance.* To calculate the dollar basis of the EQ remitted, see §1.987–5(d)(4).

(5) *Step 4—Calculation of the section 987 gain or loss on a remittance.* To calculate 987 gain or loss determined on a remittance, see §1.987–5(d)(5).

(e) *Functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987.* To determine the functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987, see §1.987–5(e).

(f) *Functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987.* To determine the functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987, see §1.987–5(f).

[T.D. 8367, 56 FR 48437, Sept. 25, 1991]

## DOMESTIC INTERNATIONAL SALES CORPORATIONS

### §1.991–1 Taxation of a domestic international sales corporation.

(a) *In general.* A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for such taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax. Thus, for example, a corporation which is a DISC for a taxable year is not subject for such year to the corporate income tax (section 11), the minimum tax on tax preferences (sections 56 through 58), or the accumulated earnings tax (sections 531 through 537). A DISC is liable for the payment of all taxes payable by corporations under other subtitles of the Code, such as, for example, income taxes withheld at the source and other employment taxes under subtitle C and the interest equalization tax and other miscellaneous excise taxes imposed by subtitle D. In addition, a DISC is subject to the provisions of chapter 3 of subtitle A (including section 1461), relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds. See §1.992–1 for the definition of the term ''DISC.''

(b) *Determination of taxable income*—(1) *In general.* Although a DISC is not subject to tax under subtitle A of the Code (other than chapter 5 thereof), a DISC's taxable income shall be determined for each taxable year in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders pursuant to §1.995–2. Except as otherwise provided in the Code and the regulations thereunder, the taxable income of a DISC

shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, for example, a DISC chooses its method of depreciation, inventory method, and annual accounting period in the same manner as if it were a corporation which had not elected to be treated as a DISC. Any elections affecting the determination of taxable income shall be made by the DISC. Thus, as a further example, a DISC which makes an installment sale described in section 453 is able to avail itself of the benefits of section 453: *Provided,* The DISC complies with the election requirements of such section. See §1.995–2(e) and §1.996–8 and the regulations thereunder for rules relating to the application for a taxable year of a DISC of a deduction under section 172 for a net operating loss carryback or carryover or of a capital loss carryback or carryover under section 1212.

(2) *Choice of method of accounting.* A DISC may, generally, choose any method of accounting permissible under section 446(c) and the regulations thereunder. However, if a DISC is a member of a controlled group (as defined in §1.993–1(k)), the DISC may not choose a method of accounting which, when applied to transactions between the DISC and other members of the controlled group, will result in a material distortion of the income of the DISC or any other member of the controlled group. Such a material distortion of income would occur, for example, if a DISC chooses to use the cash method of accounting where the DISC acts as commission agent in a substantial volume of sales of property by a related corporation which uses the accrual method of accounting and which customarily pays commissions to the DISC more than 2 months after such sales. As a further example, a material distortion of income would occur if a DISC chooses to use the accrual method of accounting where the DISC leases a substantial amount of property from a related corporation which uses the cash method of accounting, if the DISC customarily accrues any portion of the rent on such property more than 2 months before the rent is paid. Changes in the method of accounting of a DISC are subject to the requirements of section 446(e) and the regulations thereunder.

(3) *Choice of annual accounting period*—(i) *In general.* A DISC may choose its annual accounting period without regard to the annual accounting period of any of its stockholders. In general, changes in the annual accounting period of a DISC are subject to the requirements of section 442 and the regulations thereunder.

(ii) *Transition rule for change in taxable year in order to become a DISC.* A corporation may, without the consent of the Commissioner, change its annual accounting period and adopt a new taxable year beginning on the first day of any month in 1972: *Provided,* That—

(*a*) Such change has the effect of accelerating the time as of which such corporation can become a DISC,

(*b*) The Commissioner is notified of such change by means of a statement filed (with the regional service center with which such corporation files its election to be treated as a DISC) not later than the end of the period during which such corporation may file an election to be treated as a DISC for such new taxable year, and

(*c*) The short period required to effect such change is not a taxable year in which such corporation has a net operating loss as defined in section 172.

Thus, for example, if a corporation which uses the calendar year for its taxable year does not complete arrangements to become a DISC until May 15, 1972, such corporation can, pursuant to this subdivision, change its annual accounting period and adopt a taxable year beginning on the first day of any month in 1972 after May. A change to a new annual accounting period made pursuant to this subdivision is effective only if the corporation which makes such change qualifies as a DISC for such new period. A corporation may change its annual accounting period and adopt a new taxable year pursuant to this subdivision without regard to the provisions of §1.1502–76 (relating to the taxable year of members of a group). A copy of the statement described in (*b*) of this subdivision shall be attached to the return of a corporation for the new taxable year

to which such corporation changes pursuant to this subdivision. A corporation which changes its annual accounting period pursuant to this subparagraph will not be permitted under section 442 to change its annual accounting period at any time before 1982, except with the consent of the Commissioner as provided in §1.442–1(b)(1) or pursuant to subparagraph (4) of this paragraph.

(4) *Transition rule for change of taxable year of certain DISC's.* In the case of a DISC all of the shares of which are held by a single shareholder or by members of a group who file a consolidated return, such DISC may (without the consent of the Commissioner) change its annual accounting period and adopt a taxable year beginning in 1972 which is the same as the taxable year of such shareholder or the members of such group. A change to a new annual accounting period may be made by a DISC pursuant to this subparagraph even if such DISC has changed its annual accounting period pursuant to subparagraph (3)(ii) of this paragraph.

(5) *Transition rule for beginning of first taxable year of certain corporations.* If a corporation organized before January 1, 1972, neither acquires assets (other than cash or other property acquired as consideration for the issuance of stock) nor begins doing business prior to January 1, 1972, the first taxable year of such corporation is deemed to begin at the time such corporation acquires any asset (other than cash or other property acquired as consideration for the issuance of stock) or begins doing business, whichever is earlier: *Provided,* That such corporation is a DISC for such first taxable year. For purposes of §1.6012–2(a), such corporation is treated as not coming into existence until the beginning of such first taxable year.

(c) *Effective date.* The provisions of this section and the regulations under sections 992 through 997 apply with respect to taxable years ending after December 31, 1971, except that a corporation may not be a DISC for any taxable year beginning before January 1, 1972.

(d) *Related statutes.* For rules relating to the transfer, during a taxable year beginning before January 1, 1976, to a DISC of assets of an export trade corporation (as defined in section 971), where a parent owns all the outstanding stock of both such DISC and such export trade corporation, see section 505(b) of the Revenue Act of 1971 (85 Stat. 551). For rules regarding limitations on the qualification of a corporation as an export trade corporation for any taxable year beginning after October 31, 1971, see section 971(a)(3).

[T.D. 7323, 39 FR 34402, Sept. 25, 1974, as amended by T.D. 7854, 47 FR 51738, Nov. 17, 1982]

### §1.992–1 Requirements of a DISC.

(a) *''DISC'' defined.* The term ''DISC'' refers to a domestic international sales corporation. The term ''DISC'' means a corporation which, for a taxable year—

(1) Is duly incorporated and existing under the laws of any State or the District of Columbia,

(2) Satisfies the gross receipts test described in paragraph (b) of this section,

(3) Satisfies the assets test described in paragraph (c) of this section,

(4) Satisfies the capitalization requirement described in paragraph (d) of this section,

(5) Satisfies the requirement that an election to be treated as a DISC be in effect for such year, as described in paragraph (e) of this section,

(6) [Reserved]

(7) Maintains separate books and records, and

(8) Is not an ineligible corporation described in paragraph (f) of this section.

A corporation which satisfies the requirements described in subparagraphs (1) through (8) of this paragraph for a taxable year is treated as a separate corporation for Federal tax purposes and qualifies as a DISC, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes. An association cannot qualify as a DISC even if such association is taxable as a corporation pursuant to section 7701(a)(3). In addition, a corporation created or organized in, or under the law of, a possession of the United States cannot qualify as a DISC. The rules contained in this paragraph constitute a relaxation of the general rules

of corporate substance otherwise applicable under the Code. The separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary. However, this relaxation of the general rules of corporate substance does not apply with respect to other corporations in other contexts. In the case of a transaction between a DISC and a person related to such DISC for purposes of section 482, see §1.993–1(l) for rules for determining whether income is income of a DISC to which the intercompany pricing rules authorized by section 994 apply.

(b) *Gross receipts test.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, 95 percent or more of its gross receipts (as defined in §1.993–6) for such year must consist of qualified export receipts (as defined in §1.993–1). Gross receipts for a taxable year are determined in accordance with the method of accounting adopted by the corporation pursuant to §1.991–1(b)(2). However, for rules regarding gross receipts in the case of a commission sale by such corporation, see §1.993–6.

(c) *Assets test*—(1) *In general.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, the adjusted basis (determined under section 1011) of its qualified export assets at the close of such year must equal or exceed 95 percent of the sum of the adjusted bases (determined under section 1011) of all assets of such corporation at the close of such year.

(2) *Assets acquired to meet assets test.* For purposes of determining whether the requirements of subparagraph (1) of this paragraph are satisfied by a corporation at the end of a taxable year, an asset which is a qualified export asset is treated as not being an asset of such corporation at such time if such asset is held for a total of 60 days or less and is acquired directly or indirectly through borrowing, unless the acquisition of such asset is established to the satisfaction of the Commissioner or his delegate to have been for bona fide purposes. Such acquisition is deemed to have been for bona fide purposes if, for example, it is made in the usual course of the corporation's trade or business.

(d) *Capitalization requirement*—(1) *In general.* To qualify as a DISC for a taxable year, a corporation must have, on each day of that taxable year, only one class of stock. The par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock must be on each day of the taxable year at least $2,500. In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements of this paragraph (d)(1) are satisfied if the corporation has no more than one class of stock at any time during the year and if the par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock is at least $2,500 on the last day of the period within which the election must be made and on each succeeding day of the year. For purposes of this paragraph (d)(1), the stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus. The law of the State of incorporation of the DISC determines what consideration may be used to capitalize the DISC. A corporation will not be a qualified DISC unless at least $2,500 of valid consideration was used for this purpose. If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this paragraph (d)(1), that impairment does not result in disqualification under this paragraph (d)(1), provided that the corporation does not take any legal or formal action under State law to reduce capital for that year below the amount required under this paragraph (d)(1).

(2) *Treatment of debt payable to shareholders*—(i) *In general.* Purported debt of a DISC payable to any person, whether or not such person is a shareholder or a member of a controlled group (as defined in §1.993–1(k)) of

which such DISC is a member, is treated as debt for all purposes of the Code, provided that such purported debt—

(*a*) Would qualify as debt for purposes of the Code if the DISC were a corporation which did not qualify as a DISC,

(*b*) Qualifies under subdivision (ii) of this subparagraph, or

(*c*) Are trade accounts payable described in subdivision (iii) of this subparagraph.

Such debt is not treated as stock, and interest payable by the DISC on such debt is treated as interest by both the DISC and the holder of such debt. Payment of the principal of such debt by a DISC does not constitute the payment of a dividend by such DISC. The provisions of this subparagraph apply for a taxable year of a DISC, even though debt described in this subparagraph would be treated as stock of the corporation if such corporation did not qualify as a DISC for such year.

(ii) *Safe harbor rule.* Purported debt of a DISC will in no event be treated as other than debt for purposes of subdivision (i) of this subparagraph if—

(*a*) It is a written obligation to pay a sum certain on or before a fixed maturity date,

(*b*) Interest is payable on such purported debt at an arm's length interest rate (as determined under §1.482–2(a)(2)), expressed as a fixed dollar amount or a fixed percentage of principal,

(*c*) Such purported debt is not convertible into stock or into other purported debt unless such other purported debt qualifies under this subparagraph as debt of the DISC,

(*d*) Such purported debt does not confer voting rights upon its holder, except in the event of default thereon, and

(*e*) Interest and principal are paid in accordance with the terms of such purported debt or with any modification of such terms consistent with (*a*) through (*d*) of this subdivision.

The determination of whether purported debt of a DISC constitutes debt described in this subdivision is made without regard to the proportion of debt of the DISC held by any of its shareholders, to the ratio of the outstanding debt of the DISC to its equity, or to the amount of outstanding debt of such DISC. The provisions of (*e*) of this subdivision do not prevent the modification of the terms of debt of a DISC where, for example, a DISC becomes unable to make timely payments of principal required under such terms, provided that such modification is consistent with (*a*) through (*d*) of this subdivision.

(iii) *Trade accounts payable.* Trade accounts payable of a DISC which arise in the normal course of its trade or business (such as in consideration for inventory or supplies) constitute debt of the DISC (whether or not such accounts payable are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph), provided that such accounts are payable within 15 months after they arise. If such accounts are payable more than 15 months after they arise, they are debt of such DISC only if they are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph.

(iv) *Relation of subparagraph to other corporations.* The provisions of this subparagraph generally constitute a relaxation of the ordinary rules used in determining whether purported debt of a corporation is debt or equity. This relaxation is in recognition of the principle that a corporation may qualify as a DISC even though it has relatively little capital. This relaxation does not apply with respect to purported debt of other corporations in other contexts. The provisions of subdivisions (i), (ii), and (iii) of this subparagraph apply only for taxable years for which a corporation qualifies (or is treated) as a DISC.

(3) *Classes of stock.* [Reserved]

(e) *Election in effect.* In order for a corporation to be a DISC for a taxable year, an election to be treated as a DISC must be made by such corporation pursuant to §1.992–2 and must be in effect for such taxable year. A corporation does not become or remain a DISC solely by making such an election. A corporation is a DISC for a taxable year only if such an election is in effect for that year and the corporation also satisfies the requirements of paragraphs (a) through (d) of this section. See §1.992–2 for rules regarding the time and manner of making such an election.

(f) *Ineligible corporations.* The following corporations shall not be eligible to be treated as a DISC—

(1) A corporation exempt from tax by reason of section 501,

(2) A personal holding company (as defined in section 542),

(3) A financial institution to which section 581 or 593 applies,

(4) An insurance company subject to the tax imposed by subchapter L,

(5) A regulated investment company (as defined in section 851(a)),

(6) A China Trade Act corporation receiving the special deduction provided in section 941(a), or

(7) An electing small business corporation (as defined in section 1371(b)).

(g) *Status as DISC after having filed return as a DISC.* Under section 992(a)(2), notwithstanding the failure of a corporation to meet the requirements of paragraph (a) of this section for a taxable year, such corporation will be treated as a DISC for purposes of the Code for such taxable year (and, thus, will not be able to claim that it is not eligible to be a DISC) if—

(1) Such corporation files a return as a DISC for such taxable year,

(2) Such corporation does not notify the district director, more than 30 days before the expiration of the period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year (as determined under section 6501 and the regulations thereunder), that it is not a DISC for such taxable year, and

(3) The Internal Revenue Service has not issued, within such period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year, a notice of deficiency based on a determination that such corporation is not a DISC for such taxable year.

A corporation is treated as a DISC, for all purposes, pursuant to the provisions of this paragraph for any taxable year for which it meets the requirements of this paragraph, even if such corporation is an ineligible corporation described in paragraph (f) of this section for such taxable year. Thus, for example, a corporation which is treated as a DISC for a taxable year pursuant to this paragraph is treated as a DISC for that taxable year for purposes of §1.992–2(e)(3) (relating to the termination of a DISC election if a corporation is not a DISC for each of any 5 consecutive taxable years). If a corporation is treated as a DISC for a taxable year pursuant to this paragraph, persons who held stock of such corporation at any time during such taxable year are treated, with respect to such stock, as holders of stock in a DISC for the period or periods during which they held such stock within such taxable year.

(h) *Definition of ''former DISC''.* Under section 992(a)(3), the term ''former DISC'' refers to a corporation which is not a DISC for a taxable year but which was (or was treated as) a DISC for a prior taxable year. However, a corporation is not a former DISC for a taxable year unless such corporation has, at the beginning of such taxable year, undistributed previously taxed income (as defined in §1.996–3(c) or accumulated DISC income (as defined in §1.996–3(b)). A corporation which is a former DISC for a taxable year is a former DISC for all purposes of the Code.

(Secs. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

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### §1.992–2 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC for a taxable year beginning after December 31, 1971. Except as provided in paragraph (a)(1)(ii) of this section, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form. Except as provided in paragraphs (b)(3) and (c) of this section,

such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned ''Election to be Treated as a DISC.'' Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth (*a*) the name and address of the corporation and of the shareholder and (*b*) the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's taxable year for which the election is

effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: ''I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election).'' The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor, administrator, or trustee, may be made by any executor, administrator, or trustee, authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued) without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended Form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended Form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original Form 4876 or statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the Code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to §1.992–1(g)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the Code relating to the shareholders of a DISC or former DISC. Such provisions of the Code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement

shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to §1.992–1(g)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to §1.992–1(g)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus, for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7323, 39 FR 34405, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

### §1.992–3 Deficiency distributions to meet qualification requirements.

(a) *In general.* A corporation which meets the requirements described in §1.992–1 for treatment as a DISC for a taxable year, other than the 95 percent of gross receipts test described in §1.992–1(b) or the 95-percent assets test described in §1.992–1(c), or both tests, may nevertheless qualify as a DISC for such year by making deficiency distributions (attributable to its gross receipts other than qualified export receipts and its assets other than qualified export assets) if all of the following requirements are satisfied:

(1) The corporation distributes the amount determined under paragraph (b) of this section as a deficiency distribution. The amount of a deficiency distribution is determined without regard to the amount by which the corporation fails to meet either test.

(2) The reasonable cause requirements prescribed in paragraph (c)(1) of this section are satisfied with respect to both the corporation's failure to meet either test and its failure to make a deficiency distribution prior to the time the distribution is made.

(3) The corporation makes such deficiency distribution pro rata to all its shareholders.

(4) The corporation designates the distribution, at the time of the distribution, as a deficiency distribution, pursuant to section 992(c), to meet the qualification requirements to be a DISC. Such designation shall be in the form of a communication sent at the time of such distribution to each shareholder and to the service center with which the corporation has filed or will file its return for the taxable year to

which the distribution relates. A corporation may not retroactively designate a prior distribution as a deficiency distribution to meet qualification requirements. Subject to the limitation described in paragraph (c)(3) of this section, a corporation may make a deficiency distribution with respect to a taxable year at any time after the close of such taxable year or, in the case of a deficiency distribution made on or before September 29, 1975, at any time during or after such taxable year. See sections 246(d), 904(f), 995, and 996 for rules regarding the treatment of a deficiency distribution to meet qualification requirements by the shareholders and the corporation.

(b) *Amount of deficiency distribution*—(1) *In general.* In order to meet the requirements of paragraph (a) of this section, the amount of a deficiency distribution must be, if the corporation fails to meet—

(i) The 95 percent of gross receipts test, the amount determined in subparagraph (2) of this paragraph,

(ii) The 95-percent assets test, the amount determined in subparagraph (3) of this paragraph, and

(iii) Both such tests, except as provided in subparagraph (4) of this paragraph, the sum of the amounts determined in subparagraphs (2) and (3) of this paragraph.

(2) *Computation of deficiency distribution to meet 95 percent of gross receipts test*—(i) *In general.* If a corporation fails to meet the 95 percent of gross receipts test described in §1.992–1(b) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the sum of its taxable income (if any) from each transaction giving rise to gross receipts (as defined in §1.993–6) which are not qualified export receipts (as defined in §1.993–1). A corporation's taxable income from a transaction shall be the amount of such gross receipts from such transaction reduced only by (*a*) its cost of goods sold attributable to such gross receipts, and by (*b*) its expenses, losses, and other deductions properly apportioned or allocated thereto in a manner consistent with the rules set forth in §1.861–8. For purposes of this subdivision, however, any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income in such manner shall not reduce such gross receipts. If the corporation is a commission agent for a principal in a transaction, the corporation's taxable income is the amount of the commission from such transaction reduced only by the amounts described in (*b*) of this subdivision.

(ii) *Example.* The provisions of this subparagraph may be illustrated by the following example:

*Example.* (*a*) X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, which seeks to qualify as a DISC for 1973. During 1973, X manufactures a machine which is eligible to be export property as defined in §1.993–3. Y is made a commission agent with respect to exporting such machine. Thereafter, during 1973 Y is considered to receive gross receipts of $100,000, as determined under section 993(f), attributable to X's sale of the machine in a manner which causes the gross receipts to be excluded receipts pursuant to section 993(a)(2) and, therefore, not qualified export receipts. Y's total gross receipts for 1973 are $1 million of which $900,000 (*i.e.,* 90 percent) are qualified export receipts. Therefore, Y does not satisfy the 95 percent of gross receipts test for 1973 because less than 95 percent of its gross receipts are qualified export receipts. Y has $9,000 of expenses properly apportioned or allocated to its gross income from such sale and $1,000 of other expenses which cannot definitely be allocated to some item or class of gross income, determined in a manner consistent with the rules set forth in §1.861–8. In order to satisfy the 95 percent of gross receipts test for 1973, if the commission due from X to Y were $15,000, Y must make a deficiency distribution of $6,000 computed as follows:

| | |
|---|---|
| Y's commission (gross income) from the transaction | $15,000 |
| Less: Y's expenses apportioned or allocated to its gross income from the transaction | 9,000 |
| Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts | 6,000 |

(*b*) If the commission due from X to Y were $9,400, resulting in a net loss of $600 to Y ($9,400 to $10,000), Y must make a deficiency distribution of $400 computed as follows:

| | |
|---|---|
| Y's commissions (gross income) from the transaction | $9,400 |
| Less: Y's expenses apportioned or allocated to its gross income from the transaction | 9,000 |
| Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts | 400 |

(*c*) If the commission due from X to Y were $8,500, Y would not be required to make a deficiency distribution since, under this subparagraph, there would be no taxable income attributable to gross receipts from the sale.

(3) *Computation of deficiency distribution to meet 95 percent assets test*—(i) *In general.* If a corporation fails to meet the 95 percent assets test described in §1.992–1(c) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the fair market value as of the last day of such taxable year of the assets which are not qualified export assets held by such corporation on such last day.

(ii) *Asset held for more than 1 year.* In the case of a corporation which holds continuously an asset which is not a qualified export asset at the close of more than 1 taxable year, it must distribute an amount equal to its fair market value (or, if greater, the amount determined under subparagraph (4) of this paragraph) only once if, at the close of the first such taxable year, such corporation reasonably believed that such asset was a qualified export asset. This subdivision shall not apply for any taxable year beginning after the date the corporation knows (or a reasonable man would have known) that an asset is not a qualified export asset and in order to qualify for each such year, the corporation must distribute the fair market value of such asset for each such year.

(4) *Computation in the case of a failure to meet both tests as a result of a single transaction.* If a corporation fails to meet both the 95 percent of gross receipts test and the 95 percent assets test for a taxable year, and if the corporation holds at the end of such year assets (other than cash or qualified export assets) which were received as proceeds of a sale or exchange during such year which resulted in gross receipts other than qualified export receipts, then the amount of the deficiency distribution required by this paragraph with respect to such sale or exchange and assets held is the larger of the amount required by subparagraph (2) of this paragraph with respect to the sale or exchange or the amount required by subparagraph (3) of this paragraph with respect to such assets held. Thus, for example, if a corporation sells property which is not a qualified export asset for $100, receives $85 in cash and a note for $15, and derives $25 of taxable income from the sale as determined under subparagraph (2) of this paragraph, it must distribute $25. If the provisions of this subparagraph are applied with respect to assets of a DISC (other than qualified export assets), such provisions do not apply to any property received as proceeds from a sale or exchange of such assets.

(c) *Reasonable cause for failure*—(1) *In general.* If for a taxable year, a corporation has failed to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests, such corporation may satisfy any such test for such year by means of a deficiency distribution in the amount determined under paragraph (b) of this section only if the reasonable cause requirements of this subparagraph are satisfied. Such reasonable cause requirements are satisfied if—

(i) There is reasonable cause (as determined in accordance with subparagraph (2) of this paragraph) for such corporation's failure to satisfy such test and to make such distribution prior to the date on which it was made, the time limit in subparagraph (3) of this paragraph for making the distribution is satisfied, and interest (if required) is paid in the amount and in the manner prescribed by subparagraph (4) of this paragraph, or

(ii) The time and ''70-percent'' requirements of the reasonable cause test of paragraph (d) of this section are satisfied.

(2) *Determination of reasonable cause.* In general, whether a corporation's failure to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests for a taxable year and its failure to make a pro rata distribution prior to the date on which it was made will be considered for reasonable cause where the action or inaction which resulted in such failure occurred in good faith, such as failure to meet the 95 percent assets test resulting from blocked currency or expropriation, or failure to meet either test because of reasonable uncertainty as to what constitutes a qualified export receipt or a

qualified export asset. For further examples, if a corporation's reasonable determination of the percentage of its total gross receipts that are qualified export receipts is subsequently redetermined to be less than 95 percent as a result of a price adjustment by the Internal Revenue Service under section 482, or if the corporation has a casualty loss for which it receives an unanticipated insurance recovery which causes its qualified export receipts to be less than 95 percent of its total gross receipts, then the failure to satisfy the 95 percent of gross receipts test is considered to be due to reasonable cause.

(3) *Time limit for deficiency distribution.* Except as otherwise provided in this subparagraph, the time limit prescribed by this subparagraph for making a deficiency distribution is satisfied if the amount of the distribution required by paragraph (b) of this section is made within 90 days from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied the 95 percent of gross receipts test or the 95 percent assets test or both tests, for a taxable year. Upon a showing by the corporation that an extension of the 90-day time limit is reasonable and necessary, the Commissioner may grant such extension of such time limit. In any case in which a corporation contests the decision of the Internal Revenue Service that such corporation has not met the 95 percent of gross receipts test, the 95 percent assets test, or both tests, an extension of the 90-day time limit will be allowed until 30 days after the final determination of such contest. The date of the final determination of such contest shall, for purposes of section 992(c), be established in the manner specified in subdivisions (i) through (iv) of this subparagraph:

(i) The date of final determination by a decision of the United States Tax Court is the date upon which such decision becomes final, as prescribed in section 7481.

(ii) The date of final determination in a case which is contested in a court (and upon which there is a judgment) other than the Tax Court is the date upon which the judgment becomes final and will be determined on the basis of the facts and circumstances of each particular case. For example, ordinarily a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iii) The date of a final determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(iv) A final determination under section 992(c) may be made by an agreement signed by the district director or director of the service center with which the corporation files its annual return or by such other official to which authority to sign has been delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the deficiency distribution to be paid to the shareholders of the DISC for the taxable year or years. An agreement under this subdivision shall be sent to the taxpayer at his 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 for such purpose, the date of registration is considered the date of final determination; if certified mail is used for such purpose, the date of postmark on the sender's receipt for such mail is considered the date of final determination. If the corporation makes a deficiency distribution before such registration or postmark date but on or after the date the district director or director of the service center or other official has signed the agreement, the date of signature by the district director or director of the service center or other official is considered the date of final determination. If the corporation makes a deficiency distribution before the district director or director of the service center or other official signs the agreement, the date of final determination is considered to be the date of the making of the deficiency distribution. During any extension of time the

interest charge provided in subparagraph (4) of this paragraph will continue to accrue at the rate provided for in such subparagraph.

(4) *Payment of interest for delayed distribution*—(i) *In general.* If a corporation makes a deficiency distribution after the 15th day of the ninth month after the close of the taxable year with respect to which such distribution is made, such distribution will not be deemed to satisfy the 95 percent of gross receipts test or the 95 percent assets test for such year unless such corporation pays to the Internal Revenue Service a charge determined by multiplying (a) an amount equal to 4½ percent of such distribution by (*b*) the number of its taxable years which begin (*1*) after the taxable year with respect to which the distribution is made and (*2*) before such distribution is made. Such charge must be paid, within the 30-day period beginning with the day on which such distribution is made, to the service center with which the corporation files its annual information return for its taxable year in which the distribution is made. For purposes of the Internal Revenue Code, such charge is considered interest.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

*Example.* X corporation, which uses the calendar year as its taxable year, meets the 95 percent assets test but fails to meet the 95 percent of gross receipts test for 1972 and does not by September 15, 1973, make the deficiency distribution required by reason of its failure to meet such test. Assume that reasonable cause exists for the corporation's failure to meet the 95 percent of gross receipts test and failure to make the required deficiency distribution. If X makes the required deficiency distribution, in the amount of $10,000, on April 1, 1976, X must pay on or before April 30, 1976, to the service center with which it files its annual information return a charge of $1,800, computed as follows:

| | |
|---|---|
| Deficiency distribution made by X | $10,000 |
| Multiplied by 4½ percent | .045 |
| Intermediate product | 450 |
| Multiplied by: Number of X's taxable years beginning after 1972 and before April 1, 1976 | 4 |
| Charge to be paid service center because of late deficiency distribution (which is considered interest) | 1,800 |

(d) *Certain distributions deemed for reasonable cause.* If a corporation makes a distribution in the amount required by paragraph (b) of this section with respect to a taxable year on or before the 15th day of the ninth month after the close of such year, it will be deemed to have acted with reasonable cause with respect to its failure to satisfy the 95 percent of gross receipts test, the 95 percent assets test, or both tests, for such year and its failure to make such distribution prior to the date on which the distribution was made if—

(1) At least 70 percent of the gross receipts of such corporation for such taxable year consist of qualified export receipts, and

(2) The sum of the adjusted bases of the qualified export assets held by such corporation on the last day of each month of the taxable year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such day.

[T.D. 7323, 39 FR 34407, Sept. 25, 1974; 39 FR 36009, Oct. 7, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51739, Nov. 17, 1982; T.D. 8939, 66 FR 2819, Jan. 12, 2001]

### § 1.992–4 Coordination with personal holding company provisions in case of certain produced film rents.

(a) *In general.* Section 992(d)(2) provides that a personal holding company is not eligible to be treated as a DISC. Section 543(a)(5)(B) provides that, for purposes of section 543, the term ''produced film rents'' means payments received with respect to an interest in a film for the use of, or the right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. Under section 992(e), if such produced film rents are included in the ordinary gross income (as defined in section 543(b)(1)) of a qualified subsidiary for a taxable year of such subsidiary, and such interest was acquired by such subsidiary from its parent, such interest is deemed (for purposes of the application of sections 541, 543(b)(1), and 992(d)(2), and §1.992–1(f) for such taxable year) to have been acquired by such subsidiary at the time

such interest was acquired by such parent. Thus, for example, if a parent acquires an interest in a film before it is substantially completed, then substantially completes such film prior to transferring an interest in such motion picture to a qualified subsidiary, the qualified subsidiary is considered as having acquired such interest prior to substantial completion of such motion picture for purposes of determining whether payments from the rental of such motion picture will be classified as produced film rents of such subsidiary. The provisions of section 992(e) and this section are not applicable in determining whether payments received with respect to an interest in a film are included in the ordinary gross income of a parent or a qualified subsidiary. Thus, even though a qualified subsidiary is treated pursuant to this section as having acquired an interest in a film at the time such interest was acquired by such subsidiary's parent, payments received by such parent with respect to such interest prior to the transfer of such interest to such subsidiary are includible in the ordinary gross income of such parent and not includible in the ordinary gross income of such subsidiary.

(b) *Definitions*—(1) *Qualified subsidiary*. For purposes of this section, a corporation is a qualified subsidiary for a taxable year if—

(i) Such corporation was established for the purpose of becoming a DISC,

(ii) Such corporation would qualify (or be treated) as a DISC for such taxable year if it is not a personal holding company, and

(iii) On every day of such taxable year on which shares of such corporation are outstanding, at least 80 percent of such shares are held directly by a second corporation.

(2) *Parent*. For purposes of this section, the term ''parent'' means a second corporation referred to in subparagraph (1)(iii) of this paragraph.

[T.D. 7323, 39 FR 34409, Sept. 25, 1974]

### § 1.993–1 Definition of qualified export receipts.

(a) *In general*. For a corporation to qualify as a DISC, at least 95 percent of its gross receipts for a taxable year must consist of qualified export receipts. Under section 993(a), the term ''qualified export receipts'' means any of the eight amounts described in paragraphs (b) through (i) of this section, except to the extent that any of the eight amounts is an excluded receipt within the meaning of paragraph (j) of this section. For purposes of this section and §§ 1.993–2 through 1.993–6—

(1) *DISC*. All references to a DISC mean a DISC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a DISC, or a corporation being tested as to whether it qualifies as a DISC.

(2) *Sale, lease, and license*. The term ''sale'' includes an exchange or other disposition and the term ''lease'' includes a rental or a sublease. The term ''license'' includes a sublicense. All rules under this section and §§ 1.993–2 through 1.993–6 applicable to leases of export property apply in the same manner to licenses of export property. See § 1.993–3(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts*. The term ''gross receipts'' is defined by section 993(f) and § 1.993–6.

(4) *Qualified export assets*. The term ''qualified export assests'' is defined by section 993(b) and § 1.993–2.

(5) *Export property*. The term ''export property'' is defined by section 993(c) and § 1.993–3.

(6) *Related person*. The term ''related person'' means a person who is related to another person if either immediately before or after a transaction—

(i) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers), or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships), and the regulations thereunder, or

(ii) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that (*a*) ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a) and the regulations

thereunder, and (*b*) the provisions of section 1563(b) shall not apply in determining whether such persons are members of the same controlled group.

(7) *Related supplier.* The term ''related supplier'' is defined by §1.994–1(a)(3)(ii).

(8) *Controlled group.* The term ''controlled group'' is defined by paragraph (k) of this section.

(b) *Sales of export property.* Qualified export receipts of a DISC include gross receipts from the sale of export property by such DISC, or by any principal for whom such DISC acts as a commission agent (whether or not such principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by such DISC or by such principal at any time or by any other person and assigned to such DISC or such principal at any time prior to the shipment of such property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirement of this paragraph. Gross receipts from the sale of export property, whenever received, do not constitute qualified export receipts unless the seller (or the corporation acting as commission agent for the seller) is a DISC at the time of the shipment of such property to the purchaser. For example, if a corporation which sells export property under the installment method is not a DISC for the taxable year in which the property is shipped to the purchaser, gross receipts from such sale do not constitute qualified export receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from the lease of export property provided that—

(i) Such property is held by such DISC (or by a principal for whom such DISC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of such lease, and

(ii) Such DISC qualified (or was treated) as a DISC for its taxable year in which the term of such lease began.

(2) *Prepayment of lease receipts.* If part or all of the gross receipts from a lease of property are prepaid, then—

(i) All such prepaid gross receipts are qualified export receipts of a DISC if it is reasonably expected at the time of such prepayment that throughout the term of such lease they would be qualified export receipts if received not as a prepayment; or

(ii) If it is reasonably expected at the time of such prepayment that throughout the term of such lease they would not be qualified export receipts if received not as a prepayment, then only those prepaid receipts, for the taxable years of the DISC for which they would be qualified export receipts, are qualified export receipts.

Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered qualified export receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered qualified export receipts.

(d) *Related and subsidiary services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from services furnished by such DISC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by such DISC or with respect to which such DISC acts as a commission agent, provided that such DISC derives qualified export receipts from such sale or lease. Such services may be performed within or without the United States.

(2) *Services furnished by DISC.* Services are considered to be furnished by a DISC for purposes of this paragraph if such services are provided by—

(i) The person who sold or lease the export property to which such services are related and subsidiary, provided that the DISC acts as a commission agent with respect to the sale or lease of such property and with respect to such services,

(ii) The DISC as principal, or any other person pursuant to a contract between such person and such DISC, provided the DISC acted as principal or

commission agent with respect to the sale or lease of such property, or

(iii) A member of the same controlled group as the DISC where the sale or lease of the export property is made by another member of such controlled group provided, however, that the DISC act as principal or commission agent with respect to such sale or lease and as commission agent with respect to such services.

(3) *Related services.* A service is related to a sale or lease of export property if—

(i) Such service is of the type customarily and usually furnished with the type of transaction in the trade or business in which such sale or lease arose and

(ii) The contract to furnish such service—

(*a*) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(*b*) Is entered into on or before the date which is 2 years after the date on which the contract under which such sale or lease was entered into, provided that the person described in subparagraph (2) of this paragraph which is to furnish such service delivers to the purchaser or lessor a written offer or option to furnish such services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(*c*) Is a renewal of the services contract described in (*a*) or (*b*) of this subdivision. Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) may be related to a sale or lease of export property, provided that the cost of such transportation is included in the sale price or rental of the property or, if such cost is separately stated, is paid by the DISC (or its principal) which sold or leased the property to the person furnishing the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to such sale or lease only if it is reasonably expected at the time of such sale or lease that the gross receipts from all related services furnished by the DISC (as defined in subparagraphs (2) and (3) of this paragraph) will not exceed 50 percent of the sum of (a) the gross receipts from such sale or lease and (b) the gross receipts from related services furnished by the DISC (as described in subparagraph (2) of this paragraph). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the 10-year period following the date of such-sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the term of such lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to such sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to such services as determined under the facts and circumstances of each case without regard to whether—

(*a*) Such services are furnished under a separate contract or under the same contract pursuant to which such sale or lease occurs or

(*b*) The cost of such services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from such transaction and the total gross receipts from all services related to such transaction are each taken into account in determining whether such services are subsidiary to such transaction. However, the provisions of this subdivision apply only if such items could be included in the same product line, as determined under §1.994–1(c)(7).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, such contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to such sale or lease if it is reasonably expected at the time of such renewal that the gross receipts from all related services which have been and which are to be furnished by the DISC (as described in subparagraph (2) of this paragraph) will not exceed 50 percent of the sum of (*a*) the gross receipts from such sale or lease and (*b*) the gross receipts from related services furnished by the DISC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this subparagraph.

(v) *Parts used in services.* In a services contract described in subparagraph (3) of this paragraph provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of such parts are not taken into account in determining whether under this subparagraph the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts consitute qualified export receipts. See §1.993–3(c)(2)(iv) and (e)(3) for rules regarding the treatment of such parts with respect to the manufacture of export property and the foreign content of such property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all such services which are to be performed before the end of the term of such lease, then as of the time of the prepayment the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this subdivision are qualified export receipts. Thus, for example if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be qualified export receipts. However, any prepaid gross receipts for such services to be furnished in the second year cannot be qualified export receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute qualified export receipts does not depend upon whether services connected with such sale or lease are related and subsidiary to such sale or lease. Thus, for example, assume that a DISC receives gross receipts of $1,000 from the sale of export property and gross, receipts of $1,100 from installation and maintenance services which are to be furnished by such DISC within 10 years after the sale and which are related to such sale. The $1,100 which the DISC receives for such services would not be qualified export receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by such DISC. The $1,000 which the DISC receives from the sale of export property would, however, be a qualified export receipt if the sale met the requirements of paragraph (b) of this section.

(e) *Gains from sales of certain qualified export assets.* Qualified export receipts of a DISC include gross receipts from the sale by such DISC of any assets (wherever located) which, as of the date of such sale, are qualified export assets as defined in §1.993–2 even though such assets are not export property (as defined in §1.993–3). Gross receipts are derived from the sale of such assets only where such sale results in recognized gain (see §1.993–6(a)). For purposes of this paragraph, losses from the sale of such qualified export assets shall not be taken into account for purposes of determining the DISC's qualified export receipts.

(f) *Dividends.* Qualified export receipts of a DISC for a taxable year include all dividends includible in the gross income of such DISC for such taxable year with respect to the stock of related foreign export corporations (as defined in §1.993–5) and all amounts includible in the gross income of such DISC with respect to such corporations pursuant to section 951 (relating to

amounts included in the gross income of U.S. shareholders of controlled foreign corporations).

(g) *Interest on obligations which are qualified export assets.* Qualified export receipts of a DISC include interest on any obligation which is a qualified export asset of such DISC, including any amount includible in gross income as interest (such as, for example, an amount treated as original issue discount pursuant to section 1232) or as imputed interest under section 483. Gain from the sale of obligations described in this paragraph is treated (to the extent such gain is not treated as interest on such obligations) as qualified export receipts pursuant to paragraph (e) of this section.

(h) *Engineering and architectural services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from engineering services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (6) of this paragraph) furnished by such DISC (as described in subparagraph (7) of this paragraph) for a construction project (as defined in subparagraph (8) of this paragraph) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for minerals or

(ii) Technical assistance or knowhow.

For purposes of this paragraph, the term ''technical assistance or knowhow'' includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute qualified export receipts to the extent that such activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of subparagraph (8) of this paragraph) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to such professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of subparagraph (8) of this paragraph).

(7) *Definition of ''furnished by such DISC''.* For purposes of this paragraph, architectural and engineering services are considered furnished by a DISC if such services are provided—

(i) By the DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the DISC at any time prior to the furnishing of such services, provided that the DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(8) *Definition of ''construction project''.* For purposes of this paragraph, the term ''construction project'' includes the erection, expansion, or repair (but

not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad, tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not qualified export receipts unless such equipment is export property (as defined in §1.993–3).

(i) *Managerial services*—(1) *In general.* Qualified export receipts of a first DISC for its taxable year include gross receipts from the furnishing of managerial services provided for another DISC, which is not a related person, to aid such unrelated DISC in deriving qualified export receipts, provided that at least 50 percent of the gross receipts of the first DISC for such year consists of qualified export receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services, as described in paragraph (b), (c), and (d) of this section, respectively.

For purposes of this paragraph, managerial services are considered furnished by a DISC if such services are provided—

(i) By the first DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the first DISC at any time prior to the furnishing of such services, provided that the first DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(2) *Definition of ''managerial services.''* The term ''managerial services'' as used in this paragraph means activities relating to the operation of another unrelated DISC which derives qualified export receipts from the sale or lease of export property and from the furnishing of services related and subsidiary to such sales or leases. Such term includes staffing and operational services necessary to operate such other DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: (i) Export market studies, (ii) making shipping arrangements, and (iii) contracting potential foreign purchasers.

(3) *Status of recipient of managerial services*—(i) *In general.* Qualified export receipts of a first DISC include receipts from the furnishing of managerial services during any taxable year of a recipient if such recipient qualifies as a DISC (within the meaning of §1.992–1(a) for such taxable year.

(ii) *Recipient deemed to qualify as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient is deemed to qualify as a DISC for its taxable year if the first DISC obtains from such recipient a copy of such recipient's election to be treated as a DISC as described in §1.992–2(a) together with such recipient's sworn statement that such election has been filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a DISC before submitting it to the first DISC. The copy of the election and the sworn statement of such recipient must be received by the first DISC within 6 months after the beginning of the first taxable year of the recipient during which such first DISC furnishes managerial services for such recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first DISC for subsequent taxable years of the recipient.

(iii) *Recipient not treated as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient of managerial services is not treated as a DISC with respect to such services performed during a taxable year for which such recipient does not qualify as a DISC if the DISC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing DISC's managerial relationship with such recipient DISC) at the beginning of such taxable year that the recipient will qualify as a DISC for such taxable year.

(j) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (i) of this section, qualified export receipts of a DISC do not include any of the five amounts described in subparagraphs (2) through (6) of this paragraph.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See §1.993–3(d)(4) (relating to determination of where the ultimate use of the property occurs). Thus, qualified export receipts of a DISC described in paragraph (b) or (c) of this section do not include gross receipts of the DISC from the sale or lease of such property.

(3) *Sales of export property accomplished by subsidy.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b) of this section if the sale of export property (whether or not such property consists of agricultural products) is pursuant to any of the following:

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151), unless the DISC shows to the satisfaction of the district director that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms and from a seller who was not a U.S. person, goods which were substantially identical to such property and which were not manufactured, produced, grown, or extracted (as described in §1.993–3(c)) in the United States,

(ii) The Pub. L. 480 program authorized under title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701–1710),

(iii) For taxable years ending before January 1, 1974, the Barter program of the Commodity Credit Corporation authorized by section 4(h) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714b(h)), and section 303 of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1692) but only if the taxpayer treats such sales as sales giving rise to excluded receipts,

(iv) The Export Payment program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)),

(v) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c), and

(vi) For taxable years beginning after November 3, 1972, the Export Sales program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM–4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities, except that for taxable years beginning on or before November 3, 1972, the taxpayer may treat such sales as sales giving rise to excluded receipts.

(4) *Sales or lease of export property and furnishing of engineering or architectural services for use by the United States*—(i) *In general.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b), (c), or (h) of this section if a sale or lease of export property, or the furnishing of engineering or architectural services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of engineering or architectural services performed by a U.S. person. For example, a sale by a DISC of export property to the Department of Defense for use outside the United States would not produce qualified export receipts for such DISC if the Department of Defense purchased such property from appropriated funds subject to any provisions of the Armed Services Procurement Regulations (32

CFR subchapter A, part 6, subpart A) or any appropriations act for the Department of Defense for the applicable year which restricts the availability of such appropriated funds to the procurement of items which are grown, reprocessed, reused, or produced in the United States.

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof is such property is sold or leased by a DISC (or by a principal for whom such DISC acts as commission agent) to—

(*a*) A person who is a related person with respect to such DISC or such principal and who sells or leases such property for use by the United States or an instrumentality thereof or

(*b*) A person who is not a related person with respect to such DISC or such principal if, at the time of such sale or lease, there is an agreement or understanding that such property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of such sale or lease that such property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after such sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (i) and (ii) of this subparagraph do not apply in the case of a purchase by the United States or an instrumentality thereof if such purchase is pursuant to—

(*a*) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the U.S. Government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(*b*) A program (whether bilateral or multilateral) under which sales to the U.S. Government are open to international competitive bidding.

(5) *Services.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts pursuant to this paragraph.

(6) *Receipts within controlled group*—(i) *In general.* Gross receipts of a corporation do not constitute qualified export receipts for any taxable year of such corporation if—

(*a*) At the time of the sale, lease, or other transaction resulting in such gross receipts, such corporation and the person from whom such receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group (as defined in paragraph (k) of this section) and

(*b*) Such corporation and such person each qualifies (or is treated under section 992(a)(2)) as a DISC for its taxable year in which its receipts arise.

Thus, for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are DISC's. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a DISC which is a member of the same controlled group as X, and thus will not result in qualified export receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in qualified export receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in qualified export receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party, may, however, constitute qualified export receipts.

(ii) *Leased property.* See §1.993–3(f)(2) regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(k) *Definition of ''controlled group''.* For purposes of sections 991 through 996 and the regulations thereunder, the term ''controlled group'' has the same meaning as is assigned to the term

''controlled group of corporations'' by section 1563(a), except that (1) the phrase ''more than 50 percent'' is substituted for the phrase ''at least 80 percent'' each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 881 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(l) *DISC's entitlement to income*—(1) *Application of section 994.* A corporation which meets the requirements of §1.992–1(a) to be treated as a DISC for a taxable year is entitled to income, and the intercompany pricing rules of section 994(a)(1) or (2) apply, in the case of any transactions described in §1.994–1(b) between such DISC and its related supplier (as defined in §1.994–1(a)(3)). For purposes of this subparagraph, such DISC need not have employees or perform any specific function.

(2) *Other transactions.* In the case of a transaction to which the provisions of subparagraph (1) of this paragraph do not apply but from which a DISC derives gross receipts, the income to which the DISC is entitled as a result of the transaction is determined pursuant to the terms of the contract for such transaction and, if applicable, section 482 and the regulations thereunder.

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

*Example 1.* P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a franchise with respect to specified exports of P. P will sell such exports to S for resale by S. Such exports are of a type which produce qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of S using S's order forms. S places orders with P only when S itself has received orders. No inventory is maintained by S. P makes shipments directly to customers of S. Employees of P will act for S and billings and collections will be handled by P in the name of S. Under these facts, the income derived by S for such taxable year from the purchase and resale of the specified export is treated for Federal income tax purposes as the income of S, and the amount of income allocable to S will be determined under section 994 of the Code.

*Example 2.* P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a sales franchise with respect to specified exports of P and will receive commissions with respect to such exports. Such exports are of a type which will produce gross receipts for S which are qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of P. Billings and collections are handled directly by P. Under these facts, the commissions paid to S for such taxable year with respect to the specified exports shall be treated for Federal income tax purposes as the income of S, and the amount of income allocable to S is determined under section 994 of the Code.

[T.D. 7514, 42 FR 55454, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51739, Nov. 17, 1982]

### § 1.993–2 Definition of qualified export assets.

(a) *In general.* For a corporation to qualify as a DISC, at the close of its taxable year it must have qualified export assets with adjusted bases equal to at least 95 percent of the sum of the adjusted bases of all its assets. An asset which is a qualified export asset under more than one paragraph of this section shall be taken into account only once in determining the sum of the adjusted bases of all qualified export assets. Under section 993(b), the qualified export assets held by a corporation are—

(1) Export property as defined in §1.993–3 (see paragraph (b) of this section),

(2) Business assets described in paragraph (c) of this section,

(3) Trade receivables described in paragraph (d) of this section,

(4) Temporary investments to the extent described in paragraph (e) of this section,

(5) Producer's loans as defined in §1.993–4 (see paragraph (f) of this section),

(6) Stock or securities (described in paragraph (g) of this section) of related foreign export corporations as defined in §1.993–5,

(7) Export-Import Bank and other obligations described in paragraph (h) of this section,

(8) Financing obligations described in paragraph (i) of this section, and

(9) Funds awaiting investment described in paragraph (j) of this section.

(b) *Export property.* In general, export property is certain property held for sale or lease which meets the requirements of §1.993–3.

(c) *Business assets.* For purposes of this section, business assets are assets used by a DISC (other than as a lessor) primarily in connection with—

(1) The sale, lease, storage, handling, transportation, packaging, assembly, or servicing of export property, or

(2) The performance of engineering or architectural services (described in §1.993–1(h)) or managerial services (described in §1.993–1(i)) in furtherance of the production of qualified export receipts.

Assets used primarily in the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) of property are not business assets.

(d) *Trade receivables*—(1) *In general.* For purposes of this section, trade receivables are accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraph (A), (B), (C), (D), (G), or (H), of section 993(a)(1) and which are due the DISC (or, if it acts as an agent, due its principal) and held by the DISC.

(2) *Trade receivables representing commissions.* If a DISC acts as commission agent for a principal in a transaction described in §1.993–1 (b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission), such account receivable or evidence of indebtedness shall be treated as a trade receiveable. If, however, the principal is a related supplier (as defined in §1.994–1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of §1.994–1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) *Indebtedness arising under §1.994–1(e).* An indebtedness arising under §1.994–1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a DISC is not a qualified export asset. An indebtedness arising under §1.994–1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in §1.994–1(e)(5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in §1.994–1(e)(5)(i) and (ii), it is not a qualified export asset.

(e) *Temporary investments*—(1) *In general.* For purposes of this section, temporary investments are money, bank deposits (not including time deposits of more than 1 year), and other similar temporary investments to the extent maintained by a DISC as reasonably necessary to meet its requirements for working capital. For purposes of this paragraph, a temporary investment is an obligation, including an evidence of indebtedness as defined in paragraph (d)(1) of this section, which is a demand obligation or has a period remaining to maturity of not more than 1 year at the date it is acquired by the DISC. A temporary investment does not include trade receivables.

(2) *Determination of amount of working capital maintained.* For purposes of this paragraph—

(i) The working capital of a DISC is the excess of its current assets over current liabilities.

(ii) Current assets are cash and other assets (other than trade receivables) which may reasonably be expected to be converted into cash or sold or consumed during the current normal operating cycle of the DISC's trade or business.

(iii) Current liabilities are obligations (or portions of obligations) due within the current normal operating cycle of the trade or business of the DISC whose satisfaction when due is reasonably expected to require the use of current assets.

(iv) Generally accepted financial accounting treatments will be accepted, and

(v) Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary to meet his current liabilities and its requirements for working capital.

(3) *Determination of amount of working capital reasonably required.* For purposes of this paragraph, a determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working capital will depend upon the nature and volume of the activities of the DISC existing at the end of the DISC's taxable year for which such determination is made, such as, for example—

(i) In the case of a DISC which purchases and sells inventory, the amount of working capital reasonably required is limited to an amount reasonably necessary to meet the ordinary operating expenses during the current normal operating cycle of the trade or business of the DISC, an amount reasonably needed to meet specific and definite plans for expansion and any amounts necessary for reasonably anticipated extraordinary business expenses.

(ii) In the case of a DISC which actively conducts a trade or business (including the employment of a sales force) and receives commissions in respect of goods to which such DISC does not have title, the amount of working capital required will depend upon the nature and volume of the activities of the DISC which produce such income as they exist on the applicable determination date. In determining the amount of working capital which is reasonably required for the production of such income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the DISC following the applicable determination date. Anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of such income as of the applicable determination date.

(iii) In the case of a DISC which does not actively conduct a trade or business, and which receives commissions solely by reason of section 994(a)(1), (a)(2), or (b) with respect to goods to which such DISC does not have title, no working capital would be required beyond a de minimis amount unless it appears from the facts and circumstances that additional working capital will be required.

(iv) In the case of a DISC deriving income from the leasing of property, the amount of working capital required will be determined on the basis of the facts and circumstances in such case.

(4) *Relationship of working capital to other qualified export assets.* If a temporary investment is a qualified export asset under any provision of this section (other than this paragraph), this paragraph shall not affect its status as a qualified export asset. However, any such temporary investment is taken into account before other temporary investments in determining whether such other temporary investments are maintained by a DISC as reasonably necessary to meet its requirements for working capital. Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary requirements for working capital. An obligation issued or incurred by a member of a controlled group (as defined in §1.993–1(k)) of which the DISC is a member is not a qualified export asset under this paragraph. For rules regarding working capital as of the end of each month of a taxable year for purposes of the 70-percent reasonableness standard with respect to certain deficiency distributions, see paragraph (j)(3) of this section.

(f) *Producer's loans.* For purposes of this section, a producer's loan is an evidence of indebtedness arising in connection with producer's loans which are made by a DISC and which meet the requirements of §1.993–4. If a producer's loan is a qualified export asset, interest accrued with respect to the producer's loan will also be treated as a qualified export asset provided that payment is made in the form of money, property (valued at its fair market value on its date of transfer and including accounts receivable for sales by or through a DISC), a written obligation which qualifies as a debt under the safe harbor rule of §1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction and that payment is made no later than 60 days following the close of the taxable year of accrual of the interest. This paragraph (f) is effective for taxable years beginning after January 10, 1985 except that the taxpayer may at its option apply the provisions of this paragraph to taxable years ending after December 31, 1971.

(g) *Stock or securities of related foreign corporations.* For purposes of this section, the term ''stock or securities'', with respect to a related foreign export corporation (as defined in §1.993–5), has the same meaning as such term has as used in section 351 (relating to transfers to controlled corporations), except that the term ''securities'' does not include obligations which are repaid, in whole or in part, at any time during the taxable year of the DISC following the taxable year of the DISC during which such obligations were acquired by the DISC or were issued, unless the DISC demonstrates to the satisfaction of the district director that the repayment was for bona fide business purposes and not for the purpose of avoidance of Federal income taxes.

(h) *Export-Import Bank obligations.* For purposes of this section, the term ''Export-Import Bank obligations'' means obligations issued, guaranteed, insured, or reinsured (in whole or in part) by the Export-Import Bank of the United States or by the Foreign Credit Insurance Association, but only if such obligations are acquired by the DISC—

(1) From the Export-Import Bank of the United States,

(2) From the Foreign Credit Insurance Association, or

(3) From the person selling or purchasing the goods or services by reason of which such obligations arose, or from any corporation which is a member of the same controlled group (as defined in §1.993–1(k)) as such person.

For purposes of this paragraph, obligations issued by a person described in subparagraphs (1), (2), and (3) of this paragraph are treated as acquired from such person by the DISC if acquired from any person not more than 90 days after the date of original issue (as defined in §1.1232–3(b)(3)). Examples of specific types of Export-Import Bank obligations include debentures issued by such bank and certificates of loan participation.

(i) *Financing obligations.* For purposes of this section, financing obligations are obligations (held by a DISC) of a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such Bank.

(j) *Funds awaiting investment*—(1) *In general.* For purposes of this section, subject to the limitation descibed in subparagraph (2) of this paragraph, if, at the close of a DISC's taxable year, the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits in the United States to the extent of the amount of this excess are funds awaiting investment at the close of such taxable year.

(2) *Limitation.* Bank deposits described in subparagraph (1) of this paragraph are funds awaiting investment only if, by the last day of each of the sixth, seventh, and eighth months after the close of such taxable year, the sum of the adjusted bases of the qualified export assets of the DISC (other

than such bank deposits) equals or exceeds 95 percent of the sum of the adjusted bases of all assets of the DISC (including such bank deposits) it held on the last day of such taxable year. For purposes of this subparagraph, the adjusted bases of assets of a DISC are determined as of the end of each of the months referred to in this subparagraph. Funds awaiting investment as described in this paragraph need not be traceable to any of the qualified export assets held by the DISC at the end of any of the months referred to in this subparagraph.

(3) *Coordination with certain deficiency distribution provisions.* Under section 992(c)(3) and §1.992–3(d) a deficiency distribution made on or before the 15th day of the ninth month after the end of a corporation's taxable year is deemed to be for reasonable cause if certain requirements are met, including the requirement (described in section 992(c)(3)(B) and §1.992–3(d)(2)) that the sum of the adjusted bases of the qualified export assets held by the corporation on the last day of each month of such year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such last day. If, on any such last day, the sum or a DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits to the extent of the amount of this excess are funds awaiting investment on such last day, if either—

(i) The requirements of subparagraph (2) of this paragraph are satisfied with respect to the taxable year of the DISC which includes such month or

(ii) At the close of such taxable year the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section not to exceed an amount reasonably necessary to meet the DISC's requirements for working capital.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7514, 42 FR 55459, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51740, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

### § 1.993–3 Definition of export property.

(a) *General rule.* Under section 993(c), except as otherwise provided with respect to excluded property in paragraph (f) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a DISC)—

(1) Manufactured, produced, grown, or extracted in the United States by any person or persons other than a DISC (see paragraph (c) of this section),

(2) Held primarily for sale or lease in the ordinary course of a trade or business to any person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) Which is not sold or leased by a DISC, or with a DISC as commission agent, to another DISC which is a member of the same controlled group (as defined in §1.993–1(k)) as the DISC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a DISC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that such person does not qualify (and is not treated) as a DISC. Property held by a DISC which was manufactured, produced, grown, or extracted by it at a time when it did not qualify (and was not treated) as a DISC is not export property of the DISC. Property which sustains further manufacture or production outside the United States prior to sale or lease by a person but after manufacture or production in the United States will not be considered as manufactured, produced, grown, or extracted in the United States by such person.

(2) *Manufactured or produced*—(i) *In general.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured or produced by such person if such property is manufactured or produced (within the meaning of either subdivision (ii), (iii), or (iv) of this subparagraph) by such person or by another person pursuant to a contract with such person. Except as provided in subdivision (iv) of this subparagraph, manufacture or production of property does not include assembly or packaging operations with respect to property.

(ii) *Substantial transformation.* Property is manufactured or produced by a person if such property is substantially transformed by such person. Examples of substantial transformation of property would include the conversion of woodpulp to paper, steel rods to screws and bolts, and the canning of fish.

(iii) *Operations generally considered to constitute manufacturing.* Property is manufactured or produced by a person if the operations performed by such person in connection with such property are substantial in nature and are generally considered to constitute the manufacture or production of property.

(iv) *Value added to property.* Property is manufactured or produced by a person if with respect to such property conversion costs (direct labor and factory burden including packaging or assembly) of such person account for 20 percent of more of—

(*a*) The cost of goods sold or inventory amount of such person for such property is such property is sold or held for sale, or

(*b*) The adjusted basis of such person for such property, as determined in accordance with the provisions of section 1011, if such property is held for lease or leased.

The value of parts provided pursuant to a services contract, as described in §1.993–1 (d)(4)(v), is not taken into account in applying this subdivision.

(d) *Primary purpose of which property is held*—(1) *In general*—(i) *General rule.* Under paragraph (a)(2) of this section, export property (*a*) must be held primarily for the purpose of sale or lease in the ordinary course of trade or business to a DISC, or to any other person, and (*b*) such sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if such sale or lease satisfies the destination test described in subparagraph (2) of this paragraph, the proof of compliance requirements described in subparagraph (3) of this paragraph, and the use outside the United States test described in subparagraph (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a DISC is sold or leased for direct use consumption, or disposition outside the United States, the fact that the acquiring DISC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Export property need not be physically segregated from other property.

(2) *Destination test.* (i) For purposes of subparagraph (1) of this paragraph the destination test in this subparagraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by such seller or lessor (or an agent of such seller or lessor) regardless of the F.O.B. point or the

place at which title passes or risk of loss shifts from the seller or lessor—

(*a*) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(*b*) Within the United States to a purchaser or lessee, if such property is ultimately delivered, directly used, or directly consumed outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after such sale or lease,

(*c*) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a DISC and is not a member of the same controlled group (as defined in §1.993–1(k)) as the seller or lessor,

(*d*) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of a ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(*e*) Outside the United States to a purchaser or lessee from a warehouse, a storage facility, or assembly site located outside the United States, if such property was previously shipped by such seller or lessor from the United States, or

(*f*) Outside the United States to a purchaser or lessee if such property was previously shipped by such seller or lessor from the United States and if such property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) such prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the subsequent lease is not a related person (as defined in §1.993–1(a)(6)) with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this subparagraph (other than (*c*) and (*f*)(*3*) of subdivision (i) thereof), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this subparagraph satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this subparagraph.

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of subparagraph (2) of this paragraph (other than subdivision (i)(*c*) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(*a*) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(*b*) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(*c*) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(*d*) If such country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(*e*) A facsimile or carbon copy of the shipper's export declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property,

(*f*) Any other proof (including evidence as to the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i) (*a*), (*b*), (*c*), or (*e*) of this subparagraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in such subdivision (*e*) or a document such as an export bill of lading such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that such document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of subparagraph (2)(i) of this paragraph (other than subdivision (*c*) thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) *Sale or lease to an unrelated DISC.* For purposes of subparagraph (2)(i)(*c*) of this paragraph, a purchaser or lessee of property is deemed to qualify as a DISC for its taxable year if the seller or lessor obtains from such purchaser or lessee a copy of such purchaser's or lessee's election to be treated as a DISC as described in §1.992–2(a) together with such purchaser's or lessee's sworn statement that such election has been filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of such purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a DISC with respect to a sale or lease during a taxable year for which such purchaser or lessee does not qualify as a DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time such sale or lease is made that the purchaser or lessee will qualify as a DISC for such taxable year.

(v) *Failure of proof.* If a seller or lessor fails to provide proof of compliance with the destination test as required by this subparagraph, the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the use test in this subparagraph is satisfied with respect to property which—

(*a*) Under subdivisions (ii) through (iv) of this subparagraph is not sold for ultimate use in the United States or

(*b*) Under subdivision (v) of this subparagraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (i) of this subparagraph, a purchaser of property (including components, as defined in subdivision (vii) of this subparagraph) is deemed to use such property ultimately in the United States if any of the following conditions exists:

(*a*) Such purchaser is a related person (as defined in §1.993–1(a)(6)) with respect to the seller and such purchaser ultimately uses such property, or a second product into which such property is incorporated as a component, in the United States.

(*b*) At the time of the sale, there is an agreement or understanding that such property, or a second product into which such property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(*c*) At the time of the sale, a reasonable person would have believed that such property or such second product would be ultimately used by such purchaser in the United States unless, in the case of a sale of components, the fair market value of such components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which such components are incorporated (determined at the time of

completion of the production, manufacture or assembly of such second product).

For purposes of (b) of this subdivision, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (ii) of this subparagraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by such purchaser if, at any time within 3 years after the purchase of such property or components, either such property or components (or the second product into which such components are incorporated) is resold by such purchaser for use by a subsequent purchaser within the United States or such purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use such property or second product predominantly outside the United States as defined in subdivision (vi) of this subparagraph).

(iv) *Sales to retailers.* For purposes of subdivision (ii)(*c*) of this subparagraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets ouside the United States will be considered as property for ultimate use outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (i) of this subparagraph a lessee of property is deemed to use such property ultimately outside the United States during a taxable year of the lessor if such property is used predominantly outside the United States (as defined in subdivision (vi) of this subparagraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this subparagraph, property is used predominantly outside the United States for any period if, during such period, such property is 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 in deemed to be used predominantly outside the United States for any period if, during such 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 in outside the United States. However, any such property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where such transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations thereunder (relating to tax on air transportation of persons). For purposes of applying section 4262(c)(3) to this subdivision, the term ''United States'' has the same meaning as in §1.993–7.

(vii) *Component.* For purposes of this subparagraph, a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by

means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph, articles imported into the United States are referred to as ''foreign content''. The fair market value of the foreign content of export property is computed in accordance with subparagraph (4) of this paragraph. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest finance or carrying charges, or similar charges)

(2) *Application of 50 percent test.* The 50 percent test described in subparagraph (1) of this paragraph is applied on an item-by-item basis If, however, a person sells or leases a substantial volume of substantially identical export property in a taxable year and if all of such property contains substantially identical foreign content is substantially the same proportion, such person may determine the portion of foreign content contained in such property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in §1.993–1(d)(4)(v)) and the price for the parts is not separately stated, the 50 percent test described in subparagraph (1) of this paragraph is applied on an aggregate basis to the property and parts. If the price for the parts is described in subparagraph (1) of this paragraph is applied separately to the property and to the parts.

(4) *Computation of foreign content*—(i) *Valuation.* For purposes of applying the 50 percent test described in subparagraph (1) of this paragraph, it is necessary to determine the fair market value of all articles which constitute foreign content of the property being tested to determine if it is export property. The fair market value of such imported articles is determined as of the time such articles are imported into the United States. With respect to articles imported into the United States before July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 or 402a of the Tariff Act of 1930 (19 U.S.C. 1401a or 1402) in connection with their importation. With respect to articles imported into the United States on or after July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation. The appraised value of such articles is the full dutiable value of such articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value. Thus, an article which is imported into the United States is treated as entirely imported even if all or a portion of such article was originally manufactured, produced, grown, or extracted in the United States.

(ii) *Evidence of fair market value.* For purposes of subdivision (i) of this subparagraph, the fair market value of imported articles constituting foreign content may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of such articles is not the importer (or a related person with respect to the importer), the fair market value of such articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom such articles (or property incorporating such articles) were purchased. If a customs invoice or certificate described in the preceding sentence is not available to a person purchasing property, such person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(iii) *Interchangeable component articles*—(*a*) Where identical or similar component articles can be incorporated interchangeably into property and a person acquires some such component articles that are imported into the United States and other such component articles that are not imported

into the United States, the determination whether imported component articles were incorporated in such property as is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(*b*) The provisions of (*a*) of this subdivision may be illustrated by the following example:

*Example.* Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a DISC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the DISC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the DISC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the DISC, those devices are not export property. The remaining 8,000 devices purchased and exported by the DISC are treated as containing tubes produced in United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subparagraph (2) of this paragraph (relating to property leased to a member of a controlled group),

(ii) Property described in subparagraph (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to depletable products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property leased to a person (whether or not a DISC) which is a member of the same controlled group (as defined in §1.993–1(k)) as the lessor constitutes export property for any period of time only if during the period—

(*a*) Such property is held for sublease, or is subleased, by such person to a third person for the ultimate use of such third person;

(*b*) Such third person is not a member of the same controlled group; and

(*c*) Such property is used predominantly outside the United States by such third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (i)(*c*) of this subparagraph whether such property is used predominently outside the United States by such third person.

(iii) *Leasing rule.* For purposes of this subparagraph, leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of such controlled group but which subleases such property to a person which is a member of such controlled group. Thus, for example, if X, a DISC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of such group for showing to the general public, the film is not export property. On the other hand, if X, a DISC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified under this subparagraph from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subparagraph (3) of this paragraph from being export property, the ultimate use of such property is the sale or exhibition of such property to the general public. Thus, if A, a DISC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group

as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this subparagraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property.

(g) *Depletable products*—(1) *In general.* Under section 993(c)(2)(C), a product or commodity which is a depletable product (as defined in subparagraph (2) of this paragraph) or contains a depletable product is not export property if—

(i) It is a primary product from oil, gas, coal, or uranium (as described in subparagraph (3) of this paragraph), or

(ii) It does not qualify as a 50-percent manufactured or processed product (as described in subparagraph (4) of this paragraph).

(2) *Definition of ''depletable product''.* For purposes of this paragraph, the term ''depletable product'' means any product or commodity of a character with respect to which a deduction for depletion is allowable under section 613 or 613A. Thus, the term depletable product includes any mineral extracted from a mine, an oil or gas well, or any other natural deposit, whether or not the DISC or related supplier is allowed a deduction, or is eligible to take a deduction, for depletion with respect to the mineral in computing its taxable income. Thus, for example, iron ore purchased by a DISC from a broker is a depletable product in the hands of the DISC for purposes of this paragraph even though the DISC is not eligible to take a deduction for depletion under section 613 or 613A.

(3) *Primary product from oil, gas, coal, or uranium.* A primary product from oil, gas, coal, or uranium is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term ''primary product from oil'' means crude oil and all products derived from the destructive distillation of crude oil, including—

(*a*) Volatile products,

(*b*) Light oils such as motor fuel and kerosene,

(*c*) Distillates such as naphtha,

(*d*) Lubricating oils,

(*e*) Greases and waxes, and

(*f*) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term ''primary product from gas'' means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(*a*) Natural gas,

(*b*) Condensates,

(*c*) Liquefied petroleum gases such as ethane, propane, and butane, and

(*d*) Liquid products such as natural gasoline.

(iii) *Primary product from coal.* The term ''primary product from coal'' means coal and all products recovered from the carbonization of coal including—

(*a*) Coke,

(*b*) Coke-oven gas,

(*c*) Gas liquor,

(*d*) Crude light oil, and

(*e*) Coal tar.

(iv) *Primary product from uranium.* The term ''primary product from uranium'' means uranium ore and uranium concentrates (known in the industry as ''yellow cake''), and nuclear

fuel materials derived from the refining of uranium ore and uranium concentrates, or produced in a nuclear reaction, including—

(*a*) Uranium hexafluoride,

(*b*) Enriched uranium hexafluoride,

(*c*) Uranium metal,

(*d*) Uranium compounds, such as uranium carbide,

(*e*) Uranium dioxide, and

(*f*) Plutonium fuels.

(v) *Primary products and changing technology*. The primary products from oil, gas, coal, or uranium described in subdivisions (i) through (iv) of this subparagraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil, gas, coal, or uranium, or the only processes from which primary products may be derived under existing and future technologies, such as the gasification and liquefaction of coal.

(vi) *Petrochemicals*. For purposes of this paragraph, petrochemicals are not considered primary products from oil, gas, or coal.

(4) *50-percent manufactured or processed product*—(i) *In general*. A product or commodity (other than a primary product from oil, gas, coal, or uranium) which is or contains a depletable product is not excluded from the term ''export property'' by reason of section 993(c)(2)(C) if it is a 50-percent manufactured or processed product. Such a product or commodity is a ''50-percent manufactured or processed product'' if, after the cutoff point of the depletable product, it is manufactured or processed (as defined in subdivision (ii) of this subparagraph) and either the cost test described in subdivision (iv) of this subparagraph or the fair market value test described in subdivision (v) of this subparagraph is satisfied. To determine cutoff point, see subdivisions (vi) and (vii) of this subparagraph.

(ii) *Manufactured or processed*. A product is manufactured or processed if it is manufactured or produced within the meaning of paragraph (c)(2) of this section, except that for purposes of this subdivision the term manufacturing or processing does not include any excluded process (as defined in subdivision (iii) of this subparagraph) and the term conversion costs (as used in subdivision (iv) of such paragraph (c)(2)) does not include any costs attributable to any excluded process.

(iii) *Excluded processes*. For purposes of this paragraph, excluded processes are extracting (*i.e.*, all processes which are applied before the cutoff point of the mineral to which such processes are applied), and handling, packing, packaging, grading, storing, and transporting.

(iv) *Cost test*. A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) Its manufacturing and processing costs (that is, the portion of the cost of goods sold or inventory amount of the product or commodity attributable to the aggregate cost of manufacturing or processing each mineral contained therein) equal or exceed—

(*b*) An amount equal to either of the following:

(*1*) 50 percent of its cost of goods sold or inventory amount (decreased, at the DISC's option, by the portion of such cost or amount the DISC establishes is allocable to the difference between each prior owner's selling price for each depletable product contained in such product or commodity and such prior owner's cost of goods sold with respect thereto).

(*2*) The aggregate of the cost at the cutoff point (see subdivisions (vi) and (vii) of this subparagraph) properly attributable to each mineral contained in such product or commodity. However, if this subdivision (*2*) is applied, then the amount in (*a*) of this subparagraph (iv) shall be decreased and the amount in this subdivision (*2*) shall be increased, by so much of the cost of goods sold or inventory amount of the product or commodity as is properly allocable to any process other than transportation applied after the cutoff point of such mineral which would be a mining process (within the meaning of §1.613–4) were it applied before such point.

(v) *Fair market value test*. A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) The excess of its fair market value on the date it is sold, exchanged, or otherwise disposed of (or, if not sold, exchanged, or otherwise disposed of,

the last day of the DISC's taxable year) over the portion thereof properly allocable to excluded processes other than extracting is equal to or greater than

(*b*) Twice the aggregate of the fair market value at the cutoff point for each mineral contained in such product or commodity.

For purposes of this subdivision (v), the fair market value of a product or commodity on the date it is sold, exchanged, or otherwise disposed of is the price at which it is disposed of, subject to any adjustment that may be required under the arm's length standard of section 482 and the regulations thereunder. If such product or commodity is not sold, exchanged, or otherwise disposed of, then, for purposes of section 992(a)(1)(B) (relating to the 95-percent test with respect to qualified export assets), the fair market value of a product or commodity on the last day of the DISC's taxable year is the arm's length price at which such product or commodity would have been sold on such date, determined by applying the principles of section 482 and the regulations thereunder.

(vi) *Cutoff point of a mineral.* For purposes of this subparagraph:

(*a*) The cutoff point is the point at which gross income from the property (within the meaning of section 613(a)) was in fact determined.

(*b*) The cost at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral.

(*c*) The fair market value at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral, except that, if (*1*) the fair market value of a product or commodity on the date specified in subdivision (v)(*a*) of this subparagraph exceeds the aggregate of the fair market value at the cutoff point for each mineral contained therein and (*2*) 10 percent or more of such excess is attributable to a net increase in the fair market values of such minerals by reason of factors other than manufacturing or processing or the application of excluded processes (such as, for example, increases in the fair market values of some minerals by reason of inflation or speculation exceed decreases in such values of other minerals by reason of deflation or speculation), then the aggregate of the fair market value at the cutoff point for each such mineral shall be increased to reflect the net excess so attributable.

(*d*) The provisions of this subdivision (vi) are illustrated by the following example.

*Example.* An integrated manufacturer, X, on February 1, 1976, had gross income from the property (within the meaning of section 613(a)) of $50 with respect to a specified volume of a mineral. Thus, the cost at the cutoff point of the mineral was $50. X converted the mineral into a product which it sold on July 15, 1976, for $75. Of the $25 excess of the selling price over the gross income from the property, $23 was attributable to manufacturing, processing, and the application or excluded processes, and $2 was attributable to an increase in the fair market value of the mineral due to inflation between February 1 and July 15, 1976. Since only 8 percent of such excess ($2/$25) was attributable to factors other than manufacturing, processing, and the application of excluded processes, the fair market value at the cutoff point of the mineral is $50. However, had $3 of the $25 excess, or 12 percent, been attributable to an increase in the fair market value of the mineral due to inflation, then the fair market value at the cutoff point of the mineral would be $53.

(vii) [Reserved]

(viii) *Special rule for certain used products and scrap products.* If a product or commodity is a used 50-percent manufactured or processed product, or is recovered as scrap from a 50-percent manufactured or processed product, such product or commodity will be treated as a 50-percent manufactured or processed product.

(ix) *Special rule for byproducts and waste products.* For purposes of applying the cost test or fair market value test of subdivision (iv) or (v) of this subparagraph if a depletable product is recovered from a manufacturing process as a byproduct or waste product, then the cost and fair market value at the cutoff point are each deemed to be the lesser of—

(*a*) The fair market value of the waste product or byproduct containing the depletable product, determined as of the date the byproduct or waste product is recovered, or

(*b*) The amount the cost at the cutoff point would be for a depletable product of like kind and grade which is extracted, determined as of the date the byproduct or waste product is recovered.

For purposes of (*b*) of this subdivision the cutoff point for the depletable product of like kind and grade is deemed to be the point at which gross income from the property would be determined if such depletable product were sold by the taxpayer eligible to take a deduction for depletion after the completion of all mining processes applied to the depletable product and before the application of any nonmining process.

(x) *Proof of satisfaction of 50-percent manufactured or processed test.* (*a*) No substantiation is required to establish that either the cost test or the fair market value test of subdivisions (iv) or (v) of this subparagraph is satisfied or that a product or commodity qualifies under (viii) of this subdivision as either a used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product as long as it is reasonably obvious, on the basis of all relevant facts and circumstances, that either the cost test or fair market value test is satisfied, or that the product or commodity qualifies as either as used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product. Thus, for example, in the case of a DISC exporting a high precision lens at least 50 percent of the fair market value of which is obviously attributable to grinding, no substantiation of gross income from the property properly allocable to the depletable products contained in the lens, cost, or fair market values will be required.

(*b*) In cases in which satisfaction of either the cost test or the fair market value test is not reasonably obvious, a DISC will be required to substantiate the gross income from the property properly allocable to each depletable product in a product or commodity and either all costs or fair market values relied upon the DISC.

(*c*) For purposes of substantiating (*1*) gross income from the property properly allocable to a depletable product, (*2*) costs, and (*3*) fair market values, the DISC and related supplier shall each identify items in (or that were in) inventory in the same manner each used to identify items in inventory for purposes of computing Federal income tax.

(xi) *Application of 50-percent test.* The 50-percent test described in this subparagraph is applied on an item-by-item basis. If, however, a DISC sells a substantial volume of substantially identical products or commodities and if all or a group of such products or commodities contain substantially identical depletable products in substantially the same proportions and have cost or fair market value relationships (as the case may be) that are in substantially the same proportions, such DISC may apply the 50-percent test on an aggregate basis with respect to all such products or commodities, or group, as the case may be.

(5) *Effective dates.* Except as provided in subparagraph (6) of this paragraph, section 993(c)(2)(C) applies—

(i) With respect to any product or commodity not owned by a DISC, to sales, exchanges, or other dispositions made after March 18, 1975, with respect to which the DISC derives gross receipts.

(ii) With respect to any product or commodity acquired by a DISC after March 18, 1975.

(iii) With respect to any product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, or other dispositions made after March 18, 1976, and to owning such product or commodity after such date.

For purposes of this paragraph and subparagraph (6) of this paragraph, the date of a sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The accounting method of a person is not determinative of the date of a sale, exchange, or other disposition.

(6) *Fixed contracts.* Section 1101(f) of the Tax Reform Act of 1976 provides an exception to the effective date rules in this paragraph and in paragraph (h) of this section. Section 1101(f)(2) of the Act provides that section 993(c)(2)(C) and (D) shall not apply to sales, exchanges, and other dispositions made

after March 18, 1975, but before March 19, 1980, if they are made pursuant to a fixed contract. Section 1101(f)(2) also defines fixed contract. Under that definition, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), or if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of *x* amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

(h) *Export controlled products*—(1) *In general.* An export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an ''export controlled product'' at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 4(b) of the Export Administration Act of 1969 or section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in such Acts (paragraph (2)(A) of section 3 of the Export Administration Act of 1969 and paragraph (2)(C) of section 3 of the Export Administration Act of 1979). Such policy is to use export controls to the extent necessary ''to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of foreign demand.''

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (ii) of this subparagraph) and ends on and includes the final control date (as defined in subdivision (iii) of this subparagraph).

(ii) *Initial control date.* The initial control date of a product or commodity which was subject to short supply export controls on March 19, 1975, is March 19, 1975. The initial control date of a product or commodity which is subject to short supply export controls after March 19, 1975, is the effective date stated in the regulations to 15 CFR part 377 which subjects such product or commodity to short supply export controls. If there is no effective date stated in such regulations, the initial control date of such product or commodity is the date on which such regulations are filed for publications in the FEDERAL REGISTER.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes such product or commodity from short supply export controls. If there is no effective date stated in such regulations, the final control date of such product or commodity is the date on which such regulations are filed for publication in the FEDERAL REGISTER.

(iv) *Expiration of Export Administration Act.* An initial control date and a final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates*—(i) *Products controlled on March 19, 1975.* Except as provided in paragraph (g)(6) of this section, if a product or commodity was subject to short supply export controls on March 19, 1975, this paragraph applies—

(*a*) With respect to any such product or commodity not owned by a DISC, to sales, exchanges, other dispositions, or leases made after March 18, 1975, with respect to which the DISC derives gross receipts.

(*b*) With respect to any such product or commodity acquired by a DISC after March 18, 1975, and

(*c*) With respect to any such product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, other dispositions, and leases made after March 18, 1976, and to owning such product or commodity after such date.

(ii) *Products first controlled after March 19, 1975.* If a product or commodity becomes subject to short supply export controls after March 19, 1975, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sale, exchange, lease, or other disposition.* For purposes of this subparagraph, the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(iv) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive order designate such property as in short supply. Any property so designated will be treated as property which is not export property during the period beginning with the date specified in such Executive order and ending with the date specified in an Executive order setting forth the President's determination that such property is no longer in short supply.

[T.D. 7514, 42 FR 55461, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57309, Nov. 2, 1977; T.D. 7854, 47 FR 51740, Nov. 17, 1982]

### § 1.993–4 Definition of producer's loans.

(a) *General rule*—(1) *Definition.* Under section 993(d), a loan made by a DISC to a person, referred to in this section as the ''borrower,'' is a producer's loan if—

(i) The loan is made out of accumulated DISC income within the meaning of subparagraph (3) of this paragraph.

(ii) The loan is evidenced by an obligation described in subparagraph (4) of this paragraph.

(iii) The requirement as to the trade or business of the borrower described in subparagraph (5) of this paragraph is satisfied.

(iv) At the time the loan is made, the obligation referred to in subdivision (ii) of this subparagraph bears a legend stating ''This Obligation Is Designated A Producer's Loan Within The Meaning of section 993(d) of the Internal Revenue Code'' or words of substantially the same meaning.

(v) The limitation as to the export-related assets of the borrower described in paragraph (b) of this section is satisfied.

(vi) The requirement as to the increased investment of the borrower in export-related assets described in paragraph (c) of this section is satisfied, and

(vii) The requirement of paragraph (d) of this section as to proof of compliance with paragraphs (b) and (c) of this section is satisfied.

(2) *Application of this section*—(i) *In general.* A loan which is a producer's loan is a qualified export asset of the DISC (see §1.993–2(a)(5) and (F)). The interest on a producer's loan is a qualified export receipt of the DISC (see §1.993–1(g)). A producer's loan is not a dividend to a borrower which is also a shareholder of the DISC making the loan. For rules with respect to deemed distributions by reason of the amount of foreign investment attributable to producer's loans, see section 995(b)(1)(G) and (d) and the regulations thereunder.

(ii) *No tracing of loan proceeds.* For purposes of applying this section, in order to qualify as a producer's loan, the proceeds of the loan need not be traced to an investment in any specific asset.

(iii) *Unrelated borrower.* For purposes of applying this section, it is not necessary for a borrower to be a related person with respect to the DISC from which it receives a producer's loan, or a member of the same controlled group as the DISC.

(iv) *Unpaid balance of producer's loans.* For purposes of applying this section, the unpaid balance of producer's loans does not include the unpaid balance of any producer's loan to the extent the loan has been deducted or charged off by the DISC as totally or partially worthless under section 165 or 166.

(v) *Refinancing, renewal, and extension.* For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph are met.

(vi) *Events subsequent to time loan is made.* The determination as to whether a loan qualifies as a producer's loan is made on the basis of the relevant facts taken into account for purposes of determining whether the loan was a producer's loan when made. Thus, for example, if the accumulated DISC income of the lender is later reduced below the unpaid balance of all producer's loans previously made by the DISC, such subsequent decrease in the amount of accumulated DISC income will not result in later disqualification of such loan (or part thereof) as a producer's loan. Similarly, if a loan (or part of a loan) does not qualify as a producer's loan because of an insufficient amount of accumulated DISC income at the time the loan is made, a subsequent increase in the amount of accumulated DISC income will not result in later qualification of such loan (or part thereof) as a producer's loan. As a further example, for purposes of applying the borrower's export related assets limitation described in paragraph (b) of this section, a loan which qualifies as a producer's loan when made will not later be disqualified if property, the gross receipts from the sale or lease of which were includible in the numerator of the fraction described in paragraph (b)(3)(i) of this section at the time of sale or lease by the borrower, is later characterized as excluded property (as defined in §1.993–3(f)).

(vii) *Application of tests under paragraphs (b) and (c) on controlled group bases.* If the borrower is a member of a controlled group (as defined in §1.993–1(k)) at the time a loan is made, all amounts that must be determined for purposes of applying the limitation and increased investment requirement with respect to the export-related assets of the borrower (described in paragraphs (b) and (c), respectively, of this section) may be determined at the election of the borrower by aggregating such amounts for all members of the controlled group, determined for the taxable year of each member of the controlled group during which the loan is made, excluding only such members of the group as are DISC's or foreign corporations for such year. However, such amounts may be included only to the extent that such amounts have not already been taken into account in applying the limitation and increased investment requirement with respect to any other borrower. Amounts to be aggregated for all such members if such election is made include, for example, gross receipts (described in paragraphs (b)(3)(i) and (ii) of this section) and export-related assets (described in paragraph (b)(2) of this section). The borrower may make such election by causing its written statement of election to be attached to the lending DISC's return under section 6011(e)(2) for the first taxable year of the lending DISC within which or with which the borrower's taxable year for which the election is to apply ends. An election once made is binding on all members of the controlled group which includes the borrower with respect to all taxable years of the borrower beginning with its first taxable year for which the election is made. A borrower who makes such election may revoke it only if it secures the consent of the Commissioner to such revocation upon application made through the lending DISC.

(3) *Loan out of accumulated DISC income*—(i) *In general.* A loan is a producer's loan only to the extent that it is made out of accumulated DISC income. A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance at the time such loan is made of all other producer's loans made by a DISC, does not exceed the amount of accumulated DISC income of the DISC at the beginning of the month in which

the loan is made. The amount of accumulated DISC income at the beginning of any month is determined as if the DISC's taxable year closed at the end of the immediately preceding month.

(ii) *Presumption.* A loan made during a taxable year shall be deemed under subdivision (i) of this subparagraph to have been made out of accumulated DISC income if the balance of producer's loans at the beginning of the year and those made during the year do not exceed accumulated DISC income at the end of the year.

(iii) *Deemed distributions.* For purposes of this subparagraph, accumulated DISC income as of the end of any taxable year (or month) shall be determined without regard to deemed distributions under section 995(b)(1)(G) for the amount of foreign investment attributable to producer's loans for such year (or for the taxable year for which such month is a part) but actual distributions shall be taken into account.

(4) *Evidence and terms of obligation.* A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan. For purposes of this subparagraph, an evidence of indebtedness is a written instrument of indebtedness. Section 482 and the regulations thereunder are applicable to determine, in the case of a loan by the DISC to a borrower which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482, whether the interest charged on such loan is at an arm's length rate.

(5) *Borrower's trade or business.* A loan is a producer's loan only if the loan is made to a person engaged in the United States in the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) of export property determined without regard to §1.993–3(f)(1)(iii) and (iv). The borrower may also be engaged in other trades or businesses and the loan need not be traceable to specific investments in export property.

(b) *Borrower's export related assets limitation*—(1) *General rule.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount equal to the amount of the borrower's export-related assets (determined under subparagraph (2) of this paragraph) multiplied by the fraction set forth in subparagraph (3) of this paragraph.

(2) *Amount of export-related assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the amount of the borrower's export-related assets is the sum of the amounts described in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) *Borrower's plant and equipment.* The amount described in this subdivision is the sum of the borrower's adjusted bases (determined as of the beginning of the borrower's taxable year in which a loan is made to it) for plant, machinery, equipment, and supporting

production facilities, which are located in the United States. Supporting production facilities are all property used primarily in connection with the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) or storage, handling, transportation, or assembly of property by the borrower.

(iii) *Borrower's property held primarily for sale or lease.* The amount described in this subdivision is the amount of the borrower's property (at the beginning of the taxable year of the borrower in which a loan is made to it) held primarily for sale or lease to customers in the ordinary course of its trade or business. The amount of such property held for sale is determined under the methods of identifying and valuing inventory normally used by the borrower. The amount of such property held for lease or leased is the borrower's adjusted bases, determined under section 1011, for such property.

(iv) *Borrower's research and experimental expenditures.* The amount described in this subdivision is the aggregate amount, whether or not charged to capital account, of research and experimental expenditures (within the meaning of section 174) incurred in the United States by the borrower during each of its taxable years which begin after December 31, 1971, and precede the taxable year in which the loan is made to the borrower. Such research and experimental expenditures need bear no relationship to export property (as defined in §1.993–3) of the borrower. The aggregate amount of all such expenditures for each of such preceding taxable years is taken into account for purposes of this subparagraph, regardless of whether all or any portion of the aggregate amount has been taken into account with respect to producer's loans made to the borrower by any DISC in preceding taxable years. The aggregate amount of all such expenditures shall include such expenditures of a corporation, the assets of which were acquired by the borrower in a distribution or a transfer described in section 381(a)(1) or (2) (relating to carryovers in certain corporate acquisitions).

(3) *Fraction referred to in subparagraph (1) of this paragraph*—(i) *Numerator of fraction.* The numerator of the fraction set forth in this subparagraph is the sum of the borrower's gross receipts for each of its 3 taxable years immediately preceding the taxable year in which the loan is made (but not including any taxable year beginning before January 1, 1972) from the sale or lease of export property (determined without regard to §1.993–3(f)(1)(iii) and (iv)) which is manufactured, produced, grown, or extracted (within the meaning of §1.993–3(c)) by the borrower whether or not sold or leased directly or through a related domestic person (notwithstanding §1.993–3(a)(4) and (f)(2)). For purposes of the preceding sentence, with respect to a sale or lease to a related DISC in which the transfer price is determined under section 994(a)(1) or (2), the rules under §1.994–1(c)(5) (relating to incomplete transactions) shall be applied, and with respect to all other sales and leases the rules under §1.994–1(c)(5) other than subdivision (i)(*d*) thereof shall be applied.

(ii) *Denominator of fraction.* The denominator of the fraction set forth in this subparagraph is the sum of the amount included in the numerator and all other gross receipts of the borrower, for each of its taxable years for which gross receipts are included in the numerator of the fraction, from all sales or leases of all property held by the borrower primarily for sale or lease to customers in the ordinary course of its trade or business. For purposes of subdivision (i) of this subparagraph and this subdivision, if such property is sold or leased to a domestic related person which resells or subleases such property, the borrower's gross receipts shall be the gross receipts derived by the domestic related person from the resale or sublease of the export property.

(iii) *Taxable years.* If the borrower has not engaged in the sale or lease of property (as described in this subparagraph) for the 3 immediately preceding taxable years, or if 3 taxable years beginning after December 31, 1971, have not elapsed, the fraction will be computed on the basis of such gross receipts for its taxable years immediately preceding the loan and beginning after December 31, 1971, during which the borrower has so engaged. No

producer's loans can be made to a borrower until after the end of the first taxable year of the borrower beginning after December 31, 1971.

(c) *Requirement for increased investment in export-related assets*—(1) *In general.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower during the borrower's taxable year during which such loan is made, does not exceed the amount of the borrower's increase for the year in investment in export-related assets. Such increase for any taxable year is the sum of—

(i) The increase (if any) in the borrowers adjusted basis of certain types of assets as determined under subparagraph (2) of this paragraph and

(ii) The amount (if any) during the year of its research and experimental expenditures as determined under paragraph (b)(2)(iv) of this section.

(2) *Increase in adjusted basis.* The amount under this subparagraph is the amount (not less than zero) by which—

(i) The borrower's adjusted basis (determined as of the end of its taxable year in which the producer's loan is made) in all of its property which is described in paragraph (b)(2)(ii) (plant and equipment), and (iii) (property held primarily for sale or lease) of this section, including any such property acquired by it during such taxable year, exceeds

(ii) Its adjusted bases in all such property (determined as of the beginning of such year).

(3) *Ordering rule.* If during the borrower's taxable year the amount of increase in investment in export-related assets determined under this subparagraph is exceeded by amounts loaned to the borrower during such year that would otherwise qualify as producer's loans, such loans shall be applied in the order made against the amount of such increase in order to determine which loans qualify as producer's loans.

(d) *Proof of borrower's compliance with paragraphs (b) and (c) of this section.* For purposes of paragraphs (b) and (c) of this section, a DISC shall be prepared to establish initially the compliance of the borrower with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. For taxable years ending after October 17, 1977, the DISC must attach either the certification by the certified public accountant or the certification by the borrower to its return. Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district director. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required, the loan shall be deemed not to be a producer's loan.

(e) *Special limitation in the case of domestic film maker*—(1) *General rule.* The limitation of paragraph (b) of this section as to the export-related assets of the borrower will be considered satisfied if the DISC—

(i) Is engaged in the trade or business of selling or leasing films which are export property, or is acting as a commission agent for a person who is so engaged,

(ii) Makes a loan to a borrower which is a domestic film maker (as defined in subparagraph (5) of this paragraph) for the purpose of making a film, and

(iii) The amount of such loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount determined by multiplying—

(*a*) The sum of (*1*) the amount of the export-related assets of the borrower (determined under paragraph (b)(2)(i) of this section as of the beginning of the borrower's taxable year in which the loan is made), plus (*2*) the amount of a reasonable estimate of the amount of

such export related assets obtained or to be obtained by the borrower during such year and subsequent years with respect to films as to which filming begins within such year by

(*b*) The percentage which, based on the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made, the annual gross receipts (as described in §1.993–6(a)(1), whether or not such films constitute property described therein) of such other film makers from the sale or lease of such films outside the United States is of the annual gross receipts of such other film makers from all sales or leases of such films.

(2) *Purpose of loan.* A loan by a DISC will be deemed to be for the making of a film if there exists a written agreement between the DISC and the borrower, executed at or before the time the loan is made, stating that the loan is made or to be made to enable the borrower to make such film.

(3) *Reasonable estimate of amounts.* For purposes of subparagraph (1)(iii)(*a*)(*2*) of this paragraph, a reasonable estimate shall be based on the conditions known by the DISC and borrower to exist at the time a loan is made (or which the DISC and borrower have reason to know to exist at such time).

(4) *Experience of film makers.* For purposes of subparagraph (1)(iii)(*b*) of this paragraph, the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made shall be derived from such records and statistics as are acknowledged in the trade as reasonably reliable.

(5) *Domestic film maker.* For purposes of this section, a borrower is a domestic film maker with respect to a film if—

(i) The borrower is a U.S. person within the meaning of section 7701(a)(30), except that (*a*) with respect to a partnership all of the partners must be U.S. persons and (*b*) with respect to a corporation all of its officers and at least a majority of its directors must be U.S. persons,

(ii) The borrower is engaged in the trade or business of making the film with respect to which the loan is made,

(iii) Each studio, if any, used or to be used for filming or for recording sound incorporated into such film is located in the United States (as defined in section 7701(a)(9)),

(iv) At least 80 percent of the aggregate playing time of the film is or will be photographed within the United States (as defined in section 7701(a)(9)), and

(v) At least 80 percent of the total amount (not including any amount which is contingent upon receipts or profits of such film and which is fully taxable by the United States) paid or to be paid for services performed in the making of the film is either paid or to be paid to persons who are U.S. persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(6) *Amounts as fully taxable.* For purposes of subparagraph (5)(v) of this paragraph, an amount is considered fully taxable by the United States if the entire amount is included in gross income under section 61 or is subject to withholding under any provision of U.S. law or treaty to which the U.S. is a party and is not exempt from taxation under any provision of such law or treaty. Where a nonresident alien individual is engaged for the making of a film or where a foreign corporation is engaged to furnish the services of one of its officers or employees for the making of a film, the amount paid such individual or corporation will be considered as fully taxable by the United States only if it meets the test of this subparagraph.

[T.D. 7514, 42 FR 55464, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57311, Nov. 2, 1977; T.D. 7514, 42 FR 60910, Nov. 30, 1977; T.D. 7854, 47 FR 51741, Nov. 17, 1982]

### § 1.993–5 Definition of related foreign export corporation.

(a) *General rule*—(1) *Definition.* Under section 993(e), a foreign corporation is a related foreign export corporation with respect to a DISC if—

(i) It is a foreign international sales corporation described in paragraph (b) of this section,

(ii) It is a real property holding company described in paragraph (c) of this section, or

(iii) It is an associated foreign corporation described in paragraph (d) of this section.

(2) *Application of this section.* It is necessary to determine whether a foreign corporation is a related foreign export corporation with respect to a DISC for the following two purposes:

(i) *Qualified export assets.* Under §1.993–2(g), the stock or securities of a related foreign export corporation held by the DISC are qualified export assets.

(ii) *Qualified export receipts.* Under §1.993–1 (e), (f), and (g), certain receipts of the DISC with respect to stock or securities of a related foreign export corporation held by the DISC are qualified export receipts.

(b) *Foreign international sales corporation*—(1) *In general.* A foreign corporation is a foreign international sales corporation with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of §1.957–1(b) (relating to definition of controlled foreign corporation),

(ii) 95 percent or more of such foreign corporation's gross receipts (as defined in §1.993–6) for its taxable year ending with or within such taxable year of the DISC consists of qualified export receipts described in §1.993–1 (b) through (e) or interest described in §1.993–1(g) derived from any obligations described in §1.993–2 (d) or (e), and

(iii) The sum of the adjusted bases of the assets of the foreign corporation which are qualified export assets described in §1.993–2 (b) through (e) and which are held by the foreign corporation at the close of its taxable year which ends with or within such taxable year of the DISC equals or exceeds 95 percent of the sum of the adjusted bases of all assets held by the foreign corporation at the close of such taxable year.

(2) *Certain determinations.* The determinations as to whether gross receipts are qualified export receipts described in subparagraph (1)(ii) of this paragraph and as to whether assets are qualified export assets described in subparagraph (1)(iii) of this paragraph are made by applying the requirements of §§1.993–1 and 1.993–2 to the foreign corporation as if it were a domestic corporation being tested to determine whether it is a DISC. For purposes of making either of such determinations, the principles of accounting applicable for purposes of computing earnings and profits under §1.964–1 (relating to a controlled foreign corporation's earnings and profits) shall apply.

(c) *Real property holding company*—(1) *In general.* A foreign corporation is a real property holding company with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of §1.957–1(b) and

(ii) The sole function of the foreign corporation is to hold title to real property situated outside the United States for the exclusive use of the DISC, title to which may not be held by the DISC (and, if the DISC subleases such property to a related supplier, as described in subparagraph (3) of this paragraph, by such related supplier) under the law of the country in which such property is situated.

(2) *Activities of the foreign corporation.* For purposes of subparagraph (1)(ii) of this paragraph, a foreign corporation which holds title to real property situated outside the United States may also perform activities with respect to such property (such as management, maintenance, and payment of taxes) which are ancillary to its function of holding title to such property.

(3) *Exclusive use by the DISC.* Real property held by the foreign corporation must be used exclusively by the DISC whether under a lease or any other arrangement. Real property is not so used by the DISC if the DISC subleases such property to any other person. If, however, during a taxable year of the DISC—

(i) 90 percent or more of the qualified export receipts of the DISC for such year are derived from transactions with respect to which it is a commission agent for a related supplier (as defined in §1.994–1(a)(3)(ii)), and

(ii) The DISC subleases such property to such related supplier

then such property will be considered as used exclusively by the DISC during such year if such related supplier does not sublease such property.

(d) *Associated foreign corporation*—(1) *In general.* A foreign corporation is an associated foreign corporation with respect to a taxable year of the DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC, or one or more members of the same controlled group of corporations (as defined in subparagraph (2) of this paragraph) as the DISC, owns (within the meaning of section 1563 (d) and (e)) stock of the foreign corporation possessing less than 10 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote, as determined under the principles of §1.957–1(b), or owns no stock of such corporation, and

(ii) The ownership of stock, or of securities (as defined in §1.993–2(g)), of the foreign corporation by the DISC or by one or more members of such controlled group of corporations reasonably furthers a transaction or transactions giving rise to qualified export receipts for the DISC.

(2) *Controlled group of corporations.* For purposes of this paragraph, the term ''controlled group of corporations'' has the same meaning assigned to the term in section 1563(a) and not section 993(a)(3) and §1.993–1(k). Thus, for purposes of this paragraph, the test of control is 80 percent control and, since the rules of section 1563(b) apply, only domestic members are considered to be members of the controlled group.

(3) *Furtherance of qualified export receipts.* Ownership of stock or securities of a foreign corporation will be considered as reasonably furthering a transaction or transactions giving rise to qualified export receipts for a DISC if—

(i) The ownership is necessary to obtain or maintain the foreign corporation as a customer of the DISC or of a related supplier, as defined in §1.994–1(a)(3)(ii) of the DISC or to aid the sales distribution system of the DISC or of such related supplier, and

(ii) The amount of the investment in the foreign corporation bears a reasonable relationship to the amount of the DISC's annual net profit from transactions in its trade or business which it may reasonably expect to derive on account of such ownership.

In determining whether the amount of the investment is reasonable, there shall be taken into account any stock or securities of the foreign corporation owned by any other foreign corporation which, if it were a domestic corporation, would be a member of the same controlled group of corporations as the DISC.

[T.D. 7514, 42 FR 55467, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977]

### §1.993–6 Definition of gross receipts.

(a) *General rule.* Under section 993(f), for purposes of sections 991 through 996, the gross receipts of a person for a taxable year are—

(1) The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) Gross income recognized from all other sources, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subparagraph (1) of this paragraph),

(ii) Dividends and interest,

(iii) The sale at a gain of any property not described in subparagraph (1) of this paragraph, and

(iv) Commission transactions as and to the extent described in paragraph (e) of this section.

(b) *Nongross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) The proceeds of a loan or of the repayment of a loan, or

(2) A receipt of property in a transaction to which section 118 (relating to contribution to capital) or 1032 (relating to exchange of stock for property) applies.

(c) *Nonreduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by returns and allowances, costs of goods sold, expenses, losses, a deduction for dividends received under section 243, or any other deductible amounts.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a DISC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the DISC for the taxable year for which such amount is included in the gross income of the DISC.

(e) *Commission transactions.* (1) In the case of transactions which give rise to a commission on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the commission agent as gross income from all such transactions shall be the gross receipts derived by the principal from the sale or lease of the property, or the gross income derived by the principal from the furnishing of services, with respect to which the commissions are derived. In the case of a commission agent for a related supplier (as defined in §1.994–1(a)(3)(ii)), the gross receipts or gross income of such agent shall be determined as if it used the same method of accounting as its related supplier. In the case of a commission agent for a principal other than a related supplier, the gross receipts or gross income of such principal shall be determined as if such principal used the same method of accounting as its agent.

(2) If the commission arrangement provides that the commission agent will receive a commission only with respect to sales or leases of export property, or the furnishing of services, which result in qualified export receipts, the commission agent will not take into account the gross receipts or gross income, as the case may be, derived by the principal from any transaction for which the commission agent would not be entitled to a commission under the commission arrangement.

(f) *Example.* The provisions of this section may be illustrated by the following example:

*Example.* During 1973, M, a related supplier (as defined in §1.994–1(a)(3)(ii)) of N, is engaged in the manufacture of machines in the United States. N, a calendar year taxpayer, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of such machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it in a related foreign export corporation (as defined in §1.993–5), interest on producer's loans made to M, and proceeds from sales of business assets located outside the United States resulting in a recognized gains and losses. N's gross receipts for 1973 are $3,550, computed on the basis of the additional facts assumed in the table below:

| | |
|---|---|
| (1) N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses) | $1,500 |
| (2) N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses) | 500 |
| (3) N's gross income from services for machines manufactured by M (without reduction for service expenses) | 400 |
| (4) Z's sale receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales, and commission sales expenses) | 550 |
| (5) Dividends received by N | 150 |
| (6) Interest received by N on producer's loans | 200 |
| (7) Proceeds received by N representing recognized gain (but not losses) from sales of business assets located outside the United States | 250 |
| (8) N's gross receipts | 3,550 |

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

### § 1.993–7 Definition of United States.

Under section 993(g), the term ''United States'' includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and possessions of the United States. For the requirement that a DISC must be incorporated and existing under the laws of a State or the District of Columbia, see §1.992–1(a)(1).

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

### § 1.994–1 Inter-company pricing rules for DISC's.

(a) *In general*—(1) *Scope.* In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c)(2), (3), and (4) of this section: The ''4 percent'' gross receipts method, the ''50–50'' combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain ''incomplete transactions'' and for computing combined taxable income, see paragraph (c)(5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994–2 prescribes the marginal costing rules authorized by section 994(b)(2).

(2) *Performance of substantial economic functions.* The application of section 994(a)(1) or (2) does not depend on the extent to which the DISC performs substantial economic functions (except with respect to export promotion expenses). See paragraph (l) of § 1.993–1.

(3) *Related party and related supplier.* For the purposes of this section—

(i) The term ''related party'' means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 and § 1.482–1(a).

(ii) The term ''related supplier'' means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

(b) *Transactions to which section 994 applies.* Section 994(a)(3) may be applied, as described in paragraph (a) of this section, to any transaction between a related supplier and a DISC. Section 994(a)(1) or (2) may be applied, as described in paragraph (a) of this section, to a transaction between a related supplier and a DISC only in the following cases:

(1) Where the related supplier sells export property to the DISC for resale or where the DISC is commission agent for the related supplier on sales by the related supplier of export property to third parties whether or not related parties. For purposes of this section, references to sales include exchanges.

(2) Where the related supplier leases export property to the DISC for sublease for a comparable period with comparable terms of payment or where the DISC is commission agent for the related supplier on leases by the related supplier of export property to

third parties whether or not related parties.

(3) Where services are furnished by a related supplier which are related and subsidiary to any sale or lease by the DISC, acting as principal or commission agent, of export property under subparagraph (1) or (2) of this paragraph.

(4) Where engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by a related supplier where the DISC is acting as principal or commission agent with respect to the furnishing of such services to a third party whether or not a related party.

(5) Where the related supplier furnishes managerial services in furtherance of the production of qualified export receipts of an unrelated DISC where the related DISC is acting as principal or commission agent with respect to the furnishing of such services to an unrelated DISC.

Transactions are included, for purposes of this paragraph, only if they give rise to qualified export receipts (within the meaning of section 993(a)) in the hands of the related DISC. If a transaction is not included in subparagraph (1), (2), (3), (4), or (5) of this paragraph, the rules of section 994(a)(1) or (2) do not apply. Thus, for example, the rules of sectoin 994(a)(1) or (2) would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) *The ''4-percent'' gross receipts method.* Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) *The ''50–50'' combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) *Section 482 method.* If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year—

(*a*) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(*b*) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(*c*) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (*b*) of this subdivision.

(*d*) The time and manner of payment of transfer prices required by (*b*) and (*c*) of this subdivision shall be determined under paragraphs (e)(3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See §1.991–1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of §1.61–3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631–1(d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (*a*) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (*b*) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in §1.861–8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of §1.993–1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC

and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (*a*) A recognized industry or trade usage, or (*b*) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(d) *Rules under section 994(a)(1) and (2) for transactions other than sales.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales:

(1) *Leases.* In the case of a lease of export property by a related supplier to a DISC for sublease by the DISC to produce gross receipts, for any taxable year the amount of rent the DISC must pay to the related supplier shall be determined under the DISC's lease with its related supplier but must be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. For purposes of applying this subparagraph, transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(7) of this section as to combine in any one group of transactions both lease transactions and sale transactions involving the same product or product line.

(2) *Commissions.* If any transaction to which section 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts under section 993(a)—

(i) The amount of the income that may be earned by the DISC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the DISC would have been permitted to earn under the gross receipts method, the combined taxable income method, or section 482 method if the related supplier had sold (or leased) the property or service to the DISC and the DISC in turn sold (or subleased) to a third party, whether or not a related party, and

(ii) The maximum commission the DISC may charge the related supplier is the sum of the amount of income determined under subdivision (i) of this subparagraph plus the DISC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(3) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the DISC and its related supplier and the accounting method otherwise employed by the DISC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* In the case of related and subsidiary services to which subdivision (i) of this subparagraph does not apply and other services described in paragraph (b)(4) or (5) of this section performed by a related supplier (relating respectively to engineering and architectural services and certain managerial services), the amount of taxable income which the DISC may derive for any taxable year shall be determined under the arrangement between the DISC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the gross receipts method or combined taxable income method. Related and subsidiary services to which subdivision (i) of this subparagraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(7) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the product or product lines were sold or in which payment for such services is received or accrued. The rules for grouping of transactions in paragraph (c)(7) of this section shall not apply with respect to the determination of taxable income which the DISC may derive from other services described in paragraph (b)(4) or (5) of this section performed by a related supplier or commissions on such services, and such determination shall be made only on a transaction-by-transaction basis.

(e) *Methods of applying paragraphs (c) and (d) of this section*—(1) *Limitation on DISC income (''no loss'' rule)*—(i) *In general.* Except as otherwise provided in this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

(ii) *Special rule for applying ''4 percent'' gross receipts method to sales.* A transfer price or commission, determined under the ''4 percent'' gross receipts method (determined without regard to subdivision (i) of this subparagraph), for a sale of export property referred to in paragraph (b)(1) of this section, will not be considered to cause a loss for the related supplier if for the DISC's taxable year, the ratio that (a) the taxable income of the DISC derived from such sale by using such price or commission bears to (*b*) the DISC's gross receipts from such sale is not greater than the ratio that (*c*) all of the taxable income of the related supplier and the DISC from all sales of the same product or product line (domestic and foreign) to third parties whether or not related parties bears to (*d*) the total gross receipts of the related supplier and the DISC from such sales. For purposes of the preceding sentence, sales between the DISC and its related suppliers shall not be taken into account under (*c*) or (*d*) of this subdivision. For example, assume that for a taxable year of a DISC the total costs of the related supplier and the DISC with respect to all sales ($150 for domestic and $44 for foreign) of a product line are $194 and the total gross receipts of the related supplier and the DISC with respect to such sales are $200 so that the total taxable income of the related supplier and the DISC with respect to such sales is $6. The parties would thus be entitled to compute a transfer price determined under the gross receipts method on any given sale of product A of such product line by the related supplier to the DISC which would allocate to the DISC taxable income equal to not more than 3 percent (*i.e.*, $6/$200) of its gross receipts derived from its resale of such product. If the DISC were to resell an item of product A for $10, the transfer price paid by the DISC to the related

supplier determined under the gross receipts method could be as low as $9.70.

(iii) *Grouping transactions.* For purposes of subdivision (i) of this subparagraph, the basis for grouping transactions chosen by the taxpayer under paragraph (c)(7) of this section for the taxable year shall be applied. For purposes of making the computations of subdivision (ii) (*c*) and (*d*) of this subparagraph, however, the taxpayer may choose any basis for grouping transactions permissible under paragraph (c)(7) of this section, even though it may not be the same basis as that already chosen under paragraph (c)(7) of this section for computing transfer prices or commissions to a DISC. If, for example, the taxpayer has chosen to group transactions on a product basis for computing transfer prices or commissions to a DISC for a taxable year, the taxpayer may still group transactions on a product line basis for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph. For a further example, if the taxpayer computes taxable income for one group of transactions under the gross receipts method and computes taxable income for a second group of transactions under the combined taxable income method, the taxpayer may aggregate these transactions for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph.

(2) *Relationship to section 482.* In applying the rules under section 994, it may be necessary to first take into account the price of a transfer (or other transaction) between the DISC (or related supplier) and a related party which is subject to the arm's length standard of section 482. Thus, for example, where a related supplier sells export property to a DISC which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the DISC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a DISC, however, the DISC and its related supplier are treated as if they were a single entity carrying on all the functions performed by the DISC and the related supplier with respect to the transaction and the DISC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no DISC.

(3) *Initial payment of transfer price or commission.* (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of §1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under §1.993–2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date

the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see §1.993–2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)(*a*) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(*b*) With respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(*1*) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(*2*) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(*3*) The percentage that (*i*) an amount equal to (*a*) the amount actually paid by the DISC to the related supplier in respect of the property minus (*b*) the related supplier's cost of goods sold with respect to the property, bears to (*ii*) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (*iii*) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (*iv*) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(*c*) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) *Subsequent determination of transfer price or commission.* The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations thereunder or section 861 and §1.861–8 which affects the amounts which entered into the determination of the transfer price or commission.

(5) *Procedure for adjustments to transfer price or commission*—(i)(*a*) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price

(or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable due the DISC from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under §1.993–2(d)(3) as a trade receivable, and thus as a qualified export asset.

(*b*) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000 which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000 − $8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under §1.993–2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export asset.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v)(*a*) In lieu of establishing an account receivable in accordance with subdivision (i) of this subparagraph for all or part of an amount due a related supplier, the related supplier and DISC are permitted to treat all or part of any distribution which was made by the DISC out of its previously taxed income with respect to the year to which the determination or redetermination relates as an additional payment of transfer price or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the determination or redetermination due the related supplier after this treatment shall be represented by an account receivable established under subdivision (i) of this subparagraph. To the extent that a distribution is so treated under this subdivision (v), it shall cease to qualify as distribution for any Federal income tax purpose, and the DISC's account for previously taxed income shall be adjusted accordingly. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (v), the related supplier shall establish an account receivable from that shareholder for the

amount so recharacterized. Such account receivable shall be paid in the time and manner set forth in this paragraph (e)(5). In order to obtain the relief provided by this subdivision (v), the conditions and procedures prescribed by Revenue Procedure 84–3 must be met. The provisions of this paragraph (e)(5)(v) shall apply to all open taxable years ending after December 31, 1971.

(*b*) If, for example, during 1982, a DISC commission from a related supplier with respect to a transaction completed in 1980 was redetermined to be $1,000 less than the commission actually charged by, and paid to, the DISC, the amount of any distribution previously made by the DISC from its 1980 previously taxed income to the related supplies as a shareholder may, to the extent of $1,000, be treated not as a distribution but as a repayment of the commission.

(vi) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)(*b*) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500 − $8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under §1.993–2(d)(3) for the last day of such year.

*Example 2.* Assume the same facts as in example 1 except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under §1.993–2(d)(3) for the last day of such year.

(f) *Export promotion expenses*—(1) *Purpose of expense.* (i) In order for an expense or cost of a type described in subparagraph (2) of this paragraph to be an export promotion expense, the expense or cost must be incurred or treated as incurred by the DISC (under subparagraph (7) of this paragraph) to advance the sale, lease, or other distribution of export property for use, consumption, or distribution outside the United States. Costs of services in performing installation (but not assembly) on the site and for meeting warranty commitments if such services are related and subsidiary (within the meaning of §1.993–1(d)) to any qualified sale, lease, or other distribution of export property by the DISC (or with respect to which the DISC received a commission) will be considered to advance the sale, lease, or other distribution of export property. General and administrative expenses attributable to billing customers, other clerical functions of the DISC, or generally operating the DISC, will also be considered to advance the sale, lease, or other distribution of export property.

(ii) Where an expense or cost incurred or treated as incurred by the DISC qualifies only in part as an export promotion expense, such expense or cost must be allocated between the qualified portion and such other portion on a reasonable basis. See §1.994–2(b)(2) for the option of the related supplier not to claim expenses as export promotion expenses.

(2) *Types of expenses.* The only expenses or costs which may be export promotion expenses are those expenses or costs meeting the test of subparagraph (1) of this paragraph which constitute—

(i) Ordinary and necessary expenses of the DISC paid or incurred during the

DISC's taxable year in carrying on any trade or business, allowable as deductions under section 162, such as expenses for market studies, advertising, salaries and wages (including contributions or compensations deductible under section 404) of sales, clerical, and other personnel, rentals on property, sales commissions, warehousing, and other selling expenses,

(ii) A reasonable allowance under section 167 for exhaustion, wear and tear, or obsolescence of the property of the DISC,

(iii) Costs of freight (subject to the limitations of subparagraph (4) of this paragraph),

(iv) Costs of packaging for export (as defined in subparagraph (5) of this paragraph), or

(v) Costs of designing and labeling packages exclusively for export markets (under subparagraph (6) of this paragraph).

(3) *Ineligible expenses.* Items ineligible to be export promotion expenses include, for example, interest expenses, bad debt expenses, freight insurance, State and local income and franchise taxes, the cost of manufacture or assembly operations, and items of cost of goods sold (except as otherwise provided in this paragraph in the case of certain freight, packaging, and designing and labeling expenses). Income or similar taxes eligible for a foreign tax credit under sections 901 and 903 are also not eligible to be export promotion expenses.

(4) *Freight expenses*—(i) *In general.* Export promotion expenses include one-half of the freight expense (not including insurance) for shipping export property aboard a U.S.-flag carrier in those cases where law or regulation of the United States or of any State or political subdivision thereof or of any agency or instrumentality of any of these does not require that the export property be shipped aboard a U.S.-flag carrier. For purposes of this paragraph, the term ''freight expense'' includes charges paid for c.o.d. service, miscellaneous ground charges, such as charges incurred for services normally performed by U.S.-flag carriers, charges for services of loading aboard U.S.-flag carriers normally performed by such carriers, freight forwarders, or independent contractors engaged in loading property, and charges attributable to a freight consolidation function normally performed by freight forwarders. In order for one-half of freight expenses paid to the owner (or the agent of the owner) of a U.S.-flag carrier to be claimed as an export promotion expense, the DISC must obtain a written statement (such as, for example, a bill of lading) from the owner (or the agent) disclosing that the export property was shipped aboard the owner's U.S.-flag carrier or another U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the owner (or the agent). For the requirement of a written statement from a freight forwarder, see subdivision (iv) of this subparagraph.

(ii) *U.S.-flag carrier defined.* For purposes of this paragraph, the term ''U.S.-flag carrier'' is an airplane owned and operated by a U.S. person or persons (as defined in section 7701(a)(30)) or a ship documented under the laws of the United States. Shipment initiated by delivery to the U.S. Postal Service shall be considered shipment aboard a U.S.-flag carrier, but not if shipped to a place to which mail shipments from the United States are ordinarily accomplished by land transportation, such as to Canada or Mexico, unless airmail is specified.

(iii) *Shipment pursuant to law or regulation.* Shipment pursuant to law or regulation includes instances where a U.S.-flag carrier must be used in order to obtain permission from the Government to make the export. If the law or regulation requires a fixed portion of the export property to be shipped aboard a U.S.-flag carrier, the freight expense on that portion of such export property that was so shipped in order to satisfy such requirement cannot qualify as an export promotion expense.

(iv) *Freight forwarders.* A payment to a freight forwarder shall be considered freight expense within the meaning of this paragraph to the extent the forwarder utilizes a U.S.-flag carrier. For purposes of this paragraph, the term ''freight forwarder'' includes air freight consolidators and carriers owned and operated by U.S. persons utilizing U.S.-

flag carriers such as non-vessel-owning common carriers. In order for one-half of freight expenses paid to a freight forwarder to be claimed as export promotion expenses, the DISC must obtain a written statement (such as, for example, a bill of lading) from the freight forwarder disclosing that the export property was shipped aboard a U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the freight forwarder.

(v) *Freight within the United States.* A DISC may not claim as export promotion expense any amount that is attributable to carriage of export property between points within the United States. If, however, export property is carried from the United States to a foreign country on a through shipment pursuant to a single bill of lading or similar document aboard one or more U.S.-flag carriers, the freight expense of such carriage shall not be apportioned between the domestic and foreign portions of such carriage, even though a carrier may stop en route within the United States or the export property may be shifted from one carrier to another, and one-half of such freight expense may be claimed as an export promotion expense. Freight expense does not include the cost of transporting the export property to the depot of the U.S.-flag carrier or freight forwarder for shipment abroad. The expense of shipment of export property initiated by delivery to the U.S. Postal Service for ultimate delivery outside the United States shall be considered as attributable entirely to carriage of such property outside the United States.

(5) *Packaging for export.* (i) Export promotion expenses include the direct and indirect cost of packaging export property (including the cost of the package) for export whether or not the packaging is the same as domestic packaging. Such packaging costs do not include costs of manufacturing (as defined in the regulations under section 993) and assembly. Thus, if a DISC buys and packages export property for resale, its costs of packaging the export property are export promotion expenses. If, however, the process of such packaging by the DISC is physically integrated with the process of manufacturing the export property by the related supplier, the costs of such packaging are not export promotion expenses.

(ii) The cost of containers leased from a shipping company to which the DISC also pays freight for the property packaged is not a cost of packaging. However, in such circumstances, one-half of the rental charge may be allowable as a freight expense if permitted under subparagraph (4) of this paragraph.

(6) *Designing and labeling packages.* Export promotion expenses include the direct and indirect costs of designing and labeling packages, including bottles, cans, jars, boxes, cartons, or containers, to the extent incurred for export markets. Thus, for example, to the extent incurred for supplying export markets, the cost of designing labels in a foreign language and the cost of printing such labels are export promotion expenses.

(7) *DISC must incur export promotion expenses*—(i) *In general.* In order for an expense to be an export promotion expense it must be incurred or treated as incurred under this subparagraph by the DISC. For example, an expense is incurred by a DISC if the expense results from (*a*) the DISC incurring an obligation to pay compensation to its employees, (*b*) depreciation of property owned by the DISC and used by its employees, (*c*) the DISC incurring an obligation to pay for office supplies used by its employees, (*d*) the DISC incurring an obligation to pay space costs for use by its employees, or (*e*) the DISC incurring an obligation to pay other costs supporting efforts by its employees.

(ii) *Payments to independent contractors.* A payment to an independent contractor, directly or indirectly, is treated as incurred by the DISC if the cost of performing the function performed by the independent contractor would be considered an export promotion expense described in subparagraphs (1) and (2) of this paragraph if performed by the DISC, and if, in a case where the services of the independent contractor were engaged by a party related to the DISC, such related party and such DISC agreed in writing before the contract was entered into that a specified

portion or all of the contract was for the benefit of the DISC and that all of the expenses of the contract (eligible to be considered as export promotion expenses) with respect to such portion would be borne by the DISC.

(iii) *Expenses incurred by related parties.* Reimbursements or other payments by a DISC to a related party are export promotion expenses only if the expenses of the related party for which reimbursement is made are for space in a building actually used by employees of the DISC or for export property owned by the DISC. Except as otherwise provided in the preceding sentence, expenses incurred by a foreign international sales corporation (FISC) or a real property holding company (as defined in section 993(e)(1) and (2), respectively) shall not be treated as export promotion expenses of its DISC.

(iv) *Selling commissions paid by a DISC.* A commission paid by a DISC to a person other than a related person, with respect to a transaction which gives rise to qualified export receipts of the DISC, is an export promotion expense of the DISC. A commission paid by a DISC to a related person is not an export promotion expense.

(v) *Sales of promotional material.* If a DISC sells promotional material to a buyer of export property from the DISC at a price which is greater than the costs of the DISC for such material, such costs are not export promotion expenses. If, however, the DISC sells promotional material at a price which is less than its costs for such material, the excess of such costs over such price is an export promotion expense. For rules relating to the status of promotional material as qualified export assets and export property, see §§ 1.993–2 and 1.993–3, respectively.

(vi) An expense may be incurred by the DISC under subdivisions (i) through (v) of this subparagraph even if the accounting for and payment of such expense is handled by a related party and the DISC reimburses the related party for such expenses.

(8) *Incomplete transactions.* Expenses eligible to be treated as export promotion expenses which are attributable to the sale, lease, or other distribution of export property and which are incurred prior to the taxable year of sale, lease, or other distribution by the DISC are not treated as export promotion expenses until the taxable year of sale, lease, or other distribution or until the taxable year in which it is first determined that no transaction is reasonably expected to result from the expense incurred (whether or not a transaction subsequently results). Thus, for example, if a DISC incurs a packaging cost which is otherwise eligible to be treated as an export promotion expense, the DISC may not include such charge as an export promotion expense until the year in which the export property with respect to which the packaging cost was incurred is actually sold by the DISC. If no transaction is reasonably expected to result from the packaging cost, such cost should be allocated as an export promotion expense to the group of transactions to which such cost is most closely related.

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

*Example 1.* J and K are calendar year taxpayers. J, a domestic manufacturing company, owns all the stock of K, a DISC for the taxable year. During 1972, J manufactures only 100 units of a product (which is eligible to be export property as defined in section 993(c)). J enters into a written agreement with K whereby K is granted a sales franchise with respect to exporting such property and K will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold for $1,000. J's cost of goods sold attributable to the 100 units is $650. J's direct selling expenses so attributable are $100. Although J has other deductible expenses, for purposes of this example assume that J has no other deductible expenses. K pays $230 to independent contractors which qualify as export promotion expenses under paragraph (f)(7)(ii) of this section. K does not perform functions substantial enough to entitle it to an allocation of income which meets the arm's length standard of section 482. The income which K may earn under section 994 under the franchise is $20, computed as follows:

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) K's sales price | | $1,000 |
| (b) Less deductions: | | |
| J's cost of goods sold | $650 | |
| J's direct selling expenses | 100 | |
| K's export promotion expenses | 230 | |
| Total deductions | | 980 |

| | | |
|---|---|---|
| (c) Combined taxable income | | 20 |
| (2) K's profit under combined taxable income method (before application of loss limitation): | | |
| (a) 50 percent of combined taxable income | | 10 |
| (b) Plus: 10 percent of K's export promotion expenses (10% of $230) | | 23 |
| (c) K's profit | | 33 |
| (3) K's profit under gross receipts method (before application of loss limitation): | | |
| (a) 4 percent of K's sales price (4% of $1,000) | | 40 |
| (b) Plus: 10 percent of K's export promotion expenses (10% of $230) | | 23 |
| (c) K's profit | | 63 |

Since combined taxable income ($20) is lower than both K's profit under the combined taxable income method ($33) and under the gross receipts method ($63), the maximum income K may earn is $20. Accordingly, the commissions K may receive from J are $250, *i.e.*, K's expenses ($230) plus K's profit ($20).

*Example 2.* M and N are calendar year taxpayers. M, a domestic manufacturing company, owns all the stock of N, a DISC for the taxable year. During 1972, M produces and sells a particular product line of export property to N for $75, a price which can be justified as satisfying the standard of arm's length price of section 482. N performs substantial functions with respect to the transaction and resells the export property for $100. M's cost of goods sold attributable to the export property is $60. M's direct selling expenses so attributable (relating to advertising of the product line in foreign markets) are $12. Although M has other deductible expenses, for purposes of this example, assume that M has no other deductible expenses. N's expenses attributable to resale of the export property are $22 of which $20 are export promotion expenses. The maximum profit which N may earn with respect to the product line is $6, computed as follows:

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) N's sales price | | $100 |
| (b) Less deductions: | | |
| M's cost of goods sold | $60 | |
| M's direct selling expenses | 12 | |
| N's expenses | 22 | |
| Total deductions | | 94 |
| (c) Combined taxable income | | 6 |
| (2) N's profit under combined taxable income method (before application of loss limitation): | | |
| (a) 50 percent of combined taxable income | | 3 |
| (b) Plus: 10 percent of N's export promotion expenses (10% of $20) | | 2 |
| (c) N's profit | | 5 |
| (3) N's profit under gross receipts method (before application of loss limitation): | | |
| (a) 4 percent of N's sales price (4% of $100) | | 4 |
| (b) Plus: 10 percent of N's export promotion expenses (10% of $20) | | 2 |
| (c) N's profit | | 6 |
| (4) N's profit under section 482 method: | | |
| (a) N's sales price | | 100 |
| (b) Less deductions: | | |
| N's cost of goods sold (price paid by N to M) | 75 | |
| N's expenses | 22 | |
| Total deductions | | 97 |
| (c) N's profit | | 3 |

Since the gross receipts method results in greater profit to N ($6) than does the combined taxable income method ($5) or section 482 method ($3), and does not exceed combined taxable income ($6), N may earn a maximum profit of $6. Accordingly, the transfer price from M to N may be readjusted as long as the transfer price is not readjusted below $72, computed as follows:

| | | |
|---|---|---|
| (5) Transfer price from M to N: | | |
| (a) N's sales price | | $100 |
| (b) Less: | | |
| N's expenses | $22 | |
| N's profit | 6 | |
| Total subtractions | | 28 |
| (c) Transfer price | | 72 |

*Example 3.* Q and R are calendar year taxpayers. Q, a domestic manufacturing company, owns all the stock of R, a DISC for the taxable year. During 1972, Q produces and sells a product line of export property to R for $170, a price which can be justified as satisfying the standards of arm's length price of section 482, and R resells the export property for $200. Q's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.*, $200 minus $115). Q's expenses incurred in connection with the property sold are $35. Q's deductible overhead and other supportive expenses allocable to all gross income are $6. Apportionment of these supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. Q's gross income from sources other than the transaction is $170 making total gross income of Q and R (excluding the transfer price paid by R) $255 (i.e., $85 plus $170). R's expenses attributable to resale of the export property are $20, all of which are export promotion expenses. The maximum profit which R may earn with respect to the product line is $16, computed as follows:

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) R's sales price | | $200 |
| (b) Less deductions: | | |
| (i) Q's cost of goods sold | 115 | |
| (ii) Q's expenses incurred in connection with the property sold | 35 | |

| | | | |
|---|---|---|---|
| (iii) Apportionment of Q's supportive expenses: | | | |
| Q's supportive expenses | $6 | | |
| Combined gross income from sale of export property | 85 | | |
| Total gross income of Q and R | 255 | | |
| Apportionment | (6×85)/255 | 2 | |
| (iv) R's expenses | | 20 | |
| Total deductions | | | 172 |
| (c) Combined taxable income | | | 28 |
| (2) R's profit under combined taxable income method (before application of loss limitation): | | | |
| (a) 50 percent of combined taxable income | | | 14 |
| (b) Plus: 10 percent of R's export promotion expenses (10% of $20) | | | 2 |
| (c) R's profit | | | 16 |
| (3) R's profit under gross receipts method (before application of loss limitation): | | | |
| (a) 4 percent of R's sales price (4% of $200) | | | 8 |
| (b) Plus: 10 percent of R's export promotion expenses (10% of $20) | | | 2 |
| (c) R's profit | | | 10 |
| (4) R's profit under section 482 method: | | | |
| (a) R's sales price | | | 200 |
| (b) Less deductions: | | | |
| R's cost of goods sold (price paid by R to Q) | | 170 | |
| R's expenses | | 20 | |
| Total deductions | | | 190 |
| (c) R's profit | | | 10 |

Since the combined taxable income method results in greater profit to R ($16) than does the gross receipts method ($10) or section 482 method ($10), and does not exceed combined taxable income ($28), R may earn a maximum profit of $16. Accordingly, the transfer price from Q to R may be readjusted as long as the transfer price is not readjusted below $164 computed as follows:

| | | | |
|---|---|---|---|
| (5) Transfer price from Q to R: | | | |
| (a) R's sales price | | | $200 |
| (b) Less: | | | |
| R's expenses | | $20 | |
| R's profit | | 16 | |
| Total | | | 36 |
| (c) Transfer price | | | 164 |

*Example 4.* S and T are calendar year taxpayers. S, a domestic manufacturing company, owns all the stock of T, a DISC for the taxable year. During 1972, S produces and sells 100 units of a particular product to T under a written agreement which provides that the transfer price between S and T shall be that price which allocates to T the maximum permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold by T for $950. S's cost of goods sold attributable to the 100 units is $650. S's other deductible expenses so attributable are $300. Although S has other deductible expenses, for purposes of this example, assume that S has no deductible expenses not definitely allocable to any item of gross income. T's expenses attributable to the resale of the 100 units are $50. S chooses not to apply the section 482 method. T may not earn any income under the gross receipts or combined taxable income method with respect to resale of the 100 units because combined taxable income is a negative figure, computed as follows:

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) T's sales price | | $950 |
| (b) Less deductions: | | |
| S's cost of goods sold | $650 | |
| S's expenses | 300 | |
| T's expenses | 50 | |
| Total deductions | | 1,000 |
| (c) Combined taxable income (loss) | | ($50) |

Under paragraph (e)(1)(i) of this section, T is permitted to recover its expenses attributable to the 100 units ($50) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from S to T may be readjusted as long as the transfer price is not readjusted below $900, computed as follows:

| | |
|---|---|
| (2) Transfer price from S to T: | |
| (a) T's sales price | $950 |
| (b) Less: T's expenses | 50 |
| (c) Transfer price | 900 |

*Example 5.* Assume the same facts as in example 4 except that S chooses to apply the section 482 method and that under arm's length dealings T would have derived $10 of income. Accordingly, the transfer price from S to T may be set at an amount not less than $890, computed as follows:

| | | |
|---|---|---|
| (1) Transfer price from S to T: | | |
| (a) T's sales price | | $950 |
| (b) Less: | | |
| T's expenses | $50 | |
| T's profit | 10 | |
| Total deductions | | 60 |
| (c) Transfer price | | 890 |

*Example 6.* X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During March 1972, X manufactures a particular product of export property which it leases on April 1, 1972, to Y for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. Y subleases the product on April 1, 1972, for a term of 1 year at a monthly rental of $1,200. X's cost

for the product leased is $40,000. X's other deductible expenses attributable to the product are $900, all of which are incurred in 1972. Although X has other deductible expenses, for purposes of this example, assume that X has no other deductible expenses. Y's expenses attributable to sublease of the export property are $450, all of which are incurred in 1972 and are export promotion expenses. X depreciates the property on a straight line basis without the use of an averaging convention, assuming a useful life of 8 years and no salvage value. The profit which Y may earn with respect to the transaction is $2,895 for 1972 and $1,175 for 1973, computed as follows:

COMPUTATION FOR 1972

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) Y's sublease rental receipts for year ($1,200×9 months) | | $10,800 |
| (b) Less deductions: | | |
| X's depreciation ($40,000×1/8×9/12) | $3,750 | |
| X's other expenses | 900 | |
| Y's expenses | 450 | |
| Total deductions | | 5,100 |
| (c) Combined taxable income | | 5,700 |
| (2) Y's profit under combined taxable income method (before application of loss limitation): | | |
| (a) 50 percent of combined taxable income | | 2,850 |
| (b) Plus: 10 percent of Y's export promotion expenses (10% of $450) | | 45 |
| (c) Y's profit | | 2,895 |
| (3) Y's profit under gross receipts method (before application of loss limitation): | | |
| (a) 4 percent of Y's sublease rental receipts for year (4% of $10,800) | | 432 |
| (b) Plus: 10 percent of Y's export promotion expenses (10% of $450) | | 45 |
| (c) Y's profit | | 477 |
| (4) Y's profit under section 482 method: | | |
| (a) Y's sublease rental receipts for year | | $10,800 |
| (b) Less deductions: | | |
| Y's lease rental payments for year | $9,000 | |
| Y's expenses | 450 | |
| Total deductions | | 9,450 |
| (c) Y's profit | | 1,350 |

Since the combined taxable income method results in greater profit to Y ($2,895) than does the gross receipts method ($477) or section 482 method ($1,350), Y may earn a profit of $2,895 for 1972. Accordingly, the monthly rental payable by Y to X for 1972 may be readjusted as long as the monthly rental payable is not readjusted below $828.33, computed as follows:

| | | |
|---|---|---|
| (5) Monthly rental payable by Y to X for 1972: | | |
| (a) Y's sublease rental receipts for year | | $10,800.00 |
| (b) Less: | | |
| Y's expenses | 450.00 | |
| Y's profit | 2,895.00 | |
| Total | | 3,345.00 |
| (c) Rental payable for 1972 | | 7,455.00 |
| (d) Rental payable each month ($7,455÷9 months) | | 828.33 |

COMPUTATION FOR 1973

| | | |
|---|---|---|
| (1) Combined taxable income: | | |
| (a) Y's sublease rental receipts for year ($1,200×3 months) | | $3,600 |
| (b) Less: X's depreciation ($40,000×1/8×3/12) | | 1,250 |
| (c) Combined taxable income | | 2,350 |
| (2) Y's profit under combined taxable income method (before application of loss limitation): | | |
| (a) 50 percent of combined taxable income | | $1,175 |
| (b) Y's profit | | 1,175 |
| (3) Y's profit under gross receipts method (before application of loss limitation): | | |
| (a) 4 percent of Y's sublease rental receipts for year (4% of $3,600) | | 144 |
| (b) Y's profit | | 144 |
| (4) Y's profit under section 482 method: | | |
| (a) Y's sublease rental receipts for year | | 3,600 |
| (b) Less: Y's lease rental payments for year | | 3,000 |
| (c) Y's profit | | 600 |

Since the combined taxable income method results in greater profit to Y ($1,175) than does the gross receipts method ($144) or section 482 method ($600), Y may earn a profit of $1,175 for 1973. Accordingly, the monthly rental payable by Y to X for 1973 may be readjusted as long as the monthly rental payable is not readjusted below $808.33, computed as follows:

| | |
|---|---|
| (5) Monthly rental payable by Y to X for 1973: | |
| (a) Y's sublease rental receipts for year | $3,600.00 |
| (b) Less: Y's profit | 1,175.00 |
| (c) Rental payable for 1973 | 2,425.00 |
| (d) Rental payable for each month ($2,425÷3 months) | 808.33 |

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7364, 40 FR 29827, July 16, 1975, as amended by T.D. 7435, 41 FR 43142, Sept. 30, 1976; T.D. 7854, 47 FR 51741, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

### § 1.994–2 Marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 994(b)(2). If under paragraph (c)(1) of this section a DISC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in

§1.993–3) from which qualified export receipts are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied to allocate costs between gross receipts derived from such sales and other gross receipts for purposes of computing, under the ''50–50'' combined taxable income method of §1.994–1(c)(3), the combined taxable income of the DISC and related supplier derived from such sales. Such marginal costing rules may be applied whether or not the related supplier manufactures, produces, grows, or extracts (within the meaning of §1.993–3(c)) the export property sold. Such marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or such income is under the exceptions in section 954(b)(4). Such marginal costing rules do not apply to leases of property or the performance of any services whether or not related and subsidiary services (as defined in §1.994–1(b)(3).

(b) *Marginal costing rules for allocations of costs*—(1) *In general.* Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account for purposes of section 994. Where this section is applicable, costs attributable to deriving qualified export receipts for the DISC's taxable year from sales of an item, product, or product line may be determined in any manner the related supplier (as defined in §1.994–1(a)(3)(ii)) chooses, provided that the requirements of both subparagraphs (2) and (3) of this paragraph are met.

(2) *Variable costs taken into account.* There are taken into account in computing the combined taxable income of the DISC and its related supplier from sales of an item, product, or product line the following costs:

(i) Direct production costs (as defined in §1.471–11(b)(2)(i)) and

(ii) Costs which are export promotion expenses, but only if they are claimed as export promotion expenses in determining taxable income derived by the DISC under the combined taxable income method of §1.994–1(c)(3).

At the taxpayer's option, all, a part, or none of the costs which qualify as export promotion expenses may be so claimed as export promotion expenses.

(3) *Overall profit percentage limitation.* As a result of such determination of costs attributable to such qualified export receipts for the DISC's taxable year, the combined taxable income of the DISC and its related supplier from sales of such item, product, or product line for the DISC's taxable year does not exceed gross receipts (determined under §1.993–6) of the DISC derived from such sales, multiplied by the overall profit percentage (determined under paragraph (c)(2) of this section).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A DISC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which qualified export receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the combined taxable income computed under §1.994–1(c)(6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—

(*a*) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of

(*b*) The total gross receipts (determined under §1.993–6) from all such sales.

(ii) At the annual option of the related supplier, the overall profit percentage for the DISC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i) (*a*) and (*b*) of this subparagraph of the DISC, and all domestic members of the controlled group (as defined in §1.993–1(k)) of which the DISC is a member,

for the DISC's taxable year and for taxable years of such members ending with or within the DISC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) (*b*) and (ii) of this subparagraph, a sale of property between a DISC and its related supplier or between domestic members of the controlled group shall be taken into account only during the DISC's taxable year (or taxable year of the member ending within the DISC's taxable year) during which the property is ultimately sold to a person which is neither the DISC nor such a domestic member.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to §1.994–1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of §1.994–1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under §1.994–1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this subparagraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in such subdivision (i).

(4) *Full costing method.* For purposes of this section, the term ''full costing method'' is the method for determining combined taxable income set forth in §1.994–1(c)(6).

(d) *Application of limitation on DISC income (''no loss'' rule).* If the marginal costing rules of this section are applied, the combined taxable income method of §1.994–1(c)(3) may not be applied to cause in any taxable year a loss to the related supplier, but such method may be applied to the extent it does not cause a loss. For purposes of the preceding sentence, a loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC determined in accordance with paragraph (b) of this section. If, however, there is no combined taxable income (so determined), see the last sentence of §1.994–1(e)(1)(i).

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

*Example 1.* X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During 1973, X manufactures a product line which is eligible to be export property (as defined in §1.993–3). X enters into a written agreement with Y whereby Y is granted a sales franchise with respect to exporting such product line from which qualified export receipts will be derived and Y will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Commissions are computed using the combined taxable income method under §1.994–1(c)(3). For purposes of applying the combined taxable income method, X and Y compute their combined taxable income attributable to the product line of export property under the marginal costing rules in accordance with the additional facts assumed in the table below:

| | | |
|---|---|---|
| (1) Maximum combined taxable income (determined under paragraph (b)(2) of this section): | | |
| (a) Y's gross receipts from export sales | | $95.00 |
| (b) Less: | | |
| (i) Direct materials | 40.00 | |
| (ii) Direct labor | 20.00 | |
| (iii) Y's export promotion expenses claimed in determining Y's DISC taxable income | 5.00 | |
| (iv) Total deductions | 65.00 | |
| (c) Maximum combined taxable income | | 30.00 |
| (2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section): | | |
| (a) Gross receipts of X and Y from all domestic and foreign sales | | 400.00 |
| (b) Less deductions: | | |
| (i) Direct materials | 160.00 | |
| (ii) Direct labor | 80.00 | |
| (iii) Other costs (of which $8 are costs of the DISC including $5 of export promotion expenses claimed in determining Y's taxable income) | 40.00 | |
| (c) Total deductions | | 280.00 |
| (d) Total taxable income from all sales computed on a full costing method | | 120.00 |
| (e) Overall profit percentage (line (d) ($120) divided by line (a) ($400)) (percent) | | 30% |
| (f) Multiply by gross receipts from Y's export sales (line (1)(a)) | | $95.00 |
| (g) Overall profit percentage limitations | | 28.50 |

Since the overall profit percentage limitation under line (2)(g) ($28.50) is less than

maximum combined taxable income under line (1)(c) ($30), combined taxable income under marginal costing is limited to $28.50. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $28.50. Accordingly, the costs attributable to export sales (other than for direct material, direct labor, and export promotion expenses) are $1.50, *i.e.*, line (1)(c) ($30) minus line (2)(g) ($28.50). Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $14.75, i.e., the sum of 1/2 of combined taxable income (1/2 of $28.50) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the commissions Y receives from X are $22.75, i.e., Y's costs ($8, see line (2)(b)(iii)) plus Y's profit ($14.75).

*Example 2.* (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85 and gross receipts from all sales remain at $400. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

| | | |
|---|---|---|
| (1) Maximum combined taxable income (determined under paragraph (b)(2) of this section): | | |
| (a) Y's gross receipts from export sales | | $85.00 |
| (b) Less: | | |
| (i) Direct materials | 40.00 | |
| (ii) Direct labor | 20.00 | |
| (iii) Y's export promotion expenses claimed in determining Y's taxable income | 5.00 | |
| (iv) Total deductions | | 65.00 |
| (c) Maximum combined taxable income | | 20.00 |
| (2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section): | | |
| (a) Gross receipts from Y's export sales (line (1)(a)) | | 85.00 |
| (b) Multiply by overall profit percentage (as determined in example 1) (percent) | | 30% |
| (c) Overall profit percentage limitation | | 25.50 |

Since maximum combined taxable income under line (1)(c) ($20) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is limited to $20. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $20. Accordingly, no costs (other than for direct material, direct labor, and export promotion expenses) will be attributed to export sales. Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $10.50, i.e., the sum of 1/2 of combined taxable income (1/2 of $20) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the Commissions Y receives from X are $18.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($10.50).

(2) If export promotion expenses are not claimed in determining taxable income of Y under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $20.50, computed as follows:

| | | |
|---|---|---|
| (3) Maximum combined taxable income (determined under paragraph (b)(2) of this section): | | |
| (a) Y's gross receipts from export sales | $85.00 | |
| (b) Less: | | |
| (i) Direct materials | 40.00 | |
| (ii) Direct labor | 20.00 | |
| (iii) Total deductions | | 60.00 |
| (c) Maximum combined taxable income | | 25.00 |
| (4) Overall profit percentage limitation (line (2)(c)) | | 25.50 |

Since maximum combined taxable income under line (3)(c) ($25) is less than the overall profit percentage under line (4) ($25.50), combined taxable income under marginal costing is limited to $25. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $25. Accordingly, no costs (other than for direct material and direct labor) will be attributed to export sales. Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $12.50, i.e., 1/2 of combined taxable income (1/2 of $25). Accordingly, the commissions Y receives from X are $20.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($12.50).

*Example 3.* (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85, gross receipts from all sales remain at $400, and Y has costs of $40 consisting of Y's export promotion expenses of $35 and costs of $5 other than for direct material, direct labor, or export promotion expenses. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

| | | |
|---|---|---|
| (1) Maximum combined taxable income (determined under paragraph (b)(2) of this section): | | |
| (a) Y's gross receipts from export sales | | $85.00 |
| (b) Less: | | |
| (i) Direct materials | 40.00 | |

| | | |
|---|---|---|
| (ii) Direct labor | 20.00 | |
| (iii) Y's export promotion expenses claimed in determining Y's taxable income | 35.00 | |
| (iv) Total deductions | | 95.00 |
| (c) Maximum combined taxable income (loss) | | (10.00) |
| (2) Overall profit percentage limitation (as determined in example 2) | | 25.50 |

Since maximum combined taxable income under line (1)(c) (which is a loss of $10) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is a loss of $10 and, under the combined taxable income method of §1.994–1(c)(3), Y will have no taxable income or loss attributable to the sales. Accordingly, the commissions Y receives from X are $40, *i.e.*, Y's costs ($40).

(2) If export promotion expenses are not claimed in determining Y's taxable income under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $52.50 computed as follows:

| | |
|---|---|
| (3) Maximum combined taxable income (determined under paragraph (b)(2) of this section) (line (3)(c) of example 2) | $25.00 |
| (4) Overall profit percentage limitation (as determined in example 2) | 25.50 |

The results would be the same as in part (2) of example 2, except that the commissions Y receives from X are $52.50, *i.e.*, Y's costs ($40) plus Y's profit ($12.50).

[T.D. 7364, 40 FR 29836, July 16, 1975; 40 FR 33972, Aug. 13, 1975]

### § 1.995–1 Taxation of DISC income to shareholders.

(a) *In general.* (1) Under §1.991–1(a), a corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for the taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax.

(2) Under section 995(a), the shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC in accordance with the provisions of chapter 1 of the Code generally applicable to shareholders, but subject to the modifications provided in sections 995, 996, and 997.

(3) Under §1.996–3, three divisions of earnings and profits of a DISC, or former DISC, are defined: ''accumulated DISC income'', ''previously taxed income'', and ''other earnings and profits''. Under §1.995–2, certain amounts of the DISC's earnings and profits are deemed to be distributed as dividends to shareholders of the DISC at the close of the DISC's taxable year in which such earnings were derived. Such deemed distributions do not cause a reduction in the DISC's earnings and profits, but are taken into account in §1.996–3(c) as an increase in previously taxed income. To the extent the DISC's earnings and profits are paid out in a subsequent distribution which is, under §1.996–1, treated as made out of such ''previously taxed income,'' they will not be taxable to the shareholders a second time.

(4) In general, ''accumulated DISC income'' is the earnings and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. However, deferral of taxation on ''accumulated DISC income'' may be terminated, in whole or in part, in the event of: (i) Certain foreign investment attributable to producer's loans (see §1.995–2(a)(5) and §1.995–5); (ii) revocation of the election to be treated as a DISC or other disqualification (see §1.995–3); and (iii) certain dispositions of DISC stock in which gain is realized (see §1.995–4).

(5) Since a DISC is not taxed on its taxable income, section 246(d) and §1.246–4 provide that the deduction otherwise allowed under section 243 shall not be allowed with respect to a dividend from a DISC, or former DISC, paid or treated as paid out of accumulated DISC income or previously taxed income or with respect to a deemed distribution in a qualified year under §1.995–2(a).

(b) *Amounts and character of amounts includible in shareholder's gross income.* Each shareholder of a corporation which is a DISC, or former DISC, shall include in his gross income—

(1) Amounts actually distributed to him that are includible in his gross income in accordance with paragraph (c) of this section.

(2) Amounts which, pursuant to §1.995–2, he is deemed to receive as a distribution taxable as a dividend on

the last day of each of the corporation's taxable years for which it qualifies as a DISC,

(3) Amounts which, pursuant to §1.995–3, he is deemed to receive as a distribution taxable as a dividend in the event the corporation revokes its election to be treated as a DISC or otherwise is disqualified as a DISC, and

(4) Gain realized on certain dispositions of stock in the corporation which, under §1.995–4, is includible in his gross income as a dividend.

(c) *Treatment of actual distributions.* (1) Except as provided in subparagraph (3) of this paragraph, amounts actually distributed to a shareholder of a DISC, or former DISC, with respect to his stock are includible in his gross income in accordance with section 301.

(2) Since a deemed distribution does not reduce the earnings and profits of a DISC, it does not affect the determination as to whether a subsequent actual distribution is a ''dividend'' under section 316(a). Since, however, the amount of a deemed distribution increases ''previously taxed income'', it does affect the determination as to whether a subsequent actual distribution is excluded (as described in subparagraph (3) of this paragraph) from gross income.

(3) Under §1.996–1(c), the amount of any actual distribution (including a deficiency distribution made pursuant to §1.992–3), with respect to stock in a DISC, or former DISC, which is treated under §1.996–1 as made out of previously taxed income, is excluded by the distributee from gross income, but only to the extent that such amount does not exceed the adjusted basis of the distributee's stock. Under §1.996–5(b), that portion of any actual distribution which is treated as made out of previously taxed income shall be applied against and reduce the adjusted basis of the stock and, to the extent that it exceeds the adjusted basis of the stock, it shall be treated as gain from the sale or exchange of property.

(4) A deficiency distribution pursuant to §1.992–3 may be made after the close of the DISC's taxable year with respect to which it is made. The determinations as to whether such deficiency distribution is a dividend under section 301 and as to which division of earnings and profits is the source thereof depend upon the status of the DISC's earnings and profits account and divisions thereof at the time the distribution is actually made. See §1.996–1(d) for the priority of such deficiency distribution over other actual distributions made during the same taxable year.

(d) *Personal holding company income.* (1) Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a DISC, or former DISC, pursuant to paragraph (b) of this section shall be treated as a dividend for all purposes of the Code, except that for purposes of determining whether such shareholder is a personal holding company within the meaning of section 542 any amount deemed distributed for qualified years under §1.995–2 or upon disqualification under §1.995–3, any amount of gain on certain dispositions of DISC stock to which §1.995–4 applies, and any amount treated under §1.996–1 as distributed out of accumulated DISC income or previously taxed income shall not be treated as a dividend or any other kind of income described in section 543(a).

(2) Notwithstanding subparagraph (1) of this paragraph, the shareholder may treat as an item of income described under section 543 (for example, rents) any amount to which the exception in such subparagraph (1) applies, if it establishes to the satisfaction of the district director that such amount is attributable to earnings and profits derived from such item of income.

[T.D. 7324, 39 FR 35109, Sept. 30, 1974]

### §1.995–2 Deemed distributions in qualified years.

(a) *General rule.* Under section 995(b)(1), each shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock on the last day of each taxable year of the DISC, in an amount which is equal to his pro rata share of the sum (as limited by paragraph (b) of this section), of the following seven items:

(1) An amount equal to the gross interest derived by the DISC during such year from producer's loans (as defined in §1.993–4).

(2) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property (other than property which in the hands of the DISC is a qualified export asset) which was previously transferred to it in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(3) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property which in the hands of the DISC is a qualified export asset (other than stock in trade or property described in section 1221(1)) and which was previously transferred to the DISC in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC and which would have been includible in the transferor's gross income as ordinary income if its entire realized gain had been recognized upon the transfer.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(4) For taxable years beginning after December 31, 1975, an amount equal to 50 percent of the taxable income of the DISC for the taxable years attributable to military property (as defined in §1.995–6).

(5) For taxable years beginning after December 31, 1975, the taxable income for the taxable year attributable to base period export gross receipts (as defined in §1.995–7).

(6) The sum of—

(i)(A) In the case of a corporate share holder, an amount equal to 57.5 percent of the excess (if any) (one-half for DISCs' taxable years beginning before January 1, 1983) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4) and (5) of this paragraph, or

(B) In the case of a non-corporate share holder, an amount equal to one-half of the excess (if any) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4), and (5) of this paragraph.

(ii)(A) An amount equal to the amount under subdivision (i) of paragraph (a)(6) of this section multiplied by the international boycott factor as determined under section 999 (c)(1) , or

(B) In lieu of the amount determined under subdivision (ii)(A) of paragraph (a)(6) of this section, the amount described under section 999 (c)(2) of such international boycott income, and

(iii) An amount equal to the sum of any illegal bribes, kickbacks, or other payments paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a DISC where it is paid by any officer, director, employee, shareholder, or agent of the DISC for the benefit of such DISC. For purposes of this section, the principles of section 162 (c) and the regulations thereunder shall apply. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

(7) The amount of foreign investment attributable to producer's loans of the DISC, as of the close of the ''group taxable year'' ending with such taxable year of the DISC, determined in accordance with §1.995–5. The amount of such foreign investment attributable to producer's loans so determined for any taxable year of a former DISC shall be deemed distributed as a dividend to the shareholders of such former DISC on the last day of such taxable year. See §1.995–3(e) for the effect that

such deemed distribution has on scheduled installments of deemed distributions of accumulated DISC income under §1.995–3(a) upon disqualification.

(b) *Limitation on amount of deemed distributions under section 995(b)(1).* (1) The sum of the amounts described in paragraph (a)(1) through (a)(6) of this section which is deemed distributed pro rata to the DISC's shareholders a dividend for any taxable year of the corporation shall not exceed the DISC's earnings and profits for such year.

(2) The amount of foreign investment attributable to producer's loans of the DISC (as described in paragraph (a)(7) of this section) which is deemed to be distributed pro rata to the DISC's shareholders as dividends for any taxable year of the corporation shall not exceed the lower of the corporation's accumulated DISC income at the beginning of such year or the corporation's accumulated earnings and profits at the beginning of such year (but not less than zero)—

(i) Increased by any DISC income of the corporation for such year as defined in §1.996–3(b)(2) (*i.e.*, any excess of the DISC's earnings and profits for such year over the sum of the amounts described in paragraph (a)(1) through (a)(6) of this section), or

(ii) Decreased by any deficit in the corporation's earnings and profits for such year.

Thus, for example, if a DISC has a deficit in accumulated earnings and profits at the beginning of a taxable year of $10,000, current earnings and profits of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the year, and foreign investment attributable to producer's loans for the taxable year of $5,000, the DISC would have a deemed distribution described in paragraph (a)(7) of this section of $5,000 for the taxable year. On the other hand, suppose the DISC had accumulated earnings and profits of $13,000 at the beginning of the taxable year, accumulated DISC income of $10,000 at the beginning of the taxable year, a deficit in earnings and profits for the taxable year of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the taxable year, and foreign investment attributable to producer's loans for the taxable year of $5,000. Under these facts the DISC would have no deemed distribution described in paragraph (a)(7) of this section because the corporation had no DISC income for the taxable year and the current year's deficit in earnings and profits subtracted from the DISC's accumulated DISC income at the beginning of the year produces a negative amount. For rules relating to the carryover to a subsequent year of the $5,000 of foreign investment attributable to producer's loans, see §1.995–5(a)(6).

(3) If, by reason of the limitation in subparagraph (1) of this paragraph, less than the sum of the amounts described in paragraphs (a)(1) through (a)(6) of this section is deemed distributed, then the portion of such sum which is deemed distributed shall be attributed first to the amount described in subparagraph (1) of such paragraph, to the extent thereof; second to the amount described in subparagraph (2) of such paragraph, to the extent thereof; third to the amount described in subparagraph (3) of such paragraph, to the extent thereof; and so forth, and finally to the amount described in paragraph (b)(6) of this paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

*Example 1.* 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 1972, X transfers certain property to Y in exchange for Y's stock in a transaction in which X does not recognize gain or loss by reason of the application of section 351(a). Included in the property transferred to Y is depreciable property described in paragraph (a)(3) of this section on which X realizes, but does not recognize by reason of the application of section 1245(b)(3), a gain of $20,000. If X had sold such property for cash, the $20,000 gain would have been recognized as ordinary income under section 1245. Also included in the transfer to Y is 100 shares of stock in a third corporation (which is not a related foreign export corporation) on which X realizes, but does not recognize, a gain of $5,000. In 1973, Y sells such property and recognizes a gain of $25,000 on the depreciable property and $8,000 on the 100 shares of stock. Y has accumulated earnings and profits at the beginning of 1973 of $5,000, earnings and profits for 1973 of $72,000, and taxable income for 1973 of $100,000. At the beginning of 1973, Y has

$6,000 of accumulated DISC income, no previously taxed income, and a deficit of $1,000 of other earnings and profits. Under these facts and the additional facts assumed in the table below, X is treated as having received a deemed distribution taxable as a dividend of $76,000 on December 31, 1973, determined as follows:

| | |
|---|---|
| (1) Gross interest derived by Y in 1973 from producer's loans | $7,000 |
| (2) Amount of gain on depreciable property (lower of Y's recognized gain ($25,000) or X's gain not recognized on section 1245 property ($20,000)) | 20,000 |
| (3) Amount of gain on stock (lower of X's gain not recognized or Y's recognized gain ($8,000) ($5,000)) | 5,000 |
| (4) One-half excess of taxable income for 1973 over the sum of lines (1), (2), and (3) (1/2 of ($100,000 minus $32,000)) | 34,000 |
| (5) Limitation on lines (1) through (4): | |
| (a) Sum of lines (1) through (4) | 66,000 |
| (b) Earnings and profits for 1973 | 72,000 |
| (c) Lower of lines (a) and (b) | 66,000 |
| (6) Amount under paragraph (a)(5) of this section: | |
| (a) Foreign investment attributable to producer's loans under § 1.995–5 | 10,000 |
| (b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) and excess of earnings and profits for 1973 over line (5)(c) ($72,000 minus $66,000) | 11,000 |
| (c) Lower of lines (a) and (b) | 10,000 |
| (7) Total deemed distribution (sum of lines (5)(c) and (6)(c)) | 76,000 |

*Example 2.* Assume the facts are the same as in example 1, except that earnings and profits for 1973 amount to only $60,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend of $65,000 on December 31, 1973, determined as follows:

| | |
|---|---|
| (5) Limitation on lines (1) through (4): | |
| (a) Line (5)(a) of example 1 | $66,000 |
| (b) Earnings and profits for 1973 | 60,000 |
| (c) Lower of lines (a) and (b) | 60,000 |
| (6) Amount under paragraph (a)(5) of this section: | |
| (a) Line (6)(a) of example 1 | 10,000 |
| (b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) plus excess of earnings and profits for 1973 over line (5)(c) ($60,000 minus $60,000) | 5,000 |
| (c) Lower of lines (a) and (b) | 5,000 |
| (7) Total deemed distribution (sum of lines (5)(c) and (6)(c)) | 65,000 |

*Example 3.* Assume the facts are the same as in example 1, except that Y has a deficit in accumulated earnings and profits at the beginning of 1973 of $4,000. Such deficit is comprised of accumulated DISC income of $1,000, no previously taxed income, and a deficit in other earnings and profits of $5,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend in the amount of $72,000 on December 31, 1973, determined as follows:

| | |
|---|---|
| (5) Limitation on lines (1) through (4): | |
| (a) Line (5)(a) of example 1 | $66,000 |
| (b) Earnings and profits for 1973 | 72,000 |
| (c) Lower of lines (a) and (b) | 66,000 |
| (6) Amount under paragraph (a)(5) of this section: | |
| (a) Line (6)(a) of example 1 | 10,000 |
| (b) Sum of accumulated earnings and profits at beginning of 1973 (not less than $0), and excess of earnings and profits for 1973 over amount in line (5)(c) ($72,000 minus $66,000) | 6,000 |
| (c) Lower of lines (a) and (b) | 6,000 |
| (7) Total deemed distribution sum of lines (5)(c) and (6)(c) | 72,000 |

(d) *Special rules for certain tax-free acquisitions of property by the DISC.* (1) For purposes of paragraph (a)(2)(i) and (3)(i) of this section, if—

(i) A DISC acquires property in a first transaction and in a second transaction it disposes of such property in exchange for other property, and

(ii) By reason of the application of section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions), the basis in the DISC's hands of the other property acquired in such second transaction is determined in whole or in part with reference to the basis of the property acquired in the first transaction,

then upon a disposition of such other property in a third transaction by the DISC such other property shall be treated as though it had been transferred to the DISC in the first transaction. Thus, if the first transaction is a purchase of the property for cash, then paragraphs (a)(2) and (3) of this section will not apply to a sale by the DISC of the other property acquired in the second transaction.

(2) For purposes of paragraphs (a)(2)(i) and (3)(i) of this section, if a DISC acquires property in a first transaction and it transfers such property to a transferee DISC in a second transaction in which the transferor DISC's gain is not recognized in whole or in part, then such property shall be treated as though it had been transferred to

the transferee DISC in the same manner in which it was acquired in the first transaction by the transferor DISC. For example, if X and Y both qualify as DISC's and X transfers property to Y in a second transaction in which gain or loss is not recognized, paragraph (a)(2) or (3) of this section does not apply to a sale of such property by Y in a third transaction if X had acquired the property in a first transaction by a purchase for cash. If, however, X acquired the property from a transferor other than a DISC in the first transaction in which the transferor's realized gain was not recognized, then paragraph (a)(2) or (3) of this section may apply to the sale by Y if the other conditions of such paragraph (a)(2) or (3) are met.

(3) If a DISC acquires property in a second transaction described in subparagraph (1) or (2) of this paragraph in which it (or, in the case of a second transaction described in subparagraph (2) of this paragraph, the transferor DISC) recognizes a portion (but not all) of the realized gain, then the amount described in paragraph (a)(2)(ii) or (a)(3)(ii) of this section with respect to a disposition by the DISC of such acquired property in a third transaction shall not exceed the transferor's gain which was not recognized on the first transaction minus the amount of gain recognized by the DISC (or transferor DISC) on the second transaction.

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

*Example 1.* X and Y are corporations each of which qualifies as a DISC and uses the calendar year as its taxable year. In 1972, X acquires section 1245 property in a first transaction in which the transferor's entire realized gain of $17 is not recognized. In 1973, X transfers such property to Y in a second transaction in which X realizes a gain of $20 of which only $4 is recognized. (On December 31, 1973, X's shareholders are treated as having received a deemed distribution of a dividend which includes such $4 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Y sells such property and recognizes a gain of $25. With respect to Y's shareholders on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section would be limited to $13, which is the amount of the transferor's gain which was not recognized on the first transaction ($17) minus the amount of gain recognized by X on the second transaction ($4).

*Example 2.* Z is a DISC using the calendar year as its taxable year. In a first transaction in 1972, in exchange for its stock, Z acquires section 1245 property from A, an individual who is its sole shareholder, in a transaction in which A's realized gain of $30 is not recognized by reason of the application of section 351(a). In a second transaction in 1973, Z exchanges such property for other property in a like-kind exchange to which section 1031(b) applies and recognizes $10 of a realized gain of $35. (On December 31, 1973, A is treated as having received a deemed distribution of a dividend which includes such $10 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Z sells the property acquired in the like-kind exchange and recognizes a gain of $25. With respect to A on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section is limited to $20, which is the amount of A's gain which was not recognized on the first transaction ($30) minus the amount of gain recognized by Z on the second transaction ($10).

(e) *Carry back of net operating loss and capital loss to prior DISC taxable year.* For purposes of sections 991, 995, and 996, the amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover or under section 1212 for a capital loss carryback or carryover shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, the amount of the deduction will be the same whether or not the corporation was a DISC in the year of the loss or in the year to which the loss is carried. For provisions setting forth adjustments to the DISC's, or former DISC's, deemed distributions, adjustments to its divisions of earnings and profits, and other tax consequences arising from such carrybacks, see §1.996–8.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35110, Sept. 30, 1974, as amended by T.D. 7862, 47 FR 56492, Dec. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

### § 1.995–3 Distributions upon disqualification.

(a) *General rule.* Under section 995 (b)(2), a shareholder of a corporation which is disqualified from being a DISC, either because pursuant to §1.992–2(e)(2) it revoked its election to be treated as a DISC or because it has failed to satisfy the requirements as set forth in §1.992–1 to be a DISC for a taxable year, shall be deemed to have received (at the times specified in paragraph (b) of this section) distributions taxable as dividends aggregating an amount equal to his pro rata share of the accumulated DISC income (as defined in §1.996–3(b)) of such corporation which was accumulated during the immediately preceding consecutive taxable years for which the corporation was a DISC. The pro rata share referred to in the preceding sentence shall be determined as of the close of the last of such consecutive taxable years for which the corporation was a DISC. See §1.996–7(c) for rules relating to the carryover of, and maintaining a separate account for, such accumulated DISC income in certain reorganizations.

(b) *Time of receipt of deemed distributions.* Distributions described in paragraph (a) of this section shall be deemed to be received in equal installments on the last day of each of the 10 taxable years of the corporation following the year of the disqualification described in paragraph (a) of this section, except that in no case may the number of equal installments exceed the number of the immediately preceding consecutive taxable years for which the corporation was a DISC.

(c) *Transfer of shares.* Deemed distributions are includible under paragraphs (a) and (b) of this section in a shareholder's gross income as a dividend only so long as he continues to hold the shares with respect to which the distribution is deemed made. Thus, the transferee of such shareholder will include in his gross income under paragraphs (a) and (b) of this section the remaining installments of the deemed distribution which the transferor would have included in his gross income as a dividend had he not transferred the shares. However, if the transferee acquires the shares in a transaction in which the transferor's gain is treated under §1.995–4 in whole or in part as a dividend, then under §1.996–4(a) such transferee does not include subsequent installments in his gross income to the extent that the transferee treats such subsequent installments as made out of previously taxed income.

(d) *Effect of requalification.* Deemed distributions under paragraphs (a) and (b) of this section continue and are includible in gross income as dividends by the shareholders whether or not the corporation subsequently requalifies and is treated as a DISC.

(e) *Effect of actual distributions and deemed distributions under section 995(b)(1)(G).* If, during the period a shareholder of a DISC, or former DISC, is taking into account deemed distributions under paragraphs (a) and (b) of this section, an actual distribution is made to him out of accumulated DISC income or a deemed distribution because of foreign investment attributable to producer's loans is made under §1.995–2(a)(5) out of accumulated DISC income, such actual or deemed distribution shall first reduce the last installment of the deemed distributions scheduled to be included in the shareholder's gross income as a dividend, and then the preceding scheduled installments in reverse order. If deemed distributions are scheduled to be included in gross income for two or more disqualifications, an actual distribution or a deemed distribution under §1.995–2 (a)(5) which is treated as made out of accumulated DISC income reduces the deemed distributions resulting from the earlier disqualification first.

(f) *Examples.* This section may be illustrated by the following examples:

*Example 1.* X Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. X qualifies as a DISC for taxable years 1972 through 1975, but, pursuant to §1.992–2(e)(2), revokes its election as of January 1, 1976, and is disqualified as a DISC. On that date, X has $24,000 of accumulated DISC income. X's shareholders will be deemed to receive $6,000 in distributions taxable as a dividend on the last day of each of X's four succeeding taxable years (1977, 1978, 1979, and 1980).

*Example 2.* Assume the same facts as in example 1, except that in 1978 X makes an actual distribution of $22,000 to its shareholders of which $10,000 is treated under §1.996–1 as made out of accumulated DISC income. (The remaining $12,000 of such distribution is treated as made out of previously taxed income.) The actual distribution would first reduce the $6,000 deemed distribution scheduled for 1980 to zero and then reduce the $6,000 deemed distribution scheduled for 1979 to $2,000. Thus, X's shareholders include in 1978 $16,000 is gross income as dividends ($10,000 of actual distributions and the $6,000 deemed distribution scheduled for that year) and $2,000 as a dividend in 1979.

*Example 3.* Assume the same facts as in example 2, except that X requalifies as a DISC for taxable year 1977 during which it derives $7,000 of DISC income (computed after taking into account a deemed distribution under §1.995–2(a)(4) of $7,000), but is again disqualified in 1978. In addition X makes an actual distribution in 1977 equal to the deemed distribution of $7,000. Such actual distribution is excluded from gross income under §1.996–1(c). In 1977. X's shareholders include in gross income as dividends the $6,000 deemed distribution upon disqualification (in addition to the deemed distributions of $7,000 under §1.995–2 for 1977 when it was treated as a DISC). The actual distribution in 1978 still reduces the installments resulting from the earlier disqualification. Thus, in 1978, X's shareholders include $16,000 in gross income as dividends. In 1979, X's shareholders include $9,000 in gross income as dividends (the final installment of $2,000 from the earlier disqualification plus the single deemed distribution of $7,000 resulting from the later disqualification).

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982]

### § 1.995–4 Gain on disposition of stock in a DISC.

(a) *Disposition in which gain is recognized*—(1) *In general.* If a shareholder disposes, or is treated as disposing, of stock in a DISC, or former DISC, then any gain recognized on such disposition shall be included in the shareholder's gross income as a dividend, notwithstanding any other provision of the Code, to the extent of the accumulated DISC income amount (described in paragraph (d) of this section). To the extent the recognized gain exceeds the accumulated DISC income amount, it is taxable as gain from the sale or exchange of the stock.

(2) *Nonapplication of subparagraph (1).* The provisions of subparagraph (1) of this paragraph do not apply (i) to the extent gain is not recognized (such as, for example, in the case of a gift or an exchange of stock to which section 354 applies) and (ii) to the amount of any recognized gain which is taxable as a dividend (such as, for example, under section 301 or 356(a)(2)) or as gain from the sale or exchange of property which is not a capital asset. The amount taxable as a dividend under section 301 or 356(a)(2) is subject to the rules provided in §1.995–1(c) for the treatment of actual distributions by a DISC.

(b) *Disposition in which separate corporate existence of DISC is terminated*—(1) *General.* If stock in a corporation that is a DISC, or former DISC, is disposed of in a transaction in which its separate corporate existence as a DISC, or former DISC, is terminated, then, notwithstanding any other provision of the Code, an amount of realized gain shall be recognized and included in the transferor's gross income as a dividend. The realized gain shall be recognized to the extent that such gain—

(i) Would not have been recognized but for the provisions of this paragraph, and

(ii) Does not exceed the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Cessation of separate corporate existence as a DISC, or former DISC.* For purposes of subparagraph (1) of this paragraph, separate corporate existence as a DISC, or former DISC, will be treated as having ceased if, as a result of the transaction, there is no separate entity which is a DISC and to which is carried over the accumulated DISC income and other tax attributes of the DISC, or former DISC, the stock of which is disposed of. Thus, for example, if stock in a DISC, or former DISC, is exchanged in a transaction described in section 381(a) (relating to carryovers in certain corporate acquisitions), the gain realized on the transfer of such stock will not be recognized under subparagraph (1) of this paragraph if the assets of such DISC, or former DISC, are acquired by a corporation which immediately after the acquisition qualifies as a DISC. For a further example, if a DISC, or former DISC, is liquidated in a transaction to which

section 332 (relating to complete liquidations of subsidiaries) applies, the transaction will be subject to subparagraph (1) of this paragraph if the basis to the transferee corporation of the assets acquired on the liquidation is determined under section 334(b)(2) (as in effect prior to amendment by the Tax Equity and Fiscal Responsibility Act of 1982) or if immediately after such liquidation the transferee of such assets does not qualify as a DISC. However, separate corporate existence as a DISC, or former DISC, will not be treated as having ceased in the case of a mere change in place of organization, however effected. See §1.996–7 for rules for the carryover of the divisions of a DISC's earnings and profits to one or more DISC's.

(c) *Disposition to which section 311, 336, or 337 applies*—(1) *In general.* If, after December 31, 1976, a shareholder distributes, sells, or exchanges stock in a DISC, or former DISC, in a transaction to which section 311, 336, or 337 applies, then an amount equal to the excess of the fair market value of such stock over its adjusted basis in the hands of the shareholder shall, notwithstanding any other provision of the Code, be included in gross income of the shareholder as a dividend to the extent of the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Nonapplication of subparagraph (1).* Subparagraph (1) shall not apply if the person receiving the stock in the disposition has a holding period for the stock which includes the period for which the stock was held by the shareholder disposing of such stock.

(d) *Accumulated DISC income amount*—(1) *General.* For purposes of this section, the accumulated DISC income amount is the accumulated DISC income of the DISC or former DISC which is attributable to the stock disposed of and which was accumulated in taxable years of such DISC or former DISC during the period or periods such stock was held by the shareholder who disposed of such stock.

(2) *Period during which a shareholder has held stock.* For purposes of this section, the period during which a shareholder has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part under the provisions of section 1014(d) (relating to special rule for DISC stock acquired from decedent), the holding period of the decedent. Such holding period is to exclude the day of acquisition but include the day of disposition. Thus, for example, if A purchases stock in a DISC on December 31, 1972, and makes a gift of such stock to B on June 30, 1973, then on December 31, 1974, B will be treated as having held the stock for 2 full years. If the basis of the stock in C's hands is determined under section 1014(d) upon a transfer from B's estate on December 31, 1976, by reason of B's death on June 30, 1974, then on December 31, 1976, C will be treated as having held the stock for 4 full years.

(e) *Accumulated DISC income allocable to shareholder under section 995(c)(2)*—(1) *In general.* Under this paragraph, rules are prescribed for purposes of paragraph (d) of this section as to the manner of determining, with respect to the stock of a DISC, or former DISC, disposed of, the amount of accumulated DISC income which is attributable to such stock and which was accumulated in taxable years of the corporation during the period or periods the stock disposed of was held or treated under paragraph (d)(2) of this section as held by the transferor. Subparagraphs (2), (3), and (4) of this paragraph set forth a method of computation which may be employed to determine such amount. Any other method may be employed so long as the result obtained would be the same as the result obtained under such method.

(2) *Step 1.* Determine the increase (or decrease) in accumulated DISC income for each taxable year of the DISC, or former DISC, by subtracting from the amount of accumulated DISC income (as defined in §1.996–3(b)) at the close of each taxable year the amount thereof as of the close of the immediately preceding taxable year.

(3) *Step 2.* (i) Determine for each taxable year of the DISC, or former DISC, the increase (or decrease) in accumulated DISC income per share by dividing such increase (or decrease) for the

year by the number of shares outstanding or deemed outstanding on each day of such year.

(ii) If the number of shares of stock in the corporation outstanding on each day of a taxable year of the DISC, or former DISC, is not constant, then the number of such shares deemed outstanding on each day of such year shall be the sum of the fractional amounts in respect of each share which was outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing the number of days in the taxable year on which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by the total number of days in such taxable year.

(iii) If for any taxable year of a DISC, or former DISC, the share disposed of was not held (or treated under paragraph (d)(2) of this section as held) by the disposing shareholder for the entire year, then the amount of increase (or decrease) in accumulated DISC income attributable to such share for such year is the amount determined as if he held the share until the end of such year multiplied by a fraction the numerator of which is the number of days in the taxable year on which the shareholder held (or under paragraph (d)(2) of this section is treated as having held) such share and the denominator of which is the total number of days in the taxable year.

(4) *Step 3.* Add the amounts computed in step 2 for each taxable year of the DISC, or former DISC, in which the shareholder held such share of stock.

(5) *Examples.* This paragraph may be illustrated by the following examples:

*Example 1.* X Corporation uses the calendar year as its taxable year and elects to be a DISC for the first time for 1973. On January 1, 1973, X has 20 shares issued and outstanding. A and B each own 10 shares. On July 1, 1976, X issues 10 shares to C. On December 31, 1977, A sells his 10 shares to D and recognizes a gain of $120. Under these facts and other facts assumed in the table below, A includes in his gross income for 1977 a dividend under paragraph (b) of this section of $61.30 and long-term capital gain of $58.70.

| Year | (a)—Year end accumulated DISC income | (b)—Increase (decrease) in accumulated DISC income | (c)—Shares outstanding | (d)—Increase (decrease) per share (column (b) divided by column (c)) |
|---|---|---|---|---|
| 1973 | $80 | $80 | 20 | $4.00 |
| 1974 | 50 | (30) | 20 | (1.50) |
| 1975 | 80 | 30 | 20 | 1.50 |
| 1976 | 100 | 20 | [1] 25 | .80 |
| 1977 | 140 | 40 | 30 | 1.33 |
| (1) Total increase in accumulated DISC income for each share disposed of (sum of amounts in column (d)) | | | | 6.13 |
| Multiply by number of shares disposed of | | | | 10 |
| (2) Total amount of accumulated DISC income attributable to A's shares disposed of | | | | 61.30 |
| (3) A's gain | | | | 120.00 |
| (4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3)) | | | | 61.30 |
| (5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4)) | | | | 58.70 |

[1] Under subparagraph (3)(ii) of this paragraph, the aggregate fractional amounts of the 10 shares issued on July 1, 1976, is 5 shares, i.e., 10 shares, multiplied by (183 days/366 days). Thus, the number of shares deemed outstanding for 1976 is 25 shares, i.e., 20 shares plus 5 shares.

*Example 2.* Assume the same facts as in example 1, except that A sells his 10 shares to D on July 1, 1977. Under subparagraph (3)(iii) of this paragraph, the amount of increase in accumulated DISC income for 1977 which is attributable to each share disposed of is limited to $.67, *i.e.*, $1.33 multiplied by 182 days/365 days. Therefore, the sum of the yearly increases (and decreases) in accumulated DISC income for each share is reduced by $.66 (*i.e.*, $1.33 minus $.67). The total increase in accumulated DISC income for each share disposed of is $5.47 (i.e., $6.13 minus $.66). Under

these facts, A would include in his gross income for 1977 a dividend of $54.70 and long-term capital gain of $65.30 determined as follows:

| | |
|---|---|
| (1) Total increase in accumulated DISC income for each share disposed of | $5.47 |
| Multiplied by number of shares disposed of | 10 |
| (2) Total amount of accumulated DISC income attributable of to all shares disposed of | 54.70 |
| (3) A's gain | 120.00 |
| (4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3)) | 54.70 |
| (5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4)) | 65.30 |

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982]

### § 1.995–5 Foreign investment attributable to producer's loans.

(a) *In general*—(1) *Limitation.* Under section 995(d), the amount as of the close of a ''group taxable year'' (as defined in subparagraph (3) of this paragraph) of foreign investment attributable to producer's loans of a DISC for purposes of section 995(b)(1)(G) shall be the excess (as of the close of such year) of—

(i) The smallest of—

(*a*) The amount of the net increase in foreign assets (as defined in paragraph (b) of this section) by domestic and foreign members of the controlled group which includes the DISC,

(*b*) The amount of the actual foreign investment by the domestic members of such group (as determined under paragraph (c) of this section), or

(*c*) The amount of outstanding producer's loans (as determined under §1.993–4) by such DISC to members of such controlled group, over

(ii) The amount (determined under §1.995–2 (a)(5) and (b)(2)) of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the particular DISC taxable as dividends for prior taxable years of that particular DISC.

Thus, for example, if the shareholders of a DISC which uses the calendar year as its taxable year (and which is a member of a controlled group in which all of the members use the calendar year as their taxable year) are treated under section 995(b)(1)(G) as receiving foreign investment attributable to producer's loans of a DISC of $0 in 1972, $10 in 1973, and $30 in 1974, or a total of $40, and if the smallest of the amounts described in subdivision (i) of this subparagraph at the end of 1975 is $90, then the amount of the foreign investment attributable to producer's loans of a DISC at the end of 1975 is $50, *i.e.*, the excess (as of the close of 1975) of the smallest of the amounts described in subdivision (i) of this subparagraph ($90) over the sum of the amounts of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC ($40). If the separate corporate existence of the DISC as to which the amount described in subdivision (ii) of this subparagraph relates ceases to exist within the meaning of §1.995–4(c)(2), then such amount shall no longer be taken into account by the group for any purpose. For inclusion of amounts because of certain corporate acquisitions, see paragraph (d) of this section.

(2) *Controlled group; domestic and foreign member.* For purposes of this section—

(i) The term ''controlled group'' has the meaning assigned to such term by §1.993–1(k).

(ii) The term *domestic member* means a domestic corporation which is a member of a controlled group, and the term *foreign member* means a foreign corporation which is a member of a controlled group.

(3) *Group taxable year.* (i) The term *group taxable year* refers collectively to the taxable year of the DISC and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the taxable year of the DISC. Thus, for example, if a corporation has a subsidiary which uses the calendar year as its taxable year and which elects to be treated as a DISC, and if the parent has a taxable year ending on October 31, the ''group taxable year'' for 1973 would refer to calendar year 1973 for the DISC and to the parent's taxable year ending October 31, 1973.

(ii) In cases in which the DISC makes a return for a short taxable year, that is, for a taxable year consisting of a period of less than 12 months, pursuant to

section 443 and the regulations thereunder, or §1.991–1(b)(3), the following rules shall apply—

(*a*) In the case of a change in the annual accounting period of the DISC resulting in a short taxable year, the *group taxable year* refers collectively to the short taxable year and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the short taxable year.

(*b*) In the case of a DISC which is in existence during only part of what would otherwise be its taxable year, the *group taxable year* refers collectively to the short period during which the DISC was in existence and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the 12-month period ending on the last day of the short period.

(iii) With respect to periods prior to the first taxable year for which a member of the group qualified (or is treated) as a DISC, each group taxable year shall be determined under subdivision (i) of this subparagraph as if such member was in existence, it qualified as a DISC, and its taxable year ended on that date corresponding to the date such member's first taxable year ended after it qualified (or is treated) as a DISC whether or not the corporation which qualifies (or is treated) as a DISC used the same taxable year before it so qualified (or is so treated). Thus, for example, if a corporation which is organized on March 3, 1975, uses the calendar year as its taxable year, and is a member of a controlled group which does not include a DISC, first qualifies (or is treated) as a DISC for calendar year 1975, then the term ''group taxable year'' with respect to years prior to 1975 refers collectively to such prior calendar years and to the taxable year of each corporation in the group ending with or within such prior calendar years.

(iv) For special rules in the case of a group which includes more than one DISC, see paragraph (g) of this section.

(4) *Amounts determined for prior years.* Unless the 3-year limitation is properly elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investments by domestic members) of this section reflect, as of the close of a group taxable year, amounts for all taxable years of members of the group beginning after December 31, 1971 (and amounts arising after December 31, 1971, or such other date prescribed in paragraph (b)(7) of this section), provided that such amounts relate to such group taxable year and preceding group taxable years. Thus, for example, if all members of a controlled group use the calendar year as the taxable year, and 1980 is the first taxable year for which any member of the group qualifies (or is treated) as a DISC, then, unless the 3-year limitation is elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) and (c) of this section will be taken into account beginning with the dates specified in the preceding sentence. For rules as to carryovers on certain corporate acquisitions and reorganizations, see paragraph (d) of this section.

(5) *Three-year elective limitation.* (i) A DISC may elect to take into account only amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investment by domestic members) of this section for the 3 taxable years of each member immediately preceding its taxable year included in that first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC. For purposes of the preceding sentence, determinations shall be made by reference to the taxable year of the issuer or transferor (as the case may be). If an election is made under this subdivision, the offset for uncommitted transitional funds under paragraph (b)(7) of this section is not allowed. If an election is made under this subdivision, the 3-year limitation applies to amounts described in paragraphs (b)(4) and (c)(1) and (2) of this section.

(ii) An election under subdivision (i) of this subparagraph shall not apply with respect to amounts which must be carried over under paragraph (d) of this section in the case of certain corporate acquisitions and reorganizations.

(iii) An election under subdivision (i) of this subparagraph shall be made by

the DISC attaching to its first return, filed under section 6011(e)(2), a statement to the effect that the 3-year limitation is being elected under §1.995–5(a)(5)(i).

(6) *Cumulative basis.* Pursuant to section 995(d)(5), all determinations of amounts specified in this section are to be made on a cumulative basis from the 1st year (or date) provided for in this section. Thus, each such determination shall take into account a net increase or a net decrease during the year, as the case may be. However, if the 3-year limitation is elected under subparagraph (5) of this paragraph, then only amounts with respect to periods specified in such subparagraph (5) are amounts taken into account for years before a member of the group qualifies (or is treated) as a DISC. The computations described in this section may be made in any way chosen by the DISC (including a corporation being tested as to whether it qualifies as a DISC), provided such method results in the amount prescribed by this section.

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

*Example.* X Corporation, which uses the calendar year as its taxable year, is a member of a controlled group (within the meaning of subparagraph (2) of this paragraph). X elects to be treated as a DISC beginning with 1972. The amount of foreign investment attributable to X's producer's loans treated under section 995(b)(1)(G) as a distribution taxable as a dividend as of the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on lines (1), (2), (3), and (5) being running balances):

| Taxable year of X | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|
| (1) Net increase (or decrease) in foreign assets since January 1, 1972, at close of group taxable year | ($30) | $10 | $100 | $150 |
| (2) Actual foreign investment at close of group taxable year | 20 | 60 | 80 | 140 |
| (3) Outstanding producer's loans of X (the DISC) as of the close of group taxable year | 0 | 40 | 90 | 120 |
| (4) Smallest of lines (1), (2), or (3) (not less than zero) | 0 | 10 | 80 | 120 |
| (5) Less section 995(b)(1)(G) deemed distributions for prior taxable years (sum of lines (5) and (6) from prior year) | 0 | 0 | 10 | 80 |
| (6) Section 995(b)(1)(G) deemed distribution as of close of taxable year | 0 | 10 | 70 | 40 |

(b) *Net increase in foreign assets*—(1) *In general.* (i) The term *net increase in foreign assets* when used in this section means the excess for the controlled group (as of the close of the group taxable year) of (*a*) the investment in foreign assets to be taken into account under subparagraph (2) of this paragraph over (*b*) the aggregate of the five offsets allowed by subparagraphs (3) through (7) of this paragraph.

(ii) No amount described in this paragraph (other than amounts described in subparagraphs (4) and (7) of this paragraph) with respect to a member of the group (or foreign branch of a member) shall be taken into account unless it is attributable to a taxable year of such member beginning after December 31, 1971. For a 3-year elective limitation with respect to the first taxable year for which a member qualifies (or is treated) as a DISC, see paragraph (a)(5) of this section. For manner of determining amounts on a cumulative basis, see paragraph (a)(6) of this section.

(2) *Investments made in foreign assets.* (i) For purposes of subparagraph (1) of this paragraph, there shall be taken into account as investment in foreign assets the aggregate of the amounts expended (within the meaning of subdivision (ii) of this subparagraph) during the period described in subparagraph (1)(ii) of this paragraph by all members of the controlled group which includes the DISC to acquire assets described in section 1231(b) (determined without regard to any holding period therein provided) which are located outside the United States (as defined in §1.993–7) reduced by the aggregate of the amounts received by all such members of the controlled group from the sale,

exchange, or involuntary conversion of such assets described in section 1231(b) which are located outside the United States. For purposes of this section, amounts expended for assets which are qualified export assets (as defined in §1.993–2) of a DISC (or which would be qualified export assets if owned by a DISC) shall not be taken into account. Thus, for example, if a DISC acquires a qualified export asset located outside the United States, the asset is not to be taken into account for purposes of determining the net increase in foreign assets.

(ii) As used in subdivision (i) of this subparagraph, the term *amounts expended* (or amounts received) means the amount of any money or the fair market value (on the date of acquisition, sale, exchange, or involuntary conversion) of any property (other than money) used to acquire (or received for) the assets described in such subdivision (i).

(iii) For purposes of this subparagraph, an asset (other than an aircraft or vessel) is considered as located outside the United States if it was used predominantly outside the United States during the group taxable year. The determination as to whether such an asset is used predominantly outside the United States during the group taxable year in which it was acquired or sold, exchanged, or involuntarily converted shall be made by applying the rules of §1.993–3(d) except that an aircraft described in section 48(a)(2)(B)(i) or a vessel described in section 48(a)(2)(B)(iii) shall be considered located in the United States and all other aircraft or vessels shall be considered located outside the United States. Thus, for example, if a member of a controlled group which includes a DISC acquires a vessel which is documented under the laws of a foreign country, the amount expended to acquire that vessel is an amount described in subdivision (i) of this subparagraph.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

*Example 1.* X Corporation, which uses the calendar year as its taxable year, is a domestic member of a controlled group (within the meaning of paragraph (a)(2) of this section). During 1972, in a transaction to which section 1031 applies, X acquires a warehouse located outside the United States and having a fair market value of $100. As consideration, X transfers $20 in cash and a warehouse located within the United States and having a fair market value of $80. Under these facts, $100 will be taken into account as investment in foreign assets.

*Example 2.* The facts are the same as in example 1, except that the warehouse transferred by X as consideration is located outside the United States. Under these facts, only $20 will be taken into account as investment in foreign assets because the amount expended for such assets (*i.e.*, $100) is reduced by the fair market value of any property located outside the United States received in exchange for such assets (*i.e.*, $80).

(3) *Depreciation with respect to all foreign assets of a controlled group.* (i) An offset allowed by this subparagraph is the depreciation (determined under subdivision (ii) of this subparagraph) or depletion (determined under subdivision (iii) of this subparagraph) attributable to taxable years of the member beginning after December 31, 1971, with respect to all of the group's foreign assets described in subparagraph (2) of this paragraph including such assets acquired prior to the date provided in such subparagraph (2), and without regard to whether the 3-year election in paragraph (a)(5) of this section is made. Thus, for example, depreciation for a taxable year of a member beginning after December 31, 1971, with respect to an asset described in section 1231(b) which is located outside of the United States and which was acquired during a taxable year of the member beginning before January 1, 1972, is an offset allowed by this subparagraph. For a further example, depreciation with respect to a qualified export asset is not such an offset.

(ii) The depreciation taken into account under subdivision (i) of this subparagraph shall be—

(*a*) In the case of an asset owned by a domestic member, only the amount allowed under section 167(b)(1) (relating to the allowance of the straight-line method of depreciation) and §1.162–11(b) (relating to amortization in lieu of depreciation), but not the amount allowed under section 179 (relating to the additional first-year depreciation allowance).

(*b*) In the case of an asset owned by a foreign member, the depreciation and amortization (referred to in (*a*) of this subdivision) allowable for purposes of computing earnings and profits under subparagraph (5)(i) of this paragraph.

(iii) The depletion taken into account under subdivision (i) of this subparagraph shall be limited to cost depletion computed under sections 611 and 612 and the regulations thereunder. Thus, percentage depletion is not to be taken into account in computing the offset under this subparagraph.

(4) *Amount of outstanding stock or debt.* (i) An offset allowed by this subparagraph is the outstanding amount of stock (including treasury stock) or debt obligations of any member of the group issued, sold, or exchanged after December 31, 1971, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group: *Provided*, That, in the case of a debt obligation, such obligation is not repaid within 12 months after such issuance, sale, or exchange. Thus, for example, if stock is issued to a member of the group before January 1, 1972, and after December 31, 1971, it is sold to a person who is neither a United States person nor a member of the group, an offset allowed by this subparagraph includes the outstanding amount of such stock. For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(ii) The outstanding amount of stock or debt obligations shall be determined in accordance with the following provisions:

(*a*) The outstanding amount of stock or debt obligations described in subdivision (i) of this subparagraph is equal to the net amount described in (*b*) of this subdivision reduced (but not below zero) by the amount described in (*c*) of this subdivision.

(*b*) The net amount described in this subdivision (*b*) is the excess of (*1*) the aggregate of the amount of money and the fair market value of property (other than money) transferred by persons who are not members of the group and who are not U.S. persons as consideration for such stock and debt obligations over (*2*) fees and commission expenses borne by the issuer or transferror with respect to their issuance, sale, or exchange.

(*c*) The amount described in this subdivision (*c*) is the aggregate amount of money and fair market value of property (other than money) distributed to such persons on distributions in respect of such stock from other than earnings and profits or on distributions in redemption of such stock and the amount of principal paid pursuant to such debt obligations.

(*d*) For purposes of this subdivision (ii), in the case of a redemption, the stock or debt redeemed shall be charged against the earliest of such stock or debt issued, sold, or exchanged in order to determine the amount by which the balance of outstanding stock or debt is to be reduced. For purposes of this subparagraph, the fair market value of property received as consideration shall be determined as of the date the transaction occurs, and a contribution to capital within the meaning of section 118 shall be treated as the issuance of stock.

(iii) The provisions of subdivision (i) of this subparagraph apply regardless of the treatment under the Code of the transaction in which the stock or debt was issued, sold, or exchanged. Thus, for example, if X Corporation, a member of a controlled group which includes a DISC, acquires from a nonresident alien individual in exchange solely for X's voting stock all of the stock of Y Corporation pursuant to a reorganization as defined in section 368(a)(1)(B), the fair market value of the Y stock on the date of the exchange would be an offset allowed by this subparagraph.

(iv) The provisions of this subparagraph may be illustrated by the following example:

*Example.* X Corporation is a member of a controlled group (within a meaning of paragraph (a)(2) of this section) every member of which uses the calendar year as its taxable year. On January 1, 1972, X issues in a public offering its stock to persons described in subdivision (i) of this subparagraph who, in the aggregate, pay $1,000 as consideration. X pays $100 in underwriting fees. On the same date, X receives $425 upon issuing a $500 debt

obligation to such persons at a discount of $75 and pays $25 in underwriting fees. On December 31, 1972, the offset allowed under this subparagraph is $1,300, i.e., ($1,000 minus $100) plus ($425 minus $25). If, during 1973, X makes a distribution of $150 (not in redemption) from other than earnings and profits with respect to such stock, then the offset is reduced to $1,150.

(5) *Earnings and profits.* (i) An offset allowed by this subparagraph is one-half the aggregate of the earnings and profits accumulated for all taxable years beginning after December 31, 1971, computed (without regard to any distributions from earnings and profits by a foreign corporation to a domestic corporation in accordance with §1.964–1 (relating to a controlled foreign corporation's earnings and profits), of each foreign member of the group which is controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and each foreign branch of a domestic member of the group (computed as if the branch were a foreign corporation). The DISC is bound by any action on behalf of a foreign member that was taken pursuant to §1.964–1(c)(3) or by any failure to take action by or on behalf of a foreign member within the time specified in §1.964–1(c)(6). With respect to a foreign member for which action was not previously required under §1.964–1(c)(6) to be taken, the DISC may take action on behalf of such member by attaching a statement to that effect to the return of the DISC under section 6011(e)(2) for the first taxable year during which it qualifies (or is treated) as a DISC and there is outstanding a producer's loan made by such DISC to a member of the controlled group which includes the DISC.

(ii) If the aggregate of the accumulated earnings and profits described in subdivision (i) of this subparagraph is a deficit, the amount allowable as an offset under this subparagraph is zero.

(6) *Royalties and fees.* An offset allowed by this subparagraph is one-half the royalties and fees paid by foreign members of the group to domestic members of the group and by foreign branches of domestic members of the group to domestic members of the group during the taxable years of such members beginning after December 31, 1971.

(7) *Uncommitted transitional funds.* (i) An offset allowed by this subparagraph for the uncommitted transitional funds of the group is the sum described in subdivision (ii) of this subparagraph of the amount of certain capital raised under the foreign direct investment program and the amounts described in subdivision (iv) of this subparagraph of certain foreign excess working capital held on October 31, 1971.

(ii) The amount described in this subdivision of certain capital raised under the foreign direct investment program is the excess (if any) of—

(*a*) The amount of the offset allowed by subparagraph (4) of this paragraph, determined, however, with respect to the stock and debt obligations of domestic members of the group outstanding on December 31, 1971 (including amounts treated as stock outstanding by reason of a contribution to capital), whether or not outstanding after such date, which were issued, sold, or exchanged on or after January 1, 1968, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group, but only to the extent the taxpayer establishes that such amount constitutes a long-term borrowing (see 15 CFR 1000.324[1]) for purposes of the foreign direct investment program (see 15 CFR part 1000[1]), over

(*b*) The amount (determined under paragraph (c) of this section) of actual foreign investment by the domestic members of the group during the portion of the period such stock or debt obligations have been outstanding prior to January 1, 1972, such determination to be made by substituting January 1, 1968, for the December 31, 1971, date specified in such paragraph (c) and by not taking into account the earnings and profits described in paragraph (c)(3) of this section.

For purposes of this subparagraph, foreign branches of United States banks

[1] EDITORIAL NOTE: 15 CFR part 1000 was removed at 39 FR 30481, Aug. 23, 1974.

are not considered to be United States persons.

(iii)(*a*) A taxpayer may establish that an amount under subdivision (ii) (*a*) of this subparagraph constitutes a long-term borrowing for purposes of the foreign direct investment program by keeping records sufficient to demonstrate that appropriate reports were filed with the Office of Foreign Direct Investment of the Department of Commerce with respect to the foreign borrowing or by any other method satisfactory to the district director.

(*b*) The amounts described in subdivision (ii) (*a*) of this subparagraph include amounts with respect to which an election under section 4912(c), to subject certain obligations of a United States person to the interest equalization tax, has been made: *Provided*, That the obligations to which such amounts relate were issued by an ''overseas financing subsidiary'' described in 15 CFR part 1000[1] and were assumed by a United States person from such overseas financing subsidiary. Thus, for example, if an overseas financing subsidiary issues its notes to a foreign person in 1968, and such notes are assumed by its United States parent in 1973, which parent elects under section 4912(c) to have the notes subject to the interest equalization tax, then the amount of money received by the subsidiary is an amount described in subdivision (ii)(*a*) of this subparagraph.

(iv) The amount described in this subdivision of foreign excess working capital is the amount of liquid assets held by the foreign members of such group and foreign branches of domestic members of such group on October 31, 1971 (whether or not so held after such date) in excess of their reasonable working capital needs (as defined in §1.993–2 (e)) on that date, but only to the extent not included in subdivision (ii) of this subparagraph. For purposes of this subdivision, the term *liquid assets* means money, bank deposits (not including time deposits), and indebtedness of any kind (including time deposits) which on the day acquired had a maturity of 2 years or less.

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

*Example.* X Corporation, which uses the calendar year as its taxable year is a member of a controlled group (within the meaning of paragraph (a)(2) of this section). X elects to be treated as a DISC beginning with 1972. The amount of net increase in foreign assets of the group at the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on each line being running balances):

| Taxable year of X | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|
| (1) Investment in foreign assets | $150 | $165 | $260 | $300 |
| (2) Depreciation with respect to foreign assets of group | 20 | 40 | 60 | 80 |
| (3) Amount of stock or debt outstanding issued after December 31, 1971 | 30 | 30 | 30 | 30 |
| (4) One-half earnings and profits of foreign members | 40 | 70 | 100 | 130 |
| (5) Royalties and fees paid by foreign members to domestic members | 10 | 15 | 20 | 20 |
| (6) Uncommitted transitional funds | 10 | 10 | 10 | 10 |
| (7) Sum of lines (2) through (6) | 110 | 165 | 220 | 270 |
| (8) Net increase in foreign assets (line (1) minus line (6)) | 40 | 0 | 40 | 30 |

(c) *Actual foreign investment by domestic members.* For purposes of determining the limitation in paragraph (a) of this section, the amount of the actual foreign investment by domestic members of a controlled group is the sum (as of the close of the group taxable year) determined on a cumulative basis (see paragraph (a)(6) of this section) of—

(1) *Outstanding stock or debt (including contributions to capital).* The outstanding amount (determined in accordance with the principles of paragraph (b)(4)(ii) of this section, applied with respect to stock or debt obligations described in this subparagraph) of stock (including treasury stock) or debt obligations (other than normal trade indebtedness) of foreign members of the group issued, sold, or exchanged after December 31, 1971, by any person (whether or not a member) which is not a domestic member to domestic members of the group: *Provided*, That the

outstanding amount of debt obligations of any foreign member shall be the greater of such amount outstanding at the close of the taxable year of such member or the highest such amount outstanding at any time during the immediately preceding 90 days,

(2) *Transfers to foreign branches.* The amount of money or the fair market value of property (other than money) transferred by domestic members of the group after December 31, 1971, to foreign branches of such members in transactions which would, if the branch were a corporation, be in consideration for the sale of stock or debt obligations of (or a contribution of capital to) such foreign branches (as determined under subparagraph (1) of this paragraph), and

(3) *Earnings and profits of foreign members.* One-half of the earnings and profits (computed in accordance with paragraph (b)(5) of this section for purposes of computing net increase in foreign assets) of foreign members of the group which are controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and foreign branches (treated for this purpose as a corporation) of domestic members of the group accumulated during the taxable years of such foreign members (or branches) beginning after December 31, 1971, or, if later, the taxable year referred to in paragraph (a)(5)(i) of this section if the 3-year election provided for in such paragraph (a)(5)(i) is made.

(d) *Carryovers on certain corporate acquisitions and reorganizations*—(1) *Certain corporate acquisitions.* (i) If—

(*a*) A member of a controlled group (''first controlled group'') acquires in a transaction to which section 381 applies the assets of a corporation which is a member of a second controlled group or acquires stock in such a corporation pursuant to a reorganization as defined in section 368(a)(1)(B) to which section 361 applies, or

(*b*) A member or combination of members of the first controlled group acquire in a transaction not described in (*a*) of this subdivision a majority interest (as defined in paragraph (e)(2) of this section) in the stock of a corporation which is a member of a second controlled group which includes a DISC so that such DISC after the acquisition is a member of the new controlled group,

then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after such acquisition, all amounts described in paragraphs (a) through (c) of this section, including the amount specified in paragraph (a)(1)(ii) of this section (relating to amounts treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC), with respect to members of the second controlled group which become members of the new controlled group shall carry over to such new controlled group. For purposes of this subdivision (i), a controlled group may consist of only one member. With respect to certain transactions involving foreign corporations, see section 367.

(ii) If a member or combination of members of a controlled group, immediately after an acquisition of stock to which subdivision (i) of this subparagraph applies, do not control the total combined voting power (determined under §1.957–1(b)) of the corporation whose stock was acquired, proper apportionment consistent with the principles of paragraph (e)(5) of this section shall be made with respect to amounts to which paragraphs (a) through (c) of this section apply.

(iii)(*a*) If subdivision (i) of this subparagraph applies, then for purposes of determining the application of the 3-year elective limitation provided for in paragraph (a)(5) of this section, the rules in (*b*), (*c*), and (*d*) of this subdivision (iii) apply.

(*b*) If both the ''first controlled group'' and the ''second controlled group'' (as those terms are defined in subdivision (i) of this subparagraph) include a DISC, and a DISC in either group has elected the 3-year limitation provided in paragraph (a)(5) of this section, then only those amounts taken into account under such paragraph (a)(5) by the electing DISC or DISC's shall be taken into account.

(*c*) If one of the groups includes a DISC and the other does not, and if the DISC has elected the 3-year limitation

provided in paragraph (a)(5) of this section, then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after the acquisition, all amounts described in paragraphs (a) through (c) of this section with respect to members of the controlled group which did not include the DISC shall carry over to such new controlled group, but only to the extent provided in such paragraph (a)(5), computed as if the group taxable year in which the acquisition occurred was the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(*d*) If (*c*) of this subdivision (iii) applies, except that the DISC has not elected the 3-year limitation provided in paragraph (a)(5) of this section, then the DISC in the new controlled group as constituted after the acquisition may, with respect to members of the controlled group which did not include the DISC, make the election provided in such paragraph (a)(5), and treat the year in which the acquisition occurred as if it were the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(iv) If a majority interest, or an interest in addition to a majority interest, is acquired in a transaction other than a transaction described in subdivision (i) of this subparagraph, then the rules in paragraph (e) of this section (relating to the acquisition of the foreign assets of a corporation) apply.

(2) *Corporation ceasing to be a member.* As of the date a corporation which is a member of a controlled group ceases to be a member of such group, the amounts of such group described in paragraphs (a) through (c) of this section will be reduced by such amounts which are attributable to the corporation which is no longer a member of the group.

(e) *Acquisition of a majority interest in a corporation*—(1) *In general.* If paragraph (d)(1)(i) of this section (relating to certain corporate acquisitions in which all amounts described in paragraphs (a) through (c) of this section carry over) does not apply, then, for purposes of determining under paragraph (b)(2) of this section the investments made in foreign assets by a controlled group, the acquisition of a majority interest (as defined in subparagraph (2) of this paragraph) or an interest in addition to a majority interest in a corporation by any member or combination of members of the controlled group is considered an acquisition of the assets (to the extent provided in subparagraph (5) of this paragraph) of the acquired corporation by the group, including the assets of any foreign corporation in which the acquired corporation owns a majority interest (to the extent provided in subparagraph (5) of this paragraph). For the rules concerning the date upon which an acquisition of a majority interest is considered to have occurred, see subparagraph (3) of this paragraph.

(2) *Majority interest.* For purposes of this section, a majority interest is more than 50 percent of the total combined voting power of all classes of a corporation's stock entitled to vote, as determined under §1.957–1(b).

(3) *Acquisition date.* For purposes of this paragraph, an acquisition of a majority interest shall be considered to have occurred on the day on which the combined voting power of the group first reached the percentage required in subparagraph (2) of this paragraph.

(4) *Valuation of assets.* For purposes of this section, the amount of a corporation's assets deemed acquired is the fair market value of the assets on the date a majority interest, or an interest in addition to a previously held majority interest, is acquired.

(5) *Apportionment in the case of the acquisition of less than all of the voting stock.* (i) If the acquisition described in subparagraph (1) of this paragraph of a majority interest is of less than 100 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, then for purposes of subparagraph (1) of this paragraph the amount of the foreign assets of the corporation deemed acquired as of the day the majority interest is considered acquired shall be an amount equal to the fair market value of all of the corporation's foreign assets described in paragraph (b)(2) of this section as of such day multiplied

by the percentage of the total combined voting power (determined under §1.957–1(b)) held by members of the group on the day the majority interest is considered acquired.

(ii) If any member or combination of members of the controlled group hold a majority interest in a corporation, then for purposes of subparagraph (1) of this paragraph the acquisition of additional combined voting power by members of the controlled group shall be considered an acquisition of its foreign assets described in paragraph (b)(2) of this section in an amount equal to the fair market value of all such assets held by the foreign corporation on the date of the acquisition, multiplied by the increase (expressed in percentage points) in total combined voting power (as determined under §1.957–1(b)) which occurred.

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

*Example 1.* M Corporation uses the calendar year as its taxable year. On November 18, 1973, M acquires from A, an individual United States person, for $1 million cash all 10,000 shares of the voting stock of N, a foreign corporation. N's only asset is a warehouse located in France with a fair market value on the date of acquisition of $1 million. Under subparagraph (1) of this paragraph, the controlled group of which M is a member is considered to have expended $1 million for the acquisition of foreign assets described in paragraph (b)(2) of this section.

*Example 2.* The facts are the same as in example 1, except that on November 18, 1973, M acquires only 80 percent of N's voting stock. M is considered to have expended $800,000 for the acquisition of assets described in paragraph (b)(2) of this section, computed as follows:

| | |
|---|---|
| (1) Fair market value of N's foreign assets described in paragraph (b)(2) of this section | $1,000,000 |
| (2) Multiply by percentage of total combined voting power of all classes of N stock entitled to vote acquired by M | .8 |
| (3) Amount considered expended | $800,000 |

*Example 3.* The facts are the same as in example 2, except that individual A is not a United States person, and M acquires the 80 percent of N voting stock in exchange for cash of $100,000 and M stock having a fair market value on the date of the acquisition of $700,000. M is considered to have acquired assets described in paragraph (b)(2) of this section in the amount of $800,000 (see computations in example 2) and to have an offset under paragraph (b)(4) of this section (relating to outstanding stock or debt) of $700,000 (the fair market value of the M stock transferred to A who is not a United States person). However, the controlled group of which M is a member is not considered to have acquired any other amounts described in paragraphs (a) through (c) of this section with respect to N for taxable years prior to the taxable year of N during which the acquisition occurred.

*Example 4.* P Corporation, which uses the calendar year as its taxable year, is a member of a controlled group which includes a DISC. During 1973, P acquires from B, an individual United States person, for cash, 30 percent of the total combined voting power of all classes of stock entitled to vote of Q, a foreign corporation. All of Q's assets are assets described in paragraph (b)(2) of this section. No additional interest in Q is acquired by members of the group during 1973. The controlled group of which Q is a member is not considered to have made any investments in foreign assets described in such paragraph (b)(2) as of the close of 1973.

*Example 5.* Assume the same facts as in example 4. Assume further that during 1974, R Corporation, a member of the controlled group which includes P, acquires for cash 40 percent of the total combined voting power of all classes of stock of Q entitled to vote as follows: 20 percent on July 31, and 20 percent on December 31. Thus, on December 31, 1974, members of the controlled group own 70 percent of Q's voting power (30+20+20) and on that date are considered to have acquired a majority interest in Q. The fair market value of Q's assets on December 31, 1974, is $5 million. The group is considered to have expended $3,500,000 for the acquisition of assets described in paragraph (b)(2) of this section computed as follows:

| | |
|---|---|
| (1) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section as of the date the acquisition is deemed to have occurred under subparagraph (3) of this paragraph (December 31, 1974) | $5,000,000 |
| (2) Multiply by percentage of total combined voting power of all classes of Q stock entitled to vote held by members of the group on such date | .7 |
| | $3,500,000 |

*Example 6.* The facts are the same as in example 5. Assume further that on July 15, 1975, P acquires the remaining 30 percent of the total combined voting power of all classes of Q stock entitled to vote, and on such date the fair market value of Q's assets is $5,500,000. The group is considered to have expended $5,150,000 for the acquisition of assets described in paragraph (b)(2) of this section as of the close of 1975, computed as follows:

| | |
|---|---|
| (1) Amount of prior years' investment | $3,500,000 |

| | |
|---|---|
| (2) Investment during 1975: | |
| (a) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section on July 15, 1975 | $5,500,000 |
| (b) Multiply by additional percentage acquired of total combined voting power of all classes of Q stock entitled to vote | .3 |
| (c) Investment during 1975 | $1,650,000 |
| (3) Amount considered expended for foreign assets described in paragraph (b)(2) of this section by reason of the acquisition of Q stock | $5,150,000 |

(f) *Records.* A DISC shall keep or be readily able to produce such permanent books of account or records as are sufficient to establish the transactions and amounts described in this section. Where applicable, such books of account or records shall be cumulative and shall show transactions and amounts of the members of the controlled group which includes the DISC which occurred prior to the date the DISC qualified (or is treated) as a DISC.

(g) *Multiple DISC's*—(1) *Allocation among DISC's.* In the case of a controlled group which includes more than one DISC, the amounts described in paragraphs (b) and (c) of this section shall be allocated among the DISC's in order to determine the limitation in paragraph (a) of this section. Each DISC's allocable portion of these amounts shall be equal to the total of such amounts multiplied by a fraction the numerator of which is the individual DISC's outstanding producer's loans to members of the group, and the denominator of which is the aggregate amounts of outstanding producer's loans to members of the group by all DISC's which are members of the group.

(2) *Different taxable years.* If all of the DISC's which are members of the controlled group do not have the same taxable year, then one such DISC shall on behalf of all such DISC's elect to make all computations under section 995(d) as if all DISC's that are members of the group use the same taxable year as the actual taxable year of any one of the DISC's. The election as to which DISC's taxable year is to be used shall be made by the electing DISC attaching to its first return, filed under section 6011(e)(2), a statement indicating which such taxable year will be used. Once such an election is made it may not be revoked until such time as all of the DISC's which are members of the group use the same taxable year. If this subparagraph applies, books and records must be kept by the group which are adequate to show the necessary computations under section 995(d).

(3) This paragraph may be illustrated by the following example:

*Example.* Corporation X and corporation Y are members of the same controlled group and each has elected to be treated as a DISC. X uses a taxable year ending March 31, and Y uses a taxable year ending November 30. Notwithstanding the fact that all other members of the group use the calendar year as their taxable year, all computations for purposes of determining the amount of foreign investment attributable to producer's loans under section 995(d) must be made as if both DISC's use a taxable year ending either March 31 (X's taxable year) or November 30 (Y's taxable year).

[T.D. 7324, 39 FR 35114, Sept. 30, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51742, Nov. 17, 1982]

### § 1.995–6 Taxable income attributable to military property.

(a) *Gross income attributable to military property.* For purposes of section 995(b)(3)(A)(i), the term ''gross income which is attributable to military property'' includes income from the sale, exchange, lease, or rental of military property (as described in paragraph (c) of this section). The term also includes gross income from the performance of services which are related and subsidiary (as defined in § 1.993–1(d)) to any qualified sale, exchange, lease, or rental of military property. Where gross income cannot be determined on an item by item basis, the gross income with respect to those items not so determinable shall be apportioned. Such apportionment shall be accomplished using appropriate facts and circumstances, so that the gross income apportioned to sale of military property bears a reasonably close factual relationship to the actual gross income earned on such sales. The apportionment shall be based on methods which include the fair market value of property sold or exchanged, the fair rental value of any leaseholds granted, the

fair market value of any related or subsidiary services performed in connection with such sale or leases or methods based on gross receipts or costs of goods sold, where appropriate.

(b) *Deductions.* For purposes of section 995(b)(3)(A)(ii), deductions shall be properly allocated and apportioned to gross income, described in paragraph (a) of this section, in accordance with the rules of §1.861–8. These deductions include all applicable deductions from gross income provided under part VI of subchapter B of chapter 1 of the Code.

(c) *Military property.* For purposes of this section, the term *military property* means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778 which superseded 22 U.S.C. 1934) and the regulations thereunder (22 CFR 121.01).

(d) *Illustration.* The principles of this section may be illustrated by the following example:

*Example.* X Corporation elects to be a DISC for the first time in 1976. X has taxable income of $50,000, of which $30,000 is attributable to military property and $10,000 to interest on producer's loans. The total deemed distributions with respect to X are as follows:

| | |
|---|---|
| (1) Gross interest from Producer's loans in 1976 | $10,000 |
| (2) 50 percent of the taxable income of the DISC attributable to military property in 1976 | 15,000 |
| (3) One-half of the excess of taxable income for 1976 over the sum of lines (1) and (2) (½ of ($50,000 minus $25,000)) | 12,500 |
| (4) Total deemed distributions (sum of total lines (1), (2), and (3)) | 37,500 |

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7984, 49 FR 40019, Oct. 12, 1984]

### § 1.996–1 Rules for actual distributions and certain deemed distributions.

(a) *General rule.* Under section 996(a)(1), any actual distribution (other than a distribution described in paragraph (b) of this section or to which §1.995–4 applies) to a shareholder by a DISC, or former DISC, which is made out of earnings and profits shall be treated as made—

(1) First, out of ''previously taxed income'' (as defined in §1.996–3(c)) to the extent thereof,

(2) Second, out of ''accumulated DISC income'' (as defined in §1.996–3(b)) to the extent thereof, and

(3) Third, out of ''other earnings and profits'' (as defined in §1.996–3(d)) to the extent thereof.

(b) *Rules for qualifying distributions and deemed distributions under section 995(b)(1)(G)*—(1) *In general.* Except as provided in subparagraph (2), any actual distribution to meet qualification requirements made pursuant to §1.992–3 and any deemed distribution pursuant to §1.995–2(a)(5) (relating to foreign investment attributable to producer's loans) which is made out of earnings and profits shall be treated as made—

(i) First, out of ''accumulated DISC income'' (as defined in §1.996–3(b)) to the extent thereof.

(ii) Second, out of ''other earnings and profits'' (as defined in §1.996–3(d)) to the extent thereof, and

(iii) Third, out of ''previously taxed income'' (as defined in §1.996–3(c)) to the extent thereof.

(2) *Special rule.* For taxable years beginning after December 31, 1975, paragraph (b)(1) of this section shall apply to one-half of the amount of an actual distribution made pursuant to §1.992–3 to satisfy the condition of §1.992–1(b) (the gross receipts test) and paragraph (a) of this section shall apply to the remaining one-half of such amount.

(c) *Exclusion from gross income.* Under section 996(a)(3), amounts distributed out of previously taxed income shall be excluded by the distributee from gross income. However, see §1.996–5(b) for treatment as gain from the sale or exchange of property of the portion of an actual distribution out of previously taxed income to the extent it exceeds the adjusted basis of the stock with respect to which the distribution is made.

(d) *Priority of distributions.* Under section 996(c), for purposes of determining their treatment under paragraphs (a), (b), and (c) of this section, distributions made during a taxable year shall be treated as being made in the following order—

(1) Deemed distributions under §§1.995–2 and 1.995–3.

(2) Actual distributions to meet qualification requirements made pursuant to §1.992–3 in the order in which they are made, and

(3) Other actual distributions in the order in which they are made.

Thus, the treatment of any distribution shall be determined after the divisions of earnings and profits have been properly adjusted by taking into account distributions of higher priority which are made or deemed made during the same taxable year.

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

*Example 1.* Y Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. During 1973, Y makes a cash distribution of $100 to X Corporation, Y's sole shareholder. For 1973, Y has no earnings and profits. As of the beginning of 1973, Y has $300 of accumulated earnings and profits, which consist of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. The entire $100 distribution is a dividend under section 316. However, $40 thereof is treated as made out of previously taxed income and is thus excluded from gross income. Accordingly, only $60 is treated as distributed out of accumulated DISC income and includible in gross income. See §1.246–4 for the inapplicability of the dividend received deduction with respect to the entire distribution of $100.

*Example 2.* Assume the same facts as in example 1, except that the cash distribution is designated as a distribution to meet qualification requirements made pursuant to §1.992–3. Under these facts, X includes the entire distribution in its gross income as a dividend. Of the $100 distributed, $70 is treated as made out of accumulated DISC income and the remaining $30 is treated as made out of other earnings and profits. The dividend received deduction under section 243 is available only with respect to such $30.

*Example 3.* Y Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. As of the end of 1975, Y had failed to meet the gross receipts test for that year. In 1975 Y had $100 of taxable income, $80 of which was attributable to qualified export receipts and $20 of which was attributable to receipts that did not qualify as qualified export receipts. As of the beginning of 1976, Y had $300 of accumulated earnings and profits, which consisted of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. In 1976 Y makes a cash distribution of $20 pursuant to §1.992–3 in order to satisfy the gross receipts test for 1975. For 1976 Y has no earnings and profits and no deemed distributions. The entire $20 distribution is a dividend under section 316. Under §1.996–1(b)(2), half of the $20 cash distribution is treated pursuant to §1.996–1(b)(1) and half is treated pursuant to §1.996–1(a). Thus, $10 is treated as distributed out of accumulated DISC income and is includible in gross income. The other $10 is treated as made out of previously taxed income and is thus excluded from gross income. As of the beginning of 1977, Y has $280 of accumulated earnings and profits, which consists of $60 of accumulated DISC income, $30 of previously taxed income, and $190 of other earnings and profits.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982]

### § 1.996–2 Ordering rules for losses.

(a) *In general.* Under section 996(b), if for any taxable year a DISC, or a former DISC, incurs a deficit in earnings and profits, such deficit shall be charged—

(1) First, to other earnings and profits (as defined in §1.996–3(d)) to the extent thereof,

(2) Second, to accumulated DISC income (as defined in §1.996–3(b)) to the extent thereof, subject to the special rule in paragraph (b) of this section,

(3) Third, to previously taxed income (as defined in §1.996–3(c)) to the extent thereof, and

(4) To the extent that the amount of such deficit exceeds the sum of the amounts charged in accordance with subparagraphs (1), (2), and (3) of this paragraph, to other earnings and profits (as defined in §1.996–3(d)).

Thus, the excess deficit charged to other earnings and profits under subparagraph (4) of this paragraph will create a deficit therein in the amount of such excess. To determine the amount of any division of earnings and profits for the purpose of determining under §1.996–1 the treatment of any actual and certain deemed distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316–2(b) for determining the amount of earnings and profits available on the date of any distribution.

(b) *Deficits subsequent to a disqualification.* A deficit in earnings and profits of

a DISC, or former DISC, shall not be charged to accumulated DISC income which has been determined is to be deemed distributed to the shareholders pursuant to §1.995–3 as a result of a revocation of election or other disqualification. Thus, in accordance with paragraph (a) of this section as modified by this paragraph, a deficit incurred by a former DISC following such a revocation or disqualification shall be charged first to other earnings and profits and then to previously taxed income with any balance being charged to other earnings and profits and creating a deficit therein. The preceding sentence shall also apply in the case of a deficit incurred by a DISC which has no accumulated DISC income accumulated during its current taxable year and all immediately preceding consecutive taxable years for which it was a DISC. If as a result of the application of this paragraph the amount of a deficit in other earnings and profits exceeds the amount of a deficit in accumulated earnings and profits, then upon any subsequent actual distribution the deficit in other earnings and profits shall be reduced by the lower of (1) the amount of such actual distribution chargeable to accumulated DISC income or previously taxed income or (2) the amount of such excess.

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

*Example 1.* X Corporation, which uses the calendar year as its taxable year, becomes a DISC beginning with 1976. In addition to other facts assumed in the table below, X incurs a deficit in earnings and profits for 1979 of $70. Such deficit is charged to the divisions of X's earnings and profits pursuant to paragraph (a) of this section in the manner set forth in such table.

| | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|
| Balance January 1, 1976 | ..... | ..... | $50 |
| Increase for 1976 | $10 | $8 | |
| Increase for 1977 | 10 | 8 | |
| Increase for 1978 | 10 | 8 | |
| Balance January 1, 1979 | 30 | 24 | 50 |
| Deficit for 1979 of $70: | | | |
| Charge No. 1 | ..... | ..... | (50) |
| Charge No. 2 | (20) | | |
| Balance January 1, 1980 | 10 | ..... | 0 |

*Example 2.* Assume the same facts as in example 1, except that effective for taxable years beginning with 1979, X revokes its election to be treated as a DISC. Under §1.995–3, X has $30 of accumulated DISC income which is to be deemed distributed $10 per year in 1980, 1981, and 1982. The deficit in earnings and profits for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

| | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|
| Balance January 1, 1979 | $30 | $24 | $50 |
| Deficit for 1979 of $70:. | | | |
| Charge No. 1 | ..... | ..... | (50) |
| Charge No. 2 | ..... | (20) | ..... |
| Balance January 1, 1980 | 30 | 4 | 0 |

*Example 3.* Assume the same facts as in example 2, except that the deficit in earnings and profits for 1979 is $120. Assume further that for 1980, 1981, and 1982, during which years X's shareholders are receiving scheduled installments of the deemed distributions of accumulated DISC income under §1.995–3, X, a former DISC, has neither earnings and profits nor a deficit in earnings and profits. The $120 deficit for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

| | Accumulated DISC income | Previously taxed income | Other earnings and profits | Accumulated earnings and profits |
|---|---|---|---|---|
| Balance January 1, 1979 | $30 | $24 | $50 | $104 |
| Deficit for 1979 of $120 | ..... | ..... | ..... | (120) |
| Charge No. 1 | ..... | ..... | (50) | ..... |
| Charge No. 2 | ..... | (24) | ..... | ..... |
| Charge No. 3 | ..... | ..... | (46) | ..... |
| Balance January 1, 1980 | 30 | 0 | (46) | (16) |
| Deemed distributions in 1980 under §1.995–3 | (10) | 10 | ..... | ..... |
| Balance January 1, 1981 | 20 | 10 | (46) | (16) |

*Example 4.* Assume the same facts as in example 3, except that on December 31, 1980, X makes an actual distribution of $10 out of

previously taxed income. On January 1, 1981, X has $20 of accumulated DISC income, no previously taxed income, and a deficit of $36 in other earnings and profits. The deficit of $16 in accumulated earnings and profits remains the same.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974]

### § 1.996–3 Divisions of earnings and profits.

(a) *In general.* For purposes of sections 991 through 997, the earnings and profits of a DISC, or former DISC, shall be treated as composed of the following three divisions:

(1) Accumulated DISC income (as defined in paragraph (b) of this section),

(2) Previously taxed income (as defined in paragraph (c) of this section), and

(3) Other earnings and profits (as defined in paragraph (d) of this section),

(b) *Accumulated DISC income defined.* (1) Accumulated DISC income is that portion of a corporation's earnings and profits which were derived during taxable years for which it qualified as a DISC and which were deferred from taxation. Accumulated DISC income as of the close of each taxable year of the corporation is—

(i) The amount of accumulated DISC income as of the close of the immediately preceding taxable year increased by,

(ii) The amount of DISC income for the year (as determined in subparagraph (2) of this paragraph) and reduced (but not below zero) by,

(iii) The items enumerated in subparagraph (3) of this paragraph.

(2) Under section 996(f)(1), DISC income is (i) the earnings and profits derived by the corporation during a taxable year for which such corporation is a DISC minus (ii) amounts deemed distributed under §1.995–2 other than the amount of foreign investment attributable to producer's loans described in §1.995–2(a)(5). For example, the earnings and profits of a DISC for a taxable year include any amounts includible in such DISC's gross income pursuant to section 951(a) (relating to controlled foreign corporations). Deemed distributions under §1.995–2(a)(5) are taken into account under subparagraph (3) of this paragraph as a reduction in computing accumulated DISC income.

(3) The accumulated DISC income (as increased by DISC income for the year determined under subparagraph (2) of this paragraph) is reduced by each of the following items in the following order:

(i) Any amount deemed distributed for such year under §1.995–3 (relating to deemed distributions upon disqualification),

(ii) Any amount of foreign investment attributable to producer's loans deemed distributed for such year under §1.995–2(a)(5) to the extent it is charged to accumulated DISC income under §1.996–1(b)(1)(i),

(iii) The amount of any adjustment to accumulated DISC income for such year under §1.966–4(b)(1), and

(iv) To the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of accumulated DISC income, the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to each actual distribution, accumulated DISC income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(2) to accumulated DISC income.

(4) Every distribution or other reduction in accumulated DISC income pursuant to subparagraph (3) of this paragraph shall be charged to the most recently accumulated DISC income.

(c) *Previously taxed income.* Under section 996(f)(2), previously taxed income as of the close of each taxable year of the corporation is an amount equal to—

(1) The sum of—

(i) The amount of previously taxed income as of the close of the immediately preceding taxable year,

(ii) Amounts deemed distributed for the current year under §1.995–2 (relating to deemed distributions in qualified years),

(iii) Amounts deemed distributed for the current year under §1.995–3 (relating to deemed distributions upon disqualification),

(iv) With respect to a distribution in redemption to which §1.996–4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the amount of the reduction under §1.996–4(b)(1) in accumulated DISC income over (*b*) the reduction in the corporation's earnings and profits (see section 312(e)), and

(v) Any amount by which accumulated DISC income is reduced under paragraph (b)(3)(ii) of this section by reason of a deemed distribution as a dividend, under §1.995–2(a)(5), of an amount of foreign investment attributable to producer's loans,

(2) Decreased (but not below zero), to the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of previously taxed income, by the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, previously taxed income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(3) to previously taxed income.

(d) *Other earnings and profits.* Under section 996(f)(3), other earnings and profits consist of earnings and profits other than accumulated DISC income and previously taxed income described respectively in paragraphs (b) and (c) of this section. Other earnings and profits as of the close of each taxable year of the corporation is (subject to paragraph (e) of this section) an amount equal to the amount of other earnings and profits as of the close of the immediately preceding taxable year decreased (if necessary, below zero) in the following order by—

(1) To the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of other earnings and profits, the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, other earnings and profits shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(1) to other earnings and profits, and

(2) With respect to a distribution in redemption to which §1.996–4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the reduction in the corporation's earnings and profits (see section 312(e)) over (*b*) the amount of the reduction under §1.996–4(b)(1) in accumulated DISC income.

(e) *Distributions in kind.* (1) For purposes of determining, under paragraphs (b), (c), and (d) of this section, the amount by which any division of earnings and profits is reduced by reason of a distribution of property (other than money or the DISC's, or former DISC's, own obligations), the amount of such distribution is the fair market value of such property at the time of the distribution.

(2) For any taxable year in which the DISC makes a distribution of such property, the amount of other earnings and profits determined under paragraph (d) of this section (without regard to this subparagraph) shall be—

(i) Increased by the excess (if any) of the amount of such distribution treated as a dividend under section 316(a) over the adjusted basis of such property, and

(ii) Decreased by the excess (if any) of the adjusted basis of such property over the amount of such distribution treated as a dividend under section 316 (a).

Each item of property shall be considered separately for purposes of making the adjustment under this subparagraph.

(f) *Examples.* The provisions of §§1.996–1, 1.996–2, and this section may be illustrated by the following examples:

*Example 1.* M Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. During 1975, M derives no earnings and profits and makes no deemed or actual distributions, except that on December 31, 1975, M's shareholders are treated as having received a dividend distribution of $100 under §1.995–2 (a)(5) (relating to foreign investment attributable to producer's loans). M's earnings and profits are adjusted as shown on line (2) of the table below on the basis of facts assumed therein.

| | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|
| (1) Balance January 1, 1975 | $450 | $100 | $250 | $100 |
| (2) Adjustments (see paragraphs (b)(3)(ii) and (c)(1)(v) of this section) | 0 | (100) | 100 | 0 |
| (3) Balance January 1, 1976 | 450 | 0 | 350 | 100 |

*Example 2.* N Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. During 1973, N derives no earnings and profits for the year and makes no deemed or actual distributions, except that A, a shareholder, realized $200 of gain upon receiving an actual cash distribution of $300 in redemption of N stock having an adjusted basis of $100 in his hands. The redemption is treated as an exchange under section 302(a) but, under section 995(c), A includes the $200 of gain in his gross income as a dividend. Assuming that, under section 312(e), $240 is properly chargeable to capital account of N and that, under §1.996–4(b), accumulated DISC income is reduced by $200, N's accounts are adjusted on line (2) of the table below on the basis of facts assumed therein.

| | Capital | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|---|
| (1) Balance January 1, 1973 | $2,000 | $400 | $300 | $100 | 0 |
| (2) Adjustments (see §1.996–4(b) and paragraph (c)(1)(iv) of this section) | (240) | (60) | (200) | 140 | 0 |
| (3) Balance January 1, 1974 | 1,760 | 340 | 100 | 240 | 0 |

*Example 3.* P Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1973. During 1974, P derives no earnings and profits for the year and makes no deemed or actual distributions, except for a distribution to B, its sole shareholder, of property with a fair market value of $100 and an adjusted basis in P's hands of $40. Under §1.996–1(a)(1), B treats the entire amount of the distribution as being made out of previously taxed income and, under §1.996–1(c), excludes it from his gross income. P's earnings and profits, divisions are adjusted on lines (2) and (3) of the table below on the basis of facts assumed therein.

| | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|
| (1) Balance January 1, 1974 | $200 | $80 | $120 | 0 |
| (2) Adjustment under paragraphs (c)(2) and (e)(1) this section | (40) | 0 | (100) | 0 |
| (3) Adjustment under paragraph (e)(2)(i) of this section | 0 | 0 | 0 | $60 |
| (4) Balance January 1, 1975 | 160 | 80 | 20 | 60 |

*Example 4.* Q Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. On January 1, 1975, Q has accumulated earnings and profits of $1,200 and, during 1975, Q incurs a deficit in earnings and profits of $365. The amount of such deficit incurred as of any date before the close of 1975 cannot be shown. On July 1, 1975, Q makes a cash distribution of $650, with respect to its stock to C, Q's sole shareholder. C subsequently transfers by gift all of his Q stock to D. On December 31, 1975, Q makes a cash distribution of $650, with respect to its stock, to D. Under these facts and additional facts assumed in the table below, C is treated as having received a dividend of $650 of which $320 is treated as distributed out of previously taxed income and excluded from gross income. D is treated as receiving a dividend of $186. Adjustments to Q's earnings and profits accounts are illustrated in the table below:

| | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|
| (1) Balance January 1, 1975 | $1,200 | $800 | $320 | $80 |
| (2) Portion of 1975 deficit of $365 chargeable as of June 30, 1975, pursuant to § 1.996–2(a) | (181) | (101) | 0 | (80) |
| (3) Balance July 1, 1975 | 1,019 | 699 | 320 | 0 |
| (4) $650 distributed to C on July 1, 1975 | (650) | (330) | (320) | 0 |
| (5) Portion of 1975 deficit of $365 chargeable as of December 30, 1975, pursuant to § 1.996–2(a) | (183) | (183) | 0 | 0 |
| (6) Balance December 31, 1975 | $186 | $186 | 0 | 0 |
| (7) $650 distributed to D on December 31, 1975 [1] | (186) | (186) | 0 | 0 |
| (8) Balance January 1, 1976 | 0 | 0 | 0 | 0 |

[1] $60 treated as return of capital pursuant to section 301(c)(2).

*Examples 5:* (1) *Facts.* R Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. X Corporation is its sole shareholder. At the beginning of 1974, R has a deficit in earnings and profits of $60 all of which is composed of ''other earnings and profits''. For 1974, R has earnings and profits of $80 before reduction for any distributions and taxable income of $70. On June 15, 1974, R makes a cash distribution to X of $60, with respect to its stock, to which section 301 applies. On August 15, 1974, R makes a cash distribution to X of $30 designated as a distribution to meet qualification requirements pursuant to § 1.992–3. Under § 1.995–2(a), X is deemed to receive, on December 31, 1974, a distribution of a dividend of $35, i.e., one-half of R's taxable income of $70. The tax consequences of these facts to X and their effect on R's earnings and profits are set forth in the subsequent subparagraphs of this example.

(2) *Dividend treatment of actual distributions.* Since R had $80 of earnings and profits for 1974 and a deficit in accumulated earnings and profits at the beginning of 1974, only $80 of the actual distributions ($90) are treated as dividends under sections 301(c)(1) and 316(a)(2). ($10 of the actual distribution, which is not treated as a dividend is treated in the manner specified in section 301(c) (2) and (3).) Thus, under § 1.316–2(b), $26.67 of the actual qualifying distribution made on August 15, 1974 ($30× $80/$90), and $53.33 of the actual distribution made on June 15, 1974 ($60×$80/$90), are considered made out of earnings and profits.

(3) *Priority of distributions.* Under § 1.996–1(d), for purposes of adjusting the divisions of R's earnings and profits and determining the treatment of subsequent distributions, the sequence in which each distribution is treated as having been made is—

(i) First, the deemed distribution of $35,

(ii) Second, the actual qualifying distribution of $30 made on August 15, 1974, pursuant to § 1.992–3, and

(iii) Finally, the actual distribution of $60 made on June 15, 1974.

(4) *Treatment and effect of deemed distribution.* Under § 1.995–2(a), on December 31, 1974, X includes the deemed distribution of $35 in its gross income as a dividend. Under paragraph (c)(1)(ii) of this section, R's previously taxed income is increased by $35 as shown on line (3) of the table in subparagraph (7) of this example. Under paragraph (b)(1)(ii) and (2) of this section, accumulated DISC income is increased by $45 of DISC income, i.e., R's earnings and profits for 1974, $80, minus the deemed distribution of $35, as shown on line (4) of the table.

(5) *Treatment and effect of actual qualifying distribution of $30.* As indicated in subparagraph (2) of this example, $26.67 of the $30 qualifying distribution on August 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996–1(b)(1)(i), the entire $26.67 is treated as distributed out of accumulated DISC income. Thus, on August 15, 1974, X includes $26.67 in its gross income as a dividend. No deduction is allowable under section 243. Under paragraph (b)(3)(iv) of this section, R's accumulated DISC income is reduced by $26.67 as shown on line (6) of the table in subparagraph (7) of this example.

(6) *Treatment and effect of actual distribution of $60.* As indicated in subparagraph (2) of this example, $53.33 of the $60 distribution on June 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996–1(a), the $53.33 is treated as distributed out of previously taxed income to the extent thereof, $35, and then out of accumulated DISC income, $18.33. Thus, on June 15, 1974, X includes $18.33 in its gross income as a dividend. Under § 1.996–1(c), the distribution of $35 out of previously taxed income is excluded from gross income. No deduction is allowable under section 243 with respect to the actual distribution of $53.33. Under paragraph (b)(3)(iv) of this section, accumulated DISC income is reduced by $18.33 and, under paragraph (c)(2) of this section, previously taxed income is reduced by $35, as shown on

line (7) of the table in subparagraph (7) of this example.

(7) *Summary.* The effects on earnings and profits and the divisions of earnings and profits are summarized in the following table:

| | Earnings and profits for year | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|---|
| (1) Balance January 1, 1974 | ..... | ($60.00) | ..... | ..... | ($60.00) |
| (2) Earnings and profits for year before reduction for distributions | $80.00 | ..... | ..... | ..... | ..... |
| (3) Deemed distribution of $35 to X on December 31, 1974, under § 1.995–2(a) | ..... | ..... | ..... | $35.00 | ..... |
| (4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35)) | ..... | ..... | $45.00 | ..... | ..... |
| (5) Balance before actual distributions | 80.00 | (60.00) | 45.00 | 35.00 | (60.00) |
| (6) Qualifying distribution of $30 to X on August 15, 1974, pursuant to § 1.992–3 | (26.67) | ..... | (26.67) | ..... | ..... |
| (7) Actual distribution to P of $60 on June 15, 1974 | (53.33) | ..... | (18.33) | (35.00) | ..... |
| (8) Balance January 1, 1975 | 0 | (60.00) | 0 | ..... | (60.00) |

*Example 6.* Assume the facts are the same as in example 5, except that at the beginning of 1974 R's accumulated earnings and profits amount to $60 consisting of accumulated DISC income of $20, previously taxed income of $10, and other earnings and profits of $30. In addition, on August 1, 1974, X transfers all R's stock to Y Corporation in a reorganization described in section 368(a)(1)(B) in which under section 354 X recognizes no gain or loss. Under these facts, X includes in its gross income for 1974 a dividend of $15 which is attributable to the actual distribution of $60 paid out of earnings and profits on June 15, 1974. X excludes from gross income the balance of the $60 distribution ($45) paid out of earnings and profits because, under § 1.996–1(a), it is treated as paid out of previously taxed income. Y includes in its gross income for 1974 a dividend of $65 of which $35 is attributable to the deemed distribution of a dividend to Y on December 31, 1974, under § 1.995–2(a) and $30 is attributable to the qualifying distribution paid out of earnings and profits to Y on August 15, 1974. The adjustments to R's earnings and profits are summarized in the following table:

| | Earnings and profits for year | Accumulated earnings and profits | Accumulated DISC income | Previously taxed income | Other earnings and profits |
|---|---|---|---|---|---|
| (1) Balance January 1, 1974 | ..... | $60 | $20 | $10 | $30 |
| (2) Earnings and profits for year before reduction for distributions | $80 | ..... | ..... | ..... | ..... |
| (3) Deemed distribution of $35 to Y on December 31, 1974, under § 1.995–2(a) | ..... | ..... | ..... | 35 | ..... |
| (4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35)) | ..... | ..... | 45 | ..... | ..... |
| (5) Balance before actual distributions | 80 | 60 | 65 | 45 | 30 |
| (6) Qualifying distribution of $30 to Y on August 15, 1974, pursuant to § 1.992–3 | (26.67) | (3.33) | (30) | ..... | ..... |
| (7) Actual distribution to X of $60 on June 15, 1974 | (53.33) | (6.67) | (15) | (45) | ..... |
| (8) Balance January 1, 1975 | ..... | 50 | 20 | 0 | 30 |

(g) *DISCs having corporate and noncorporate shareholders.* In the case of a DISC having one or more corporate shareholders but less than all of its shareholders subject to the special rules of section 291(a)(4), relating to certain deferred DISC income as a corporate preference item, accumulated DISC income and previously taxed income of the DISC are divided between the corporate shareholders, as a class, and the other shareholders, as a class,

in proportion to amounts of DISC income not deemed distributed and amounts deemed distributed to each class. Subsequent taxation of actual and qualifying distributions shall be based upon this division. Thus, if a DISC is owned 50 percent by corporate shareholders and 50 percent by individual shareholders and has undistributed taxable income of $2,000 for its year, the division is made as follows:

| | |
|---|---|
| Corporate shareholders: | |
| Previously taxed income (57.5% of $2,000÷2) | $575 |
| Accumulated DISC income (42.5% of $2,000÷2) | 425 |
| Individual shareholders: | |
| Previously taxed income (50% of $2,000÷2) | 500 |
| Accumulated DISC income (50% of $2,000÷2) | 500 |

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35121, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982; T.D. 7984, 49 FR 40024, Oct. 12, 1984]

### § 1.996–4 Subsequent effect of previous disposition of DISC stock.

(a) *Shareholder adjustment for previously taxed income.* (1) Under section 996(d)(1), except as provided in subparagraph (2) of this paragraph, if—

(i) Gain with respect to a share of stock of a DISC, or former DISC, is treated under §1.995–4 as a dividend, and

(ii) With respect to such share, any person subsequently receives an actual distribution made out of accumulated DISC income, or a deemed distribution made, pursuant to §1.995–3, by reason of disqualification, out of accumulated DISC income,

then such person shall treat such distribution in the same manner as a distribution from previously taxed income (and thus excludable from gross income under §1.996–1(c)) to the extent that the gain referred to in subdivision (i) of this subparagraph exceeds the aggregate amount of any other distributions with respect to such share which were treated under this subparagraph as made from previously taxed income.

(2) In applying subparagraph (1) of this paragraph with respect to a share of stock in a DISC, or former DISC, the gain referred to in subparagraph (1)(i) of this paragraph does not include any gain to a shareholder on a redemption of such share which qualifies as an exchange under section 302(a) or any gain on a disposition of such share prior to such redemption. Distributions described in subparagraph (1)(ii) of this paragraph do not include a distribution in a redemption which qualifies as an exchange under section 302(a). For adjustments to accumulated DISC income by reason of dividend treatment under §1.995–4 with respect to gain upon a redemption of DISC stock to which section 302(a) applies and upon a prior disposition of such stock, see paragraph (b) of this section.

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

*Example.* In 1974, under §1.995–4, A, a shareholder of a DISC, on the sale of his DISC stock to B, is required to treat $20 of his gain as a dividend. The DISC has no previously taxed income and $40 of accumulated DISC income. Subsequently in the same year, B, the purchaser of the stock, receives an actual dividend distribution of $15 with respect to such stock which, under §1.996–1(a), is treated as made out of accumulated DISC income. The amounts of the DISC's previously taxed income and accumulated DISC income were not adjusted by reason of the $20 treated as a dividend on the prior sale. However, even though the DISC had no previously taxed income, the purchaser would treat the $15 as though it had been paid out of previously taxed income and, therefore would not include the $15 in gross income. If in 1975, B receives another actual distribution of $9 with respect to such stock, $5 (*i.e.*, $20 dividend on A's sale less the $15 distribution to B in 1974 which was treated under subparagraph (1) of this paragraph as made from previously taxed income) is treated as made from previously taxed income and excluded from gross income. The result would be the same if, on January 1, 1975, B had transferred such stock to C by gift and the $9 distribution had been made to C.

(b) *Corporate adjustment upon redemption.* (1) Under section 996(d)(2), if by reason of §1.995–4 gain on a redemption of stock in a DISC, or former DISC, is included in the shareholder's gross income as a dividend, then the accumulated DISC income shall be reduced by an amount equal to the sum of—

(i) The amount of gain on such redemption which, under §1.995–4, is treated as a dividend, and

(ii) The amount of any gain with respect to such redeemed stock which, under §1.995–4, was treated as a dividend on a disposition prior to such redemption minus the amount of distributions with respect to such stock which have been treated as made out of previously taxed income by reason of the application of paragraph (a)(1) of this section.

(2) The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* The entire stock of a DISC, which uses the calendar year as its taxable year, has been owned equally by A, B, C, and D since it was organized. At the close of 1976, when the DISC has $100 of accumulated DISC income, it redeems all of A's shares in a transaction qualifying as an exchange under section 302(a) and A, under §1.995–4, includes $25 in his gross income as a dividend. The redemption has the effect of reducing accumulated DISC income by $25 to $75.

*Example 2.* Assume the same facts as in example 1 except that the stock of the DISC has not been held equally by A, B, C, and D since its organization. A purchased his shares from X in 1974 in a transaction in which X, under §1.995–4, included in his gross income $30 as a dividend. In 1975, A receives a distribution of $10 out of accumulated DISC income which, under paragraph (a)(1) of this section, is treated as made out of previously taxed income. Under these facts, the redemption of A's stock in 1976 has the effect of reducing accumulated DISC income by $45 to $55 determined as follows:

| | | |
|---|---|---|
| (a) Accumulated DISC income | | $100 |
| (b) Minus sum of: | | |
| (1) Dividend on redemption of A's stock | $25 | |
| (2) Excess of dividend on X's sale ($30) over distribution to A treated as made out of previously taxed income ($10) | $20 | |
| Total | | 45 |
| (c) Accumulated DISC income on 12/31/76 | | 55 |

[T.D. 7324, 39 FR 35121, Sept. 30, 1974]

## § 1.996–5 Adjustment to basis.

(a) *Addition to basis.* Under section 996(e)(1) amounts representing deemed distributions as provided in section 995(b) shall increase the basis of the stock with respect to which the distribution is made.

(b) *Reductions of basis.* Under section 996(e)(2), the portion of an actual distribution treated as made out of previously taxed income shall reduce the basis of the stock with respect to which it is made and, to the extent that it exceeds the adjusted basis of such stock, shall be treated as gain from the sale or exchange of property. In the case of stock includible in the gross estate of a decedent for which an election is made under section 2032 (relating to alternate valuation), this paragraph shall not apply to any distribution made after the date of the decendent's death and before the alternate valuation date provided by section 2032. See section 1014(d) for a special rule for determining the basis of stock in a DISC, or former DISC, acquired from a decedent.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

## § 1.996–6 Effectively connected income.

In the case of a shareholder who is a nonresident alien individual or a foreign corporation, trust, or estate, amounts taxable as dividends by reason of the application of §1.995–4 (relating to gain on disposition of stock in a DISC), amounts treated under §1.996–1 as distributed out of accumulated DISC income, and amounts deemed distributed under §1.995–2(a) (1) through (4) shall be treated as gains and distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and shall be subject to tax in accordance with the provisions of section 871(b) and the regulations thereunder in the case of nonresident alien individuals, trusts, or estates, or section 882 and the regulations thereunder in the case of foreign corporations. In no case, however shall other income of such shareholder be taxable as effectively connected with the conduct of a trade or business through a permanent establishment in the United States solely because of the application of this section.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

## § 1.996–7 Carryover of DISC tax attributes.

(a) *In general.* Carryover of a DISC's divisions of earnings and profits to acquiring corporations in nontaxable transactions shall be subject to rules generally applicable to other corporate tax attributes. For example, a DISC

which acquires the assets of another DISC in a transaction to which section 381(a) applies shall succeed to, and take into account, the divisions of the earnings and profits of the transferor DISC in accordance with section 381(c)(2).

(b) *Allocation of divisions of earnings and profits in corporate separations.* (1) If one DISC transfers part of its assets to a controlled DISC in a transaction to which section 368(a)(1)(D) applies and immediately thereafter the stock of the controlled DISC is distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then—

(i) The earnings and profits of the distributing DISC immediately before the transaction shall be allocated between the distributing DISC and the controlled DISC in accordance with the provisions of §1.312–10.

(ii) Each of the divisions of such earnings and profits, namely previously taxed income, accumulated DISC income, and other earnings and profits, shall be allocated between the distributing DISC and the controlled DISC on the same basis as the earnings and profits are allocated.

(iii) Any assets of the distributing DISC whose status as qualified export assets is limited by its accumulated DISC income (e.g., producer's loans described in §1.993–4, Export-Import Bank and other obligations described in §1.993–2(h), and financing obligations described in §1.993–2(i)) shall be treated as having been allocated, for the purpose of determining the classification of such assets in the hands of the distributing DISC or the controlled DISC, on the same basis as the earnings and profits are allocated regardless of how such assets are actually allocated.

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

*Example.* On January 1, 1974, P Corporation transfers part of its assets to S Corporation, a newly organized subsidiary of P, in a transaction described in section 368(a)(1)(D) and distributes all the S stock in a transaction which qualifies under section 355. Immediately before such transfer, P had earnings and profits of $120,000 of which $100,000 constitutes accumulated DISC income. The unpaid balance of P's producer's loans is $80,000 all of which is retained by P. Pursuant to §1.312–10, 25 percent of P's accumulated DISC income is allocated to S (*i.e.*, $25,000). P's producer's loans will be treated as allocated to S in the same proportion. Accordingly, for purposes of determining, under §1.993–4(a)(3), the amount of producer's loans which S is entitled to make, S is treated as having an unpaid balance of producer's loans of $20,000 (*i.e.*, 25% × $80,000) and P is treated as having an unpaid balance of $60,000 (*i.e.*, 75% × $80,000).

(c) *Accumulated DISC income accounts of separate DISC's maintained after corporate combination.* If two or more DISC's combine to form a new DISC, or if the assets of one DISC are acquired by another DISC, in a transaction described in section 381(a), accumulated DISC income of the acquired DISC or DISC's shall carry over and be taken into account by the acquiring or new DISC, except that a separate account shall be maintained for the accumulated DISC income of any DISC scheduled to be received as a deemed distribution by its shareholders under §1.995–3 (relating to deemed distributions upon disqualification). If, as a part of such transaction, the stock of the DISC which has accumulated DISC income scheduled to be deemed distributed is exchanged for stock of the acquiring or new DISC to which such accumulated DISC income is carried over and which maintains a separate account, then such accumulated DISC income shall be deemed distributed pro rata to shareholders of the acquiring or new DISC on the basis of stock ownership immediately after the exchange.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

### §1.996–8 Effect of carryback of capital loss or net operating loss to prior DISC taxable year.

(a) Under §1.995–2(e), the deduction under section 172 for a net operating loss carryback or under section 1212 for a capital loss carryback is determined as if the DISC were a domestic corporation which had not elected to be treated as a DISC. A carryback of a net operating loss or of a capital loss of any corporation which reduces its taxable income for a preceding taxable year for which it qualified as a DISC will have the consequences enumerated in paragraphs (b) through (e) of this section.

(b) For such preceding taxable year, the amount of a deemed distribution of

one-half of certain taxable income described in §1.995–2(a)(4) will ordinarily be reduced in effect (but not below zero) by one-half of the sum of the amount of the deduction under section 172 for such year for net operating loss carrybacks and the amount of the deduction under section 1212 for such year for capital loss carrybacks.

(c) The amount of reduction in the deemed distribution under paragraph (b) of this section will have the effect of increasing the limitation, provided in §1.995–2(b)(2), on the amount of foreign investment attributable to producer's loans which is deemed distributed under §1.995–2(a)(5).

(d) If the amount of a deemed distribution for a preceding taxable year is reduced as described in paragraph (b) of this section, then for such preceding taxable year the previously taxed income (as defined in §1.996–3(c)) shall be decreased by the amount of such reduction and the accumulated DISC income (as defined in §1.996–3(b)) shall be increased by the amount of such reduction. Such adjustments shall be made as of the time the deemed distribution for such preceding taxable year is treated as having occurred. See §1.996–1(d) for the priority of such deemed distribution in relation to other distributions made in that preceding taxable year.

(e) The amount and treatment of any actual distribution made in such preceding taxable year or a year subsequent to such preceding year, and the treatment of gain on a disposition (in any such year) of the DISC's stock to which §1.995–4 applies, shall be properly adjusted to reflect the adjustments to previously taxed income and accumulated DISC income described in paragraph (d) of this section.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

### §1.997–1 Special rules for subchapter C of the Code.

(a) For purposes of applying the provisions of sections 301 through 395 of the Code, any distribution in property to a corporation by a DISC, or former DISC, which is made out of previously taxed income or accumulated DISC income shall be treated as a distribution in the same amount as if such distribution of property were made to an individual, and have a basis, in the hands of the recipient corporation, equal to such amount treated as having been distributed.

(b) This section may be illustrated by the following example:

*Example.* X Corporation is the sole shareholder of Y Corporation which is a DISC. Y makes an actual distribution of property to X with respect to X's stock in Y. The property has a basis of $50 and a fair market value of $100. The distribution is treated as made out of accumulated DISC income under section 996(a) and is taxable as a dividend under section 301(c)(1). Even though X is a corporation, the amount of the distribution is $100 notwithstanding the provisions of section 301(b)(1)(B) and the basis the property in X's hands is $100 notwithstanding the provisions of section 301(d)(2).

[T.D. 7324, 39 FR 35125, Sept. 30 1974]

### §§1.998–1.1000 [Reserved]

# FINDING AIDS

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# Table of OMB Control Numbers

The OMB control numbers for chapter I of title 26 were consolidated into §§ 601.9000 and 602.101 at 50 FR 10221, Mar. 14, 1985. At 61 FR 58008, Nov. 12, 1996, § 601.9000 was removed. Section 602.101 is reprinted below for the convenience of the user.

## PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

### § 602.101 OMB Control numbers.

(a) *Purpose.* This part collects and displays the control numbers assigned to collections of information in Internal Revenue Service regulations by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1980. The Internal Revenue Service intends that this part comply with the requirements of §§ 1320.7(f), 1320.12, 1320.13, and 1320.14 of 5 CFR part 1320 (OMB regulations implementing the Paperwork Reduction Act), for the display of control numbers assigned by OMB to collections of information in Internal Revenue Service regulations. This part does not display control numbers assigned by the Office of Management and Budget to collections of information of the Bureau of Alcohol, Tobacco, and Firearms.

(b) *Display.*

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| 1.148–4 | 1545–1098 |
| | 1545–1347 |
| 1.148–5 | 1545–1098 |
| | 1545–1490 |
| 1.148–6 | 1545–1098 |
| | 1545–1451 |
| 1.148–7 | 1545–1098 |
| | 1545–1347 |
| 1.148–8 | 1545–1098 |
| 1.148–11 | 1545–1098 |
| | 1545–1347 |
| 1.149(e)–1 | 1545–0720 |
| 1.150–1 | 1545–1347 |
| 1.151–1 | 1545–0074 |
| 1.152–3 | 1545–0071 |
| | 1545–1783 |
| 1.152–4 | 1545–0074 |
| 1.152–4T | 1545–0074 |
| 1.162–1 | 1545–0139 |
| 1.162–2 | 1545–0139 |
| 1.162–3 | 1545–0139 |
| 1.162–4 | 1545–0139 |
| 1.162–5 | 1545–0139 |
| 1.162–6 | 1545–0139 |
| 1.162–7 | 1545–0139 |
| 1.162–8 | 1545–0139 |
| 1.162–9 | 1545–0139 |
| 1.162–10 | 1545–0139 |
| 1.162–11 | 1545–0139 |
| 1.162–12 | 1545–0139 |
| 1.162–13 | 1545–0139 |
| 1.162–14 | 1545–0139 |
| 1.162–15 | 1545–0139 |
| 1.162–16 | 1545–0139 |
| 1.162–17 | 1545–0139 |
| 1.162–18 | 1545–0139 |
| 1.162–19 | 1545–0139 |
| 1.162–20 | 1545–0139 |
| 1.162–27 | 1545–1466 |
| 1.163–5 | 1545–0786 |
| | 1545–1132 |
| 1.163–8T | 1545–0995 |
| 1.163–10T | 1545–0074 |
| 1.163–13 | 1545–1491 |
| 1.163(d)–1 | 1545–1421 |
| 1.165–1 | 1545–0177 |
| 1.165–2 | 1545–0177 |
| 1.165–3 | 1545–0177 |
| 1.165–4 | 1545–0177 |
| 1.165–5 | 1545–0177 |
| 1.165–6 | 1545–0177 |
| 1.165–7 | 1545–0177 |
| 1.165–8 | 1545–0177 |
| 1.165–9 | 1545–0177 |
| 1.165–10 | 1545–0177 |
| 1.165–11 | 1545–0074 |
| | 1545–0177 |
| | 1545–0786 |
| 1.165–12 | 1545–0786 |
| 1.166–1 | 1545–0123 |
| 1.166–2 | 1545–1254 |
| 1.166–4 | 1545–0123 |

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| 1.166–10 | 1545–0123 |
| 1.167(a)–5T | 1545–1021 |
| 1.167(a)–7 | 1545–0172 |
| 1.167(a)–11 | 1545–0152 |
| | 1545–0172 |
| 1.167(a)–12 | 1545–0172 |
| 1.167(d)–1 | 1545–0172 |
| 1.167(e)–1 | 1545–0172 |
| 1.167(f)–11 | 1545–0172 |
| 1.167(l)–1 | 1545–0172 |
| 1.168(d)–1 | 1545–1146 |
| 1.168(f)(8)–1T | 1545–0923 |
| 1.168(i)–1 | 1545–1331 |
| 1.168–5 | 1545–0172 |
| 1.169–4 | 1545–0172 |
| 1.170–1 | 1545–0074 |
| 1.170–2 | 1545–0074 |
| 1.170–3 | 1545–0123 |
| 1.170A–1 | 1545–0074 |
| 1.170A–2 | 1545–0074 |
| 1.170A–4(A)(b) | 1545–0123 |
| 1.170A–8 | 1545–0074 |
| 1.170A–9 | 1545–0052 |
| | 1545–0074 |
| 1.170A–11 | 1545–0123 |
| | 1545–0074 |
| | 1545–1868 |
| 1.170A–12 | 1545–0020 |
| | 1545–0074 |
| 1.170A–13 | 1545–0074 |
| | 1545–0754 |
| | 1545–0908 |
| | 1545–1431 |
| 1.170A–13(f) | 1545–1464 |
| 1.170A–14 | 1545–0763 |
| 1.171–4 | 1545–1491 |
| 1.171–5 | 1545–1491 |
| 1.172–1 | 1545–0172 |
| 1.172–13 | 1545–0863 |
| 1.173–1 | 1545–0172 |
| 1.174–3 | 1545–0152 |
| 1.174–4 | 1545–0152 |
| 1.175–3 | 1545–0187 |
| 1.175–6 | 1545–0152 |
| 1.177–1 | 1545–0172 |
| 1.179–2 | 1545–1201 |
| 1.179–3 | 1545–1201 |
| 1.179–5 | 1545–0172 |
| | 1545–1201 |
| 1.180–2 | 1545–0074 |
| 1.181–1T and 1.181–2T | 1545–2059 |
| 1.182–6 | 1545–0074 |
| 1.183–1 | 1545–0195 |
| 1.183–2 | 1545–0195 |
| 1.183–3 | 1545–0195 |
| 1.183–4 | 1545–0195 |
| 1.190–3 | 1545–0074 |
| 1.194–2 | 1545–0735 |
| 1.194–4 | 1545–0735 |
| 1.195–1 | 1545–1582 |
| 1.197–1T | 1545–1425 |
| 1.197–2 | 1545–1671 |
| 1.199–6 | 1545–1966 |
| 1.213–1 | 1545–0074 |
| 1.215–1T | 1545–0074 |
| 1.217–2 | 1545–0182 |
| 1.243–3 | 1545–0123 |
| 1.243–4 | 1545–0123 |
| 1.243–5 | 1545–0123 |
| 1.248–1 | 1545–0172 |
| 1.261–1 | 1545–1041 |
| 1.263(a)–5 | 1545–1870 |
| 1.263(e)–1 | 1545–0123 |
| 1.263A–1 | 1545–0987 |
| 1.263A–1T | 1545–0187 |
| 1.263A–2 | 1545–0987 |
| 1.263A–3 | 1545–0987 |
| | 1545–0987 |
| 1.263A–8(b)(2)(iii) | 1545–1265 |
| 1.263A–9(d)(1) | 1545–1265 |
| 1.263A–9(f)(1)(ii) | 1545–1265 |
| 1.263A–9(f)(2)(iv) | 1545–1265 |
| 1.263A–9(g)(2)(iv)(C) | 1545–1265 |
| 1.263A–9(g)(3)(iv) | 1545–1265 |
| 1.265–1 | 1545–0074 |
| 1.265–2 | 1545–0123 |
| 1.266–1 | 1545–0123 |
| 1.267(f)–1 | 1545–0885 |
| 1.268–1 | 1545–0184 |
| 1.274–1 | 1545–0139 |
| 1.274–2 | 1545–0139 |
| 1.274–3 | 1545–0139 |
| 1.274–4 | 1545–0139 |
| 1.274–5 | 1545–0771 |
| 1.274–5A | 1545–0139 |
| | 1545–0771 |
| 1.274–5T | 1545–0074 |
| | 1545–0172 |
| | 1545–0771 |
| 1.274–6 | 1545–0139 |
| | 1545–0771 |
| 1.274–6T | 1545–0074 |
| | 1545–0771 |
| 1.274–7 | 1545–0139 |
| 1.274–8 | 1545–0139 |
| 1.279–6 | 1545–0123 |
| 1.280C–4 | 1545–1155 |
| 1.280F–3T | 1545–0074 |
| 1.280G–1 | 1545–1851 |
| 1.281–4 | 1545–0123 |
| 1.302–4 | 1545–0074 |
| 1.305–3 | 1545–0123 |
| 1.305–5 | 1545–1438 |
| 1.307–2 | 1545–0074 |
| 1.312–15 | 1545–0172 |
| 1.316–1 | 1545–0123 |
| 1.331–1 | 1545–0074 |
| 1.332–4 | 1545–0123 |
| 1.332–6 | 1545–2019 |
| 1.337(d)–1 | 1545–1160 |
| 1.337(d)–2 | 1545–1160 |
| 1.337(d)–2 | 1545–1774 |
| 1.337(d)–4 | 1545–1633 |
| 1.337(d)–5 | 1545–1672 |
| 1.337(d)–6 | 1545–1672 |
| 1.337(d)–7 | 1545–1672 |
| 1.338–2 | 1545–1658 |
| 1.338–5 | 1545–1658 |
| 1.338–10 | 1545–1658 |
| 1.338–11 | 1545–1990 |
| 1.338(h)(10)–1 | 1545–1658 |
| 1.338(i)–1 | 1545–1990 |
| 1.341–7 | 1545–0123 |
| 1.351–3 | 1545–2019 |
| 1.355–5 | 1545–2019 |
| 1.362–2 | 1545–0123 |
| 1.367(a)–1T | 1545–0026 |
| 1.367(a)–2T | 1545–0026 |
| 1.367(a)–3 | 1545–0026 |
| | 1545–1478 |
| 1.367(a)–6T | 1545–0026 |
| 1.367(a)–8 | 1545–1271 |
| 1.367(a)–8T | 1545–2056 |
| 1.367(b)–1 | 1545–1271 |

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| 1.367(b)–3T | 1545–1666 |
| 1.367(d)–1T | 1545–0026 |
| 1.367(e)–1 | 1545–1487 |
| 1.367(e)–2 | 1545–1487 |
| 1.368–1 | 1545–1691 |
| 1.368–3 | 1545–2019 |
| 1.371–1 | 1545–0123 |
| 1.371–2 | 1545–0123 |
| 1.374–3 | 1545–0123 |
| 1.381(b)–1 | 1545–0123 |
| 1.381(c)(4)–1 | 1545–0123 |
| | 1545–0152 |
| | 1545–0879 |
| 1.381(c)(5)–1 | 1545–0123 |
| | 1545–0152 |
| 1.381(c)(6)–1 | 1545–0123 |
| | 1545–0152 |
| 1.381(c)(8)–1 | 1545–0123 |
| 1.381(c)(10)–1 | 1545–0123 |
| 1.381(c)(11)–1(k) | 1545–0123 |
| 1.381(c)(13)–1 | 1545–0123 |
| 1.381(c)(17)–1 | 1545–0045 |
| 1.381(c)(22)–1 | 1545–1990 |
| 1.381(c)(25)–1 | 1545–0045 |
| 1.382–1T | 1545–0123 |
| 1.382–2 | 1545–0123 |
| 1.382–2T | 1545–0123 |
| 1.382–3 | 1545–1281 |
| | 1545–1345 |
| 1.382–4 | 1545–1120 |
| 1.382–6 | 1545–1381 |
| 1.382–8 | 1545–1434 |
| 1.382–9 | 1545–1260 |
| | 1545–1120 |
| | 1545–1275 |
| | 1545–1324 |
| 1.382–11 | 1545–2019 |
| 1.382–91 | 1545–1260 |
| | 1545–1324 |
| 1.383–1 | 1545–0074 |
| | 1545–1120 |
| 1.401–1 | 1545–0020 |
| | 1545–0197 |
| | 1545–0200 |
| | 1545–0534 |
| | 1545–0710 |
| 1.401(a)–11 | 1545–0710 |
| 1.401(a)–20 | 1545–0928 |
| 1.401(a)–31 | 1545–1341 |
| 1.401(a)–50 | 1545–0710 |
| 1.401(a)(31)–1 | 1545–1341 |
| 1.401(b)–1 | 1545–0197 |
| 1.401(f)–1 | 1545–0710 |
| 1.401(k)–1 | 1545–1039 |
| | 1545–1069 |
| | 1545–1669 |
| | 1545–1930 |
| 1.401(k)–2 | 1545–1669 |
| 1.401(k)–3 | 1545–1669 |
| 1.401(k)–4 | 1545–1669 |
| 1.401(m)–3 | 1545–1699 |
| 1.401(a)(9)–1 | 1545–1573 |
| 1.401(a)(9)–3 | 1545–1466 |
| 1.401(a)(9)–4 | 1545–1573 |
| 1.401–12(n) | 1545–0806 |
| 1.401–14 | 1545–0710 |
| 1.402(c)–2 | 1545–1341 |
| 1.402(f)–1 | 1545–1341 |
| | 1545-1632 |
| 1.402A–1 | 1545–1992 |
| 1.403(b)–1 | 1545–0710 |
| 1.403(b)–3 | 1545–0996 |
| 1.403(b)–7 | 1545–1341 |
| 1.403(b)–10 | 1545–2068 |
| 1.404(a)–4 | 1545–0710 |
| 1.404(a)–12 | 1545–0710 |
| 1.404A–2 | 1545–0123 |
| 1.404A–6 | 1545–0123 |
| 1.408–2 | 1545–0390 |
| 1.408–5 | 1545–0747 |
| 1.408–6 | 1545–0203 |
| | 1545–0390 |
| 1.408–7 | 1545–0119 |
| 1.408(q)–1 | 1545–1841 |
| 1.408A–2 | 1545–1616 |
| 1.408A–4 | 1545–1616 |
| 1.408A–5 | 1545–1616 |
| 1.408A–7 | 1545–1616 |
| 1.410(a)–2 | 1545–0710 |
| 1.410(d)–1 | 1545–0710 |
| 1.411(a)–11 | 1545–1471 |
| | 1545–1632 |
| 1.411(d)–4 | 1545–1545 |
| 1.411(d)–6 | 1545–1477 |
| 1.412(b)–5 | 1545–0710 |
| 1.412(c)(1)–2 | 1545–0710 |
| 1.412(c)(2)–1 | 1545–0710 |
| 1.412(c)(3)–2 | 1545–0710 |
| 1.414(c)–5 | 1545–0797 |
| 1.414(r)–1 | 1545–1221 |
| 1.415–2 | 1545–0710 |
| 1.415–6 | 1545–0710 |
| 1.417(a)(3)–1 | 1545–0928 |
| 1.417(e)–1 | 1545–1471 |
| | 1545–1724 |
| 1.417(e)–1T | 1545–1471 |
| 1.419A(f)(6)–1 | 1545–1795 |
| 1.422–1 | 1545–0820 |
| 1.441–2 | 1545–1748 |
| 1.442–1 | 1545–0074 |
| | 1545–0123 |
| | 1545–0134 |
| | 1545–0152 |
| | 1545–0820 |
| | 1545–1748 |
| 1.443–1 | 1545–0123 |
| 1.444–3T | 1545–1036 |
| 1.444–4 | 1545–1591 |
| 1.446–1 | 1545–0074 |
| | 1545–0152 |
| 1.446–4(d) | 1545–1412 |
| 1.448–1(g) | 1545–0152 |
| 1.448–1(h) | 1545–0152 |
| 1.448–1(i) | 1545–0152 |
| 1.448–2 | 1545–1855 |
| 1.448–2T | 1545–0152 |
| | 1545–1855 |
| 1.451–1 | 1545–0091 |
| 1.451–4 | 1545–0123 |
| 1.451–5 | 1545–0074 |
| 1.451–6 | 1545–0074 |
| 1.451–7 | 1545–0074 |
| 1.453–1 | 1545–0152 |
| 1.453–2 | 1545–0152 |
| 1.453–8 | 1545–0152 |
| | 1545–0228 |
| 1.453–10 | 1545–0152 |
| 1.453A–1 | 1545–0152 |
| | 1545–1134 |
| 1.453A–2 | 1545–0152 |
| | 1545–1134 |
| 1.453A–3 | 1545–0963 |
| 1.454–1 | 1545–0074 |
| 1.455–2 | 1545–0152 |

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| 1.455–6 | 1545–0123 |
| 1.456–2 | 1545–0123 |
| 1.456–6 | 1545–0123 |
| 1.456–7 | 1545–0123 |
| 1.457–8 | 1545–1580 |
| 1.458–1 | 1545–0879 |
| 1.458–2 | 1545–0152 |
| 1.460–1 | 1545–1650 |
| 1.460–6 | 1545–1031 |
| | 1545–1572 |
| | 1545–1732 |
| 1.461–1 | 1545–0074 |
| 1.461–2 | 1545–0096 |
| 1.461–4 | 1545–0917 |
| 1.461–5 | 1545–0917 |
| 1.463–1T | 1545–0916 |
| 1.465–1T | 1545–0712 |
| 1.466–1T | 1545–0152 |
| 1.466–4 | 1545–0152 |
| 1.468A–3 | 1545–1269 |
| | 1545–1378 |
| | 1545–1511 |
| 1.468A–3T | 1545–1269 |
| | 1545–1378 |
| | 1545–1511 |
| 1.468A–4 | 1545–0954 |
| 1.468A–4T | 1545–0954 |
| 1.468A–7 | 1545–0954 |
| 1.468A–7T | 1545–0954 |
| 1.468A–8 | 1545–1269 |
| 1.468A–3T(h), 1.468A–7T, and 1.468A–8T(d) | 1545–2091 |
| 1.468B–1 | 1545–1631 |
| 1.468B–9 | 1545–1631 |
| 1.468B–1(j) | 1545–1299 |
| 1.468B–2(k) | 1545–1299 |
| 1.468B–2(l) | 1545–1299 |
| 1.468B–3(b) | 1545–1299 |
| 1.468B–3(e) | 1545–1299 |
| 1.468B–5(b) | 1545–1299 |
| 1.469–1 | 1545–1008 |
| 1.469–2T | 1545–0712 |
| | 1545–1091 |
| 1.469–4T | 1545–0985 |
| | 1545–1037 |
| 1.469–7 | 1545–1244 |
| 1.471–2 | 1545–0123 |
| 1.471–5 | 1545–0123 |
| 1.471–6 | 1545–0123 |
| 1.471–8 | 1545–0123 |
| 1.471–11 | 1545–0123 |
| | 1545–0152 |
| 1.472–1 | 1545–0042 |
| | 1545–0152 |
| 1.472–2 | 1545–0152 |
| 1.472–3 | 1545–0042 |
| 1.472–5 | 1545–0152 |
| 1.472–8 | 1545–0028 |
| | 1545–0042 |
| | 1545–1767 |
| 1.475(a)–4 | 1545–1945 |
| 1.475(b)–4 | 1545–1496 |
| 1.481–4 | 1545–0152 |
| 1.481–5 | 1545–0152 |
| 1.482–1 | 1545–1364 |
| 1.482–4 | 1545–1364 |
| 1.482–7 | 1545–1364 |
| | 1545–1794 |
| 1.501(a)–1 | 1545–0056 |
| | 1545–0057 |
| 1.501(c)(3)–1 | 1545–0056 |
| 1.501(c)(9)–5 | 1545–0047 |
| 1.501(c)(17)–3 | 1545–0047 |
| 1.501(e)–1 | 1545–0814 |
| 1.503(c)–1 | 1545–0047 |
| | 1545–0052 |
| 1.505(c)–1T | 1545–0916 |
| 1.507–1 | 1545–0052 |
| 1.507–2 | 1545–0052 |
| 1.508–1 | 1545–0052 |
| | 1545–0056 |
| 1.509(a)–3 | 1545–0047 |
| 1.509(a)–5 | 1545–0047 |
| 1.509(c)–1 | 1545–0052 |
| 1.512(a)–1 | 1545–0687 |
| 1.512(a)–4 | 1545–0047 |
| | 1545–0687 |
| 1.521–1 | 1545–0051 |
| | 1545–0058 |
| 1.527–2 | 1545–0129 |
| 1.527–5 | 1545–0129 |
| 1.527–6 | 1545–0129 |
| 1.527–9 | 1545–0129 |
| 1.528–8 | 1545–0127 |
| 1.533–2 | 1545–0123 |
| 1.534–2 | 1545–0123 |
| 1.542–3 | 1545–0123 |
| 1.545–2 | 1545–0123 |
| 1.545–3 | 1545–0123 |
| 1.547–2 | 1545–0045 |
| | 1545–0123 |
| 1.547–3 | 1545–0123 |
| 1.551–4 | 1545–0074 |
| 1.552–3 | 1545–0099 |
| 1.552–4 | 1545–0099 |
| 1.552–5 | 1545–0099 |
| 1.556–2 | 1545–0704 |
| 1.561–1 | 1545–0044 |
| 1.561–2 | 1545–0123 |
| 1.562–3 | 1545–0123 |
| 1.563–2 | 1545–0123 |
| 1.564–1 | 1545–0123 |
| 1.565–1 | 1545–0043 |
| | 1545–0123 |
| 1.565–2 | 1545–0043 |
| 1.565–3 | 1545–0043 |
| 1.565–5 | 1545–0043 |
| 1.565–6 | 1545–0043 |
| 1.585–1 | 1545–0123 |
| 1.585–3 | 1545–0123 |
| 1.585–8 | 1545–1290 |
| 1.586–2 | 1545–0123 |
| 1.593–1 | 1545–0123 |
| 1.593–6 | 1545–0123 |
| 1.593–6A | 1545–0123 |
| 1.593–7 | 1545–0123 |
| 1.595–1 | 1545–0123 |
| 1.597–2 | 1545–1300 |
| 1.597–4 | 1545–1300 |
| 1.597–6 | 1545–1300 |
| 1.597–7 | 1545–1300 |
| 1.611–2 | 1545–0099 |
| 1.611–3 | 1545–0007 |
| | 1545–0099 |
| | 1545–1784 |
| 1.612–4 | 1545–0074 |
| 1.612–5 | 1545–0099 |
| 1.613–3 | 1545–0099 |
| 1.613–4 | 1545–0099 |
| 1.613–6 | 1545–0099 |
| 1.613–7 | 1545–0099 |
| 1.613A–3 | 1545–0919 |
| 1.613A–3(e) | 1545–1251 |
| 1.613A–3(l) | 1545–0919 |
| 1.613A–5 | 1545–0099 |

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| 1.613A–6 | 1545–0099 |
| 1.614–2 | 1545–0099 |
| 1.614–3 | 1545–0099 |
| 1.614–5 | 1545–0099 |
| 1.614–6 | 1545–0099 |
| 1.614–8 | 1545–0099 |
| 1.617–1 | 1545–0099 |
| 1.617–3 | 1545–0099 |
| 1.617–4 | 1545–0099 |
| 1.631–1 | 1545–0007 |
| 1.631–2 | 1545–0007 |
| 1.641(b)–2 | 1545–0092 |
| 1.642(c)–1 | 1545–0092 |
| 1.642(c)–2 | 1545–0092 |
| 1.642(c)–5 | 1545–0074 |
| 1.642(c)–6 | 1545–0020 |
| | 1545–0074 |
| | 1545–0092 |
| 1.642(g)–1 | 1545–0092 |
| 1.642(i)–1 | 1545–0092 |
| 1.645–1 | 1545–1578 |
| 1.663(b)–2 | 1545–0092 |
| 1.664–1 | 1545–0196 |
| 1.664–1(a)(7) | 1545–1536 |
| 1.664–2 | 1545–0196 |
| 1.664–3 | 1545–0196 |
| 1.664–4 | 1545–0020 |
| | 1545–0196 |
| 1.665(a)–0A through | |
| 1.665(g)–2A | 1545–0192 |
| 1.666(d)–1A | 1545–0092 |
| 1.671–4 | 1545–1442 |
| 1.671–5 | 1545–1540 |
| 1.701–1 | 1545–0099 |
| 1.702–1 | 1545–0074 |
| 1.703–1 | 1545–0099 |
| 1.704–2 | 1545–1090 |
| 1.706–1 | 1545–0099 |
| | 1545–0074 |
| | 1545–0134 |
| 1.706–1T | 1545–0099 |
| 1.707–3(c)(2) | 1545–1243 |
| 1.707–5(a)(7)(ii) | 1545–1243 |
| 1.707–6(c) | 1545–1243 |
| 1.707–8 | 1545–1243 |
| 1.708–1 | 1545–0099 |
| 1.732–1 | 1545–0099 |
| | 1545–1588 |
| 1.736–1 | 1545–0074 |
| 1.743–1 | 1545–0074 |
| | 1545–1588 |
| 1.751–1 | 1545–0074 |
| | 1545–0099 |
| | 1545–0941 |
| 1.752–2 | 1545–1905 |
| 1.752–5 | 1545–1090 |
| 1.752–7 | 1545–1843 |
| 1.754–1 | 1545–0099 |
| 1.755–1 | 1545–0099 |
| 1.761–2 | 1545–1338 |
| 1.801–1 | 1545–0123 |
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| 1.801–3 | 1545–0123 |
| 1.801–5 | 1545–0128 |
| 1.801–8 | 1545–0128 |
| 1.804–4 | 1545–0128 |
| 1.811–2 | 1545–0128 |
| 1.812–2 | 1545–0128 |
| 1.815–6 | 1545–0128 |
| 1.818–4 | 1545–0128 |
| 1.818–5 | 1545–0128 |
| 1.818–8 | 1545–0128 |
| 1.819–2 | 1545–0128 |
| 1.821–1 | 1545–1027 |
| 1.821–3 | 1545–1027 |
| 1.821–4 | 1545–1027 |
| 1.822–5 | 1545–1027 |
| 1.822–6 | 1545–1027 |
| 1.822–8 | 1545–1027 |
| 1.822–9 | 1545–1027 |
| 1.823–2 | 1545–1027 |
| 1.823–5 | 1545–1027 |
| 1.823–6 | 1545–1027 |
| 1.825–1 | 1545–1027 |
| 1.826–1 | 1545–1027 |
| 1.826–2 | 1545–1027 |
| 1.826–3 | 1545–1027 |
| 1.826–4 | 1545–1027 |
| 1.826–6 | 1545–1027 |
| 1.831–3 | 1545–0123 |
| 1.831–4 | 1545–0123 |
| 1.832–4 | 1545–1227 |
| 1.832–5 | 1545–0123 |
| 1.848–2(g)(8) | 1545–1287 |
| 1.848–2(h)(3) | 1545–1287 |
| 1.848–2(i)(4) | 1545–1287 |
| 1.851–2 | 1545–1010 |
| 1.851–4 | 1545–0123 |
| 1.852–1 | 1545–0123 |
| 1.852–4 | 1545–0123 |
| | 1545–0145 |
| 1.852–6 | 1545–0123 |
| | 1545–0144 |
| 1.852–7 | 1545–0074 |
| 1.852–9 | 1545–0074 |
| | 1545–0123 |
| | 1545–0144 |
| | 1545–0145 |
| | 1545–1783 |
| 1.852–11 | 1545–1094 |
| 1.853–3 | 1545–2035 |
| 1.853–4 | 1545–2035 |
| 1.854–2 | 1545–0123 |
| 1.855–1 | 1545–0123 |
| 1.856–2 | 1545–0123 |
| | 1545–1004 |
| 1.856–6 | 1545–0123 |
| 1.856–7 | 1545–0123 |
| 1.856–8 | 1545–0123 |
| 1.857–8 | 1545–0123 |
| 1.857–9 | 1545–0074 |
| 1.858–1 | 1545–0123 |
| 1.860–2 | 1545–0045 |
| 1.860–4 | 1545–0045 |
| | 1545–1054 |
| | 1545–1057 |
| 1.860E–1 | 1545–1675 |
| 1.860E–2(a)(5) | 1545–1276 |
| 1.860E–2(a)(7) | 1545–1276 |
| 1.860E–2(b)(2) | 1545–1276 |
| 1.861–2 | 1545–0089 |
| 1.861–3 | 1545–0089 |
| 1.861–4 | 1545–1900 |
| 1.861–8 | 1545–0126 |
| 1.861–8(e)(6) and (g) | 1545–1224 |
| 1.861–9T | 1545–0121 |
| | 1545–1072 |
| 1.861–18 | 1545–1594 |
| 1.863–1 | 1545–1476 |
| 1.863–3 | 1545–1476 |
| | 1545–1556 |
| 1.863–3A | 1545–0126 |
| 1.863–4 | 1545–0126 |
| 1.863–7 | 1545–0132 |

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| 1.863–8 | 1545–1718 |
| 1.863–9 | 1545–1718 |
| 1.864–4 | 1545–0126 |
| 1.871–1 | 1545–0096 |
| 1.871–6 | 1545–0795 |
| 1.871–7 | 1545–0089 |
| 1.871–10 | 1545–0089 |
| | 1545–0165 |
| 1.874–1 | 1545–0089 |
| 1.881–4 | 1545–1440 |
| 1.882–4 | 1545–0126 |
| 1.882–5T | 1545–2030 |
| 1.883–1 | 1545–1677 |
| 1.883–1T | 1545–1667 |
| 1.883–2 | 1545–1677 |
| 1.883–2T | 1545–1667 |
| 1.883–3 | 1545–1677 |
| 1.883–3T | 1545–1667 |
| 1.883–4 | 1545–1677 |
| 1.883–4T | 1545–1667 |
| 1.883–5 | 1545–1677 |
| 1.883–5T | 1545–1667 |
| 1.884–0 | 1545–1070 |
| 1.884–1 | 1545–1070 |
| 1.884–2 | 1545–1070 |
| 1.884–2T | 1545–0126 |
| | 1545–1070 |
| 1.884–4 | 1545–1070 |
| 1.884–5 | 1545–1070 |
| 1.892–1T | 1545–1053 |
| 1.892–2T | 1545–1053 |
| 1.892–3T | 1545–1053 |
| 1.892–4T | 1545–1053 |
| 1.892–5T | 1545–1053 |
| 1.892–6T | 1545–1053 |
| 1.892–7T | 1545–1053 |
| 1.897–2 | 1545–0123 |
| | 1545–0902 |
| 1.897–3 | 1545–0123 |
| 1.897–5T | 1545–0902 |
| 1.897–6T | 1545–0902 |
| 1.901–2 | 1545–0746 |
| 1.901–2A | 1545–0746 |
| 1.901–3 | 1545–0122 |
| 1.902–1 | 1545–0122 |
| | 1545–1458 |
| 1.904–1 | 1545–0121 |
| | 1545–0122 |
| 1.904–2 | 1545–0121 |
| | 1545–0122 |
| 1.904–3 | 1545–0121 |
| 1.904–4 | 1545–0121 |
| 1.904–5 | 1545–0121 |
| 1.904–7T | 1545–2104 |
| 1.904(f)–1 | 1545–0121 |
| | 1545–0122 |
| 1.904(f)–2 | 1545–0121 |
| 1.904(f)–3 | 1545–0121 |
| 1.904(f)–4 | 1545–0121 |
| 1.904(f)–5 | 1545–0121 |
| 1.904(f)–6 | 1545–0121 |
| 1.904(f)–7 | 1545–1127 |
| 1.905–2 | 1545–0122 |
| 1.905–3T | 1545–1056 |
| 1.905–4T | 1545–1056 |
| 1.905–5T | 1545–1056 |
| 1.911–1 | 1545–0067 |
| | 1545–0070 |
| 1.911–2 | 1545–0067 |
| | 1545–0070 |
| 1.911–3 | 1545–0067 |
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| 1.911–4 | 1545–0067 |
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| 1.911–5 | 1545–0067 |
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| 1.911–6 | 1545–0067 |
| | 1545–0070 |
| 1.911–7 | 1545–0067 |
| | 1545–0070 |
| 1.913–13 | 1545–0067 |
| 1.921–1T | 1545–0190 |
| | 1545–0884 |
| | 1545–0935 |
| | 1545–0939 |
| 1.921–2 | 1545–0884 |
| 1.921–3T | 1545–0935 |
| 1.923–1T | 1545–0935 |
| 1.924(a)–1T | 1545–0935 |
| 1.925(a)–1T | 1545–0935 |
| 1.925(b)–1T | 1545–0935 |
| 1.926(a)–1T | 1545–0935 |
| 1.927(a)–1T | 1545–0935 |
| 1.927(b)–1T | 1545–0935 |
| 1.927(d)–1 | 1545–0884 |
| 1.927(d)–2T | 1545–0935 |
| 1.927(e)–1T | 1545–0935 |
| 1.927(e)–2T | 1545–0935 |
| 1.927(f)–1 | 1545–0884 |
| 1.931–1 | 1545–0074 |
| | 1545–0123 |
| 1.934–1 | 1545–0782 |
| 1.935–1 | 1545–0074 |
| | 1545–0087 |
| | 1545–0803 |
| 1.936–1 | 1545–0215 |
| | 1545–0217 |
| 1.936–4 | 1545–0215 |
| 1.936–5 | 1545–0704 |
| 1.936–6 | 1545–0215 |
| 1.936–7 | 1545–0215 |
| 1.936–10(c) | 1545–1138 |
| 1.937–1 | 1545–1930 |
| 1.952–2 | 1545–0126 |
| 1.953–2 | 1545–0126 |
| 1.954–1 | 1545–1068 |
| 1.954–2 | 1545–1068 |
| 1.955–2 | 1545–0123 |
| 1.955–3 | 1545–0123 |
| 1.955A–2 | 1545–0755 |
| 1.955A–3 | 1545–0755 |
| 1.956–1 | 1545–0704 |
| 1.956–2 | 1545–0704 |
| 1.959–1 | 1545–0704 |
| 1.959–2 | 1545–0704 |
| 1.960–1 | 1545–0122 |
| 1.962–2 | 1545–0704 |
| 1.962–3 | 1545–0704 |
| 1.962–4 | 1545–0704 |
| 1.964–1 | 1545–0126 |
| | 1545–0704 |
| | 1545–1072 |
| 1.964–1T | 1545–2104 |
| 1.964–3 | 1545–0126 |
| 1.970–2 | 1545–0126 |
| 1.985–2 | 1545–1051 |
| | 1545–1131 |
| 1.985–3 | 1545–1051 |
| 1.988–0 | 1545–1131 |
| 1.988–1 | 1545–1131 |
| 1.988–2 | 1545–1131 |
| 1.988–3 | 1545–1131 |
| 1.988–4 | 1545–1131 |
| 1.988–5 | 1545–1131 |

| CFR part or section where identified and described | Current OMB control No. |
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| 1.992–1 | 1545–0190 |
| | 1545–0938 |
| 1.992–2 | 1545–0190 |
| | 1545–0884 |
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| 1.992–3 | 1545–0190 |
| | 1545–0938 |
| 1.992–4 | 1545–0190 |
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| 1.993–3 | 1545–0938 |
| 1.993–4 | 1545–0938 |
| 1.994–1 | 1545–0938 |
| 1.995–5 | 1545–0938 |
| 1.1001–1 | 1545–1902 |
| 1.1012–1 | 1545–0074 |
| | 1545–1139 |
| 1.1014–4 | 1545–0184 |
| 1.1015–1 | 1545–0020 |
| 1.1017–1 | 1545–1539 |
| 1.1031(d)–1T | 1545–1021 |
| 1.1033(a)–2 | 1545–0184 |
| 1.1033(g)–1 | 1545–0184 |
| 1.1034–1 | 1545–0072 |
| 1.1039–1 | 1545–0184 |
| 1.1041–1T | 1545–0074 |
| 1.1041–2 | 1545–1751 |
| 1.1042–1T | 1545–0916 |
| 1.1044(a)–1 | 1545–1421 |
| 1.1045–1 | 1545–1893 |
| 1.1060–1 | 1545–1658 |
| | 1545–1990 |
| 1.1071–1 | 1545–0184 |
| 1.1071–4 | 1545–0184 |
| 1.1081–4 | 1545–0028 |
| | 1545–0046 |
| | 1545–0123 |
| 1.1081–11 | 1545–2019 |
| 1.1082–1 | 1545–0046 |
| 1.1082–2 | 1545–0046 |
| 1.1082–3 | 1545–0046 |
| | 1545–0184 |
| 1.1082–4 | 1545–0046 |
| 1.1082–5 | 1545–0046 |
| 1.1082–6 | 1545–0046 |
| 1.1083–1 | 1545–0123 |
| 1.1092(b)–1T | 1545–0644 |
| 1.1092(b)–2T | 1545–0644 |
| 1.1092(b)–3T | 1545–0644 |
| 1.1092(b)–4T | 1545–0644 |
| 1.1092(b)–5T | 1545–0644 |
| 1.1211–1 | 1545–0074 |
| 1.1212–1 | 1545–0074 |
| 1.1221–2 | 1545–1480 |
| 1.1231–1 | 1545–0177 |
| | 1545–0184 |
| 1.1231–2 | 1545–0177 |
| | 1545–0184 |
| 1.1231–2 | 1545–0074 |
| 1.1232–3 | 1545–0074 |
| 1.1237–1 | 1545–0184 |
| 1.1239–1 | 1545–0091 |
| 1.1242–1 | 1545–0184 |
| 1.1243–1 | 1545–0123 |
| 1.1244(e)–1 | 1545–0123 |
| | 1545–1447 |
| 1.1245–1 | 1545–0184 |
| 1.1245–2 | 1545–0184 |
| 1.1245–3 | 1545–0184 |
| 1.1245–4 | 1545–0184 |
| 1.1245–5 | 1545–0184 |
| 1.1245–6 | 1545–0184 |
| 1.1247–1 | 1545–0122 |
| 1.1247–2 | 1545–0122 |
| 1.1247–4 | 1545–0122 |
| 1.1247–5 | 1545–0122 |
| 1.1248–7 | 1545–0074 |
| 1.1250–1 | 1545–0184 |
| 1.1250–2 | 1545–0184 |
| 1.1250–3 | 1545–0184 |
| 1.1250–4 | 1545–0184 |
| 1.1250–5 | 1545–0184 |
| 1.1251–1 | 1545–0184 |
| 1.1251–2 | 1545–0074 |
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| 1.1251–3 | 1545–0184 |
| 1.1251–4 | 1545–0184 |
| 1.1252–1 | 1545–0184 |
| 1.1252–2 | 1545–0184 |
| 1.1254–1(c)(3) | 1545–1352 |
| 1.1254–4 | 1545–1493 |
| 1.1254–5(d)(2) | 1545–1352 |
| 1.1258–1 | 1545–1452 |
| 1.1272–3 | 1545–1353 |
| 1.1273–2(h)(2) | 1545–1353 |
| 1.1274–3(d) | 1545–1353 |
| 1.1274–5(b) | 1545–1353 |
| 1.1274A–1(c) | 1545–1353 |
| 1.1275–2 | 1545–1450 |
| 1.1275–3 | 1545–0887 |
| | 1545–1353 |
| | 1545–1450 |
| 1.1275–4 | 1545–1450 |
| 1.1275–6 | 1545–1450 |
| 1.1287–1 | 1545–0786 |
| 1.1291–9 | 1545–1507 |
| 1.1291–10 | 1545–1507 |
| | 1545–1304 |
| 1.1294–1T | 1545–1002 |
| | 1545–1028 |
| 1.1295–1 | 1545–1555 |
| 1.1295–3 | 1545–1555 |
| 1.1298–3 | 1545–1507 |
| 1.1301–1 | 1545–1662 |
| 1.1311(a)–1 | 1545–0074 |
| 1.1361–1 | 1545–0731 |
| | 1545–1591 |
| 1.1361–3 | 1545–1590 |
| 1.1361–5 | 1545–1590 |
| 1.1362–1 | 1545–1308 |
| 1.1362–2 | 1545–1308 |
| 1.1362–3 | 1545–1308 |
| 1.1362–4 | 1545–1308 |
| 1.1362–5 | 1545–1308 |
| 1.1362–6 | 1545–1308 |
| 1.1362–7 | 1545–1308 |
| 1.1362–8 | 1545–1590 |
| 1.1363–2 | 1545–1906 |
| 1.1366–1 | 1545–1613 |
| 1.1367–1(f) | 1545–1139 |
| 1.1368–1(f)(2) | 1545–1139 |
| 1.1368–1(f)(3) | 1545–1139 |
| 1.1368–1(f)(4) | 1545–1139 |
| 1.1368–1(g)(2) | 1545–1139 |
| 1.1374–1A | 1545–0130 |
| 1.1377–1 | 1545–1462 |
| 1.1378–1 | 1545–1748 |
| 1.1383–1 | 1545–0074 |
| 1.1385–1 | 1545–0074 |
| | 1545–0098 |
| 1.1388–1 | 1545–0118 |
| | 1545–0123 |
| 1.1397E–1T | 1545–1908 |
| 1.1398–1 | 1545–1375 |

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| 1.1398–2 | 1545–1375 |
| 1.1402(a)–2 | 1545–0074 |
| 1.1402(a)–5 | 1545–0074 |
| 1.1402(a)–11 | 1545–0074 |
| 1.1402(a)–15 | 1545–0074 |
| 1.1402(a)–16 | 1545–0074 |
| 1.1402(b)–1 | 1545–0171 |
| 1.1402(c)–2 | 1545–0074 |
| 1.1402(e)(1)–1 | 1545–0074 |
| 1.1402(e)(2)–1 | 1545–0074 |
| 1.1402(e)–1A | 1545–0168 |
| 1.1402(e)–2A | 1545–0168 |
| 1.1402(e)–3A | 1545–0168 |
| 1.1402(e)–4A | 1545–0168 |
| 1.1402(e)–5A | 1545–0168 |
| 1.1402(f)–1 | 1545–0074 |
| 1.1402(h)–1 | 1545–0064 |
| 1.1441–1 | 1545–1484 |
| 1.1441–2 | 1545–0795 |
| 1.1441–3 | 1545–0165 |
| | 1545–0795 |
| 1.1441–4 | 1545–1484 |
| 1.1441–5 | 1545–0096 |
| | 1545–0795 |
| | 1545–1484 |
| 1.1441–6 | 1545–0055 |
| | 1545–0795 |
| | 1545–1484 |
| 1.1441–7 | 1545–0795 |
| 1.1441–8 | 1545–1053 |
| | 1545–1484 |
| 1.1441–9 | 1545–1484 |
| 1.1443–1 | 1545–0096 |
| 1.1445–1 | 1545–0902 |
| 1.1445–2 | 1545–0902 |
| | 1545–1060 |
| | 1545–1797 |
| 1.1445–3 | 1545–0902 |
| | 1545–1060 |
| | 1545–1797 |
| 1.1445–4 | 1545–0902 |
| 1.1445–5 | 1545–0902 |
| 1.1445–6 | 1545–0902 |
| | 1545–1060 |
| 1.1445–7 | 1545–0902 |
| 1.1445–8 | 1545–0096 |
| 1.1445–9T | 1545–0902 |
| 1.1445–10T | 1545–0902 |
| 1.1446–1 | 1545–1852 |
| 1.1446–3 | 1545–1852 |
| 1.1446–4 | 1545–1852 |
| 1.1446–5 | 1545–1852 |
| 1.1446–6T | 1545–1934 |
| 1.1451–1 | 1545–0054 |
| 1.1451–2 | 1545–0054 |
| 1.1461–1 | 1545–0054 |
| | 1545–0055 |
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| | 1545–1484 |
| 1.1461–2 | 1545–0054 |
| | 1545–0055 |
| | 1545–0096 |
| | 1545–0795 |
| 1.1462–1 | 1545–0795 |
| 1.1492–1 | 1545–0026 |
| 1.1494–1 | 1545–0026 |
| 1.1502–5 | 1545–0257 |
| 1.1502–9 | 1545–1634 |
| 1.1502–9A | 1545–0121 |
| 1.1502–13 | 1545–0123 |
| | 1545–0885 |
| | 1545–1161 |
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| 1.1502–16 | 1545–0123 |
| 1.1502–18 | 1545–0123 |
| 1.1502–19 | 1545–0123 |
| 1.1502–20 | 1545–1160 |
| | 1545–1218 |
| | 1545–1774 |
| 1.1502–20T | 1545–1774 |
| 1.1502–21 | 1545–1237 |
| 1.1502–21T | 1545–1790 |
| 1.1502–31 | 1545–1344 |
| 1.1502–32 | 1545–1344 |
| | 1545–1774 |
| 1.1502–32T | 1545–1774 |
| 1.1502–33 | 1545–1344 |
| 1.1502–35 | 1545–1828 |
| 1.1502–35T | 1545–2019 |
| 1.1502–47 | 1545–0123 |
| 1.1502–75 | 1545–0025 |
| | 1545–0123 |
| | 1545–0133 |
| | 1545–0152 |
| 1.1502–76 | 1545–1344 |
| 1.1502–76T | 1545–2019 |
| 1.1502–77 | 1545–1699 |
| 1.1502–77A | 1545–0123 |
| | 1545–1046 |
| 1.1502–78 | 1545–0582 |
| 1.1502–95 | 1545–1218 |
| 1.1502–95A | 1545–1218 |
| 1.1502–96 | 1545–1218 |
| 1.1503–2 | 1545–1583 |
| 1.1503–2A | 1545–1083 |
| 1.1503(d)–1 | 1545–1946 |
| 1.1503(d)–3 | 1545–1946 |
| 1.1503(d)–4 | 1545–1946 |
| 1.1503(d)–5 | 1545–1946 |
| 1.1503(d)–6 | 1545–1946 |
| 1.1552–1 | 1545–0123 |
| 1.1561–3 | 1545–0123 |
| 1.1563–1 | 1545–0123 |
| | 1545–0797 |
| 1.1563–1T | 1545–2019 |
| 1.1563–3 | 1545–0123 |
| 1.6001–1 | 1545–0058 |
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| 1.6011–1 | 1545–0055 |
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| 1.6011–2 | 1545–0055 |
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| 1.6011–3 | 1545–0238 |
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| 1.6011–4 | 1545–1685 |
| 1.6012–1 | 1545–0067 |
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| 1.6012–2 | 1545–0047 |

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| | 1545–1027 |
| 1.6012–3 | 1545–0047 |
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| 1.6015(i)–1 | 1545–0087 |
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| 1.6031(c)–1T | 1545–0099 |
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| 1.6035–3 | 1545–0704 |
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| 1.6038A–3 | 1545–1191 |
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| 1.6043–1 | 1545–0041 |
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| | 1545–1705 |
| 1.6045–2 | 1545–0115 |
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| 1.6046–3 | 1545–0704 |
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| 1.6049–7 | 1545–1018 |
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| | 1545–0232 |
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| 1.6050S–3 | 1545–1678 |
| 1.6050S–4 | 1545–1729 |
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| 1.6063–1 | 1545–0123 |
| 1.6065–1 | 1545–0123 |
| 1.6071–1 | 1545–0123 |
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| 1.6072–2 | 1545–0123 |
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| | 1545–0233 |
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| 1.6662–4(e) and (f) | 1545–0889 |
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| 1.6694–2 | 1545–0074 |
| 1.6694–2(c) | 1545–1231 |
| 1.6694–3(e) | 1545–1231 |
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| 1.7476–2 | 1545–0197 |
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| 1.7520–4 | 1545–1343 |
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| 2.1–11 | 1545–0123 |

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| 2.1–26 | 1545–0123 |
| 3.2 | 1545–0123 |
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| 4.954–2 | 1545–1068 |
| 5.6411–1 | 1545–0098 |
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| | 1545–0172 |
| | 1545–0619 |
| 5c.44F–1 | 1545–0619 |
| 5c.128–1 | 1545–0123 |
| 5c.168(f)(8)–1 | 1545–0123 |
| 5c.168(f)(8)–2 | 1545–0123 |
| 5c.168(f)(8)–6 | 1545–0123 |
| 5c.168(f)(8)–8 | 1545–0123 |
| 5c.305–1 | 1545–0110 |
| 5c.442–1 | 1545–0152 |
| 5f.103–1 | 1545–0720 |
| 5f.103–3 | 1545–0720 |
| 5f.6045–1 | 1545–0715 |
| 6a.103A–2 | 1545–0123 |
| | 1545–0720 |
| 6a.103A–3 | 1545–0720 |
| 7.465–1 | 1545–0712 |
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| 7.465–4 | 1545–0712 |
| 7.465–5 | 1545–0712 |
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| 7.999–1 | 1545–0216 |
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| 7.6041–1 | 1545–0115 |
| 11.410–1 | 1545–0710 |
| 11.412(c)–7 | 1545–0710 |
| 11.412(c)–11 | 1545–0710 |
| 12.7 | 1545–0190 |
| 12.8 | 1545–0191 |
| 12.9 | 1545–0195 |
| 14a.422A–1 | 1545–0123 |
| 15A.453–1 | 1545–0228 |
| 16.3–1 | 1545–0159 |
| 16A.126–2 | 1545–0074 |
| 16A.1255–1 | 1545–0184 |
| 16A.1255–2 | 1545–0184 |
| 18.1371–1 | 1545–0130 |
| 18.1378–1 | 1545–0130 |
| 18.1379–1 | 1545–0130 |
| 18.1379–2 | 1545–0130 |
| 20.2011–1 | 1545–0015 |
| 20.2014–5 | 1545–0015 |
| | 1545–0260 |
| 20.2014–6 | 1545–0015 |
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| 20.2031–6 | 1545–0015 |
| 20.2031–7 | 1545–0020 |
| 20.2031–10 | 1545–0015 |
| 20.2032–1 | 1545–0015 |
| 20.2032A–3 | 1545–0015 |
| 20.2032A–4 | 1545–0015 |
| 20.2032A–8 | 1545–0015 |
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| 20.2056(b)–7 | 1545–0015 |
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| 20.2056A–4 | 1545–1360 |
| 20.2056A–10 | 1545–1360 |
| 20.2106–1 | 1545–0015 |
| 20.2106–2 | 1545–0015 |
| 20.2204–1 | 1545–0015 |
| 20.2204–2 | 1545–0015 |
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| 20.6011–1 | 1545–0015 |
| 20.6018–1 | 1545–0015 |
| | 1545–0531 |
| 20.6018–2 | 1545–0015 |
| 20.6018–3 | 1545–0015 |
| 20.6018–4 | 1545–0015 |
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| 20.6166A–3 | 1545–0015 |
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| 20.7520–3 | 1545–1343 |
| 20.7520–4 | 1545–1343 |
| 22.0 | 1545–0015 |
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| 25.2512–9 | 1545–0020 |
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| 25.2513–2 | 1545–0020 |
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| 25.2522(c)–3 | 1545–0020 |
| | 1545–0196 |
| 25.2523(a)–1 | 1545–0020 |
| | 1545–0196 |
| 25.2523(f)–1 | 1545–0015 |
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| 25.2701–5 | 1545–1273 |
| 25.2702–5 | 1545–1485 |
| 25.2702–6 | 1545–1273 |
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| 25.6011–1 | 1545–0020 |
| 25.6019–1 | 1545–0020 |

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| 25.6075–1 | 1545–0020 |
| 25.6081–1 | 1545–0020 |
| 25.6091–1 | 1545–0020 |
| 25.6091–2 | 1545–0020 |
| 25.6151–1 | 1545–0020 |
| 25.6161–1 | 1545–0020 |
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| 25.7520–4 | 1545–1343 |
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| 26.2632–1 | 1545–0985 |
| | 1545–1892 |
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| 26.2642–3 | 1545–0985 |
| 26.2642–4 | 1545–0985 |
| 26.2642–6 | 1545–1902 |
| 26.2652–2 | 1545–0985 |
| 26.2654–1 | 1545–1902 |
| 26.2662–1 | 1545–0015 |
| | 1545–0985 |
| 26.2662–2 | 1545–0985 |
| 31.3102–3 | 1545–0029 |
| | 1545–0059 |
| | 1545–0065 |
| 31.3121(b)(19)–1 | 1545–0029 |
| 31.3121(d)–1 | 1545–0004 |
| 31.3121(i)–1 | 1545–0034 |
| 31.3121(k)–4 | 1545–0137 |
| 31.3121(r)–1 | 1545–0029 |
| 31.3121(s)–1 | 1545–0029 |
| 31.3121(v)(2)–1 | 1545–1643 |
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| 31.3302(a)–3 | 1545–0028 |
| 31.3302(b)–2 | 1545–0028 |
| 31.3302(e)–1 | 1545–0028 |
| 31.3306(c)(18)–1 | 1545–0029 |
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| 31.3401(a)(6) | 1545–1484 |
| 31.3401(a)(6)–1 | 1545–0029 |
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| 31.3401(a)(8)(A)–1 | 1545–0029 |
| | 1545–0666 |
| 31.3401(a)(8)(C)–1 | 1545–0029 |
| 31.3401(a)(15)–1 | 1545–0182 |
| 31.3401(c)–1 | 1545–0004 |
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| 31.3402(c)–1 | 1545–0010 |
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| 31.3402(f)(4)–2 | 1545–0010 |
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| 31.3402(h)(3)–1 | 1545–0010 |
| 31.3402(h)(3)–1 | 1545–0029 |
| 31.3402(h)(4)–1 | 1545–0010 |
| 31.3402(i)–(1) | 1545–0010 |
| 31.3402(i)–(2) | 1545–0010 |
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| 31.3402(l)–(1) | 1545–0010 |
| 31.3402(m)–(1) | 1545–0010 |
| 31.3402(n)–(1) | 1545–0010 |
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| 31.3402(o)–3 | 1545–0008 |
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| 31.6011(a)–2 | 1545–0001 |
| | 1545–0002 |
| 31.6011(a)–3 | 1545–0028 |
| 31.6011(a)–3A | 1545–0955 |
| 31.6011(a)–4 | 1545–0034 |
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| 31.6011(a)–5 | 1545–0718 |
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| 31.6011(a)–10 | 1545–0112 |
| 31.6011(b)–1 | 1545–0003 |
| 31.6011(b)–2 | 1545–0029 |
| 31.6051–1 | 1545–0008 |
| | 1545–0182 |
| | 1545–0458 |
| | 1545–1729 |
| 31.6051–2 | 1545–0008 |
| 31.6051–3 | 1545–0008 |
| 31.6053–1 | 1545–0029 |
| | 1545–0062 |
| | 1545–0064 |
| | 1545–0065 |
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| 31.6053–2 | 1545–0008 |
| 31.6053–3 | 1545–0065 |
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| 31.6053–4 | 1545–0065 |
| | 1545–1603 |
| 31.6065(a)–1 | 1545–0029 |
| 31.6071(a)–1 | 1545–0001 |
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| 31.6071(a)–1A | 1545–0955 |
| 31.6081(a)–1 | 1545–0008 |
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| 31.6091–1 | 1545–0028 |
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| 31.6157–1 | 1545–0955 |
| 31.6205–1 | 1545–0029 |
| 31.6301(c)–1AT | 1545–0035 |
| | 1545–0112 |
| | 1545–0257 |
| 31.6302–1 | 1545–1413 |
| 31.6302–2 | 1545–1413 |
| 31.6302–3 | 1545–1413 |
| 31.6302–4 | 1545–1413 |
| 31.6302(c)–2 | 1545–0001 |
| | 1545–0257 |
| 31.6302(c)–2A | 1545–0955 |
| 31.6302(c)–3 | 1545–0257 |
| 31.6402(a)–2 | 1545–0256 |
| 31.6413(a)–1 | 1545–0029 |
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| 31.6413(c)–1 | 1545–0029 |
| | 1545–0171 |
| 31.6414–1 | 1545–0029 |
| 32.1 | 1545–0029 |
| | 1545–0415 |
| 32.2 | 1545–0029 |
| 35a.3406–2 | 1545–0112 |
| 35a.9999–5 | 1545–0029 |
| 36.3121(l)(1)–1 | 1545–0137 |
| 36.3121(l)(1)–2 | 1545–0137 |
| 36.3121(l)(3)–1 | 1545–0123 |
| 36.3121(1)(7)–1 | 1545–0123 |
| 36.3121(1)(10)–1 | 1545–0029 |
| 36.3121(1)(10)–3 | 1545–0029 |
| 36.3121(1)(10)–4 | 1545–0257 |
| 40.6302(c)–3(b)(2)(ii) | 1545–1296 |
| 40.6302(c)–3(b)(2)(iii) | 1545–1296 |
| 40.6302(c)–3(e) | 1545–1296 |
| 40.6302(c)–3(f)(2)(ii) | 1545–1296 |
| 41.4481–1 | 1545–0143 |
| 41.4481–2 | 1545–0143 |
| 41.4483–3 | 1545–0143 |
| 41.6001–1 | 1545–0143 |
| 41.6001–2 | 1545–0143 |
| 41.6001–3 | 1545–0143 |
| 41.6071(a)–1 | 1545–0143 |
| 41.6081(a)–1 | 1545–0143 |
| 41.6091–1 | 1545–0143 |
| 41.6109–1 | 1545–0143 |
| 41.6151(a)–1 | 1545–0143 |
| 41.6156–1 | 1545–0143 |
| 41.6161(a)(1)–1 | 1545–0143 |
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| 44.4403–1 | 1545–0235 |
| 44.4412–1 | 1545–0236 |
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| 44.4905–1 | 1545–0236 |
| 44.4905–2 | 1545–0236 |
| 44.6001–1 | 1545–0235 |
| 44.6011(a)–1 | 1545–0235 |
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| 44.6071–1 | 1545–0235 |
| 44.6091–1 | 1545–0235 |
| 44.6151–1 | 1545–0235 |
| 44.6419–1 | 1545–0235 |
| 44.6419–1 | 1545–0235 |
| 44.6419–2 | 1545–0235 |
| 46.4371–4 | 1545–0023 |
| 46.4374–1 | 1545–0023 |
| 46.4701–1 | 1545–0023 |
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| 48.4041–4 | 1545–0023 |
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| 48.4041–6 | 1545–0023 |
| 48.4041–7 | 1545–0023 |
| 48.4041–9 | 1545–0023 |
| 48.4041–10 | 1545–0023 |
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| 48.4042–2 | 1545–0023 |
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| 48.4064–1 | 1545–0014 |
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| 48.4071–1 | 1545–0023 |
| 48.4073–1 | 1545–0023 |
| 48.4073–3 | 1545–0023 |
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| 48.4081–2 | 1545–1270 |
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| 48.4081–3 | 1545–1270 |
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| 48.4216(a)–3 | 1545–0023 |
| 48.4216(c)–1 | 1545–0023 |
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| 48.4221–2 | 1545–0023 |
| 48.4221–3 | 1545–0023 |
| 48.4221–4 | 1545–0023 |
| 48.4221–5 | 1545–0023 |
| 48.4221–6 | 1545–0023 |
| 48.4221–7 | 1545–0023 |
| 48.4222(a)–1 | 1545–0023 |
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| 48.4223–1 | 1545–0023 |
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| 48.6416(a)–3 | 1545–0723 |
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| 48.6416(b)(1)–2 | 1545–0723 |
| 48.6416(b)(1)–3 | 1545–0723 |
| 48.6416(b)(1)–4 | 1545–0723 |
| 48.6416(b)(2)–1 | 1545–0723 |
| 48.6416(b)(2)–2 | 1545–0723 |
| 48.6416(b)(2)–3 | 1545–0723 |
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| 48.6416(b)(2)–4 | 1545–0723 |
| 48.6416(b)(3)–1 | 1545–0723 |
| 48.6416(b)(3)–2 | 1545–0723 |
| 48.6416(b)(3)–3 | 1545–0723 |
| 48.6416(b)(4)–1 | 1545–0723 |
| 48.6416(b)(5)–1 | 1545–0723 |
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| 48.6416(e)–1 | 1545–0023 |
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| 48.6416(g)–1 | 1545–0723 |
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| 48.6420(f)–1 | 1545–0023 |
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| 48.6424–6 | 1545–0723 |
| 48.6427–0 | 1545–0723 |
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| 52.4682–5(d) | 1545–1361 |
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| 53.4942(b)–3 | 1545–0052 |
| 53.4945–1 | 1545–0052 |
| 53.4945–4 | 1545–0052 |
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| 53.4945–6 | 1545–0052 |
| 53.4947–1 | 1545–0196 |
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| 53.6065–1 | 1545–0052 |
| 53.6071–1 | 1545–0049 |
| 53.6081–1 | 1545–0066 |
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| 53.6161–1 | 1545–0575 |
| 54.4972–1 | 1545–0197 |
| 54.4975–7 | 1545–0575 |
| 54.4977–1T | 1545–0771 |
| 54.4980B–6 | 1545–1581 |
| 54.4980B–7 | 1545–1581 |
| 54.4980B–8 | 1545–1581 |
| 54.4980F–1 | 1545–1780 |
| 54.4981A–1T | 1545–0203 |
| 54.6011–1 | 1545–0575 |
| 54.6011–1T | 1545–0575 |
| 54.9801–3 | 1545–1537 |
| 54.9801–4 | 1545–1537 |
| 54.9801–5 | 1545–1537 |
| 54.9801–6 | 1545–1537 |
| 55.6001–1 | 1545–0123 |
| 55.6011–1 | 1545–0999 |
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| 55.6061–1 | 1545–0999 |
| 55.6071–1 | 1545–0999 |
| 56.4911–6 | 1545–0052 |
| 56.4911–7 | 1545–0052 |
| 56.4911–9 | 1545–0052 |
| 56.4911–10 | 1545–0052 |
| 56.6001–1 | 1545–1049 |
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| 56.6081–1 | 1545–1049 |
| 56.6161–1 | 1545–1049 |
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| 145.4061–1 | 1545–0745 |
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| 156.6011–1 | 1545–1049 |
| 156.6081–1 | 1545–1049 |
| 156.6161–1 | 1545–1049 |
| 157.6001–1 | 1545–1824 |
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| 301.6059–1 | 1545–0710 |
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| 301.6104(a)–1 | 1545–0495 |
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| 301.6104(a)–6 | 1545–0056 |
| 301.6104(b)–1 | 1545–0094 |
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| 301.6104(d)–1 | 1545–1655 |
| 301.6104(d)–2 | 1545–1655 |
| 301.6104(d)–3 | 1545–1655 |
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| 301.6110–3 | 1545–0074 |
| 301.6110–5 | 1545–0074 |
| 301.6111–1T | 1545–0865 |
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| 301.6111–2 | 1545–0865 |
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| 301.6112–1T | 1545–0865 |
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| 301.6222(b)–1 | 1545–0790 |
| 301.6222(b)–2 | 1545–0790 |
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| 301.6223(b)–1 | 1545–0790 |
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| 301.6227(c)–1 | 1545–0790 |
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| 301.6230(b)–1 | 1545–0790 |
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| 301.6231(a)(7)–1 | 1545–0790 |
| 301.6231(c)–1 | 1545–0790 |
| 301.6231(c)–2 | 1545–0790 |
| 301.6241–1T | 1545–0130 |
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| 301.6316–6 | 1545–0074 |
| 301.6316–7 | 1545–0029 |
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| 301.6689–1T | 1545–1056 |
| 301.6707–1T | 1545–0865 |
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| 301.6723–1A(d) | 1545–0909 |
| 301.6903–1 | 1545–0013 |
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| 301.6905–1 | 1545–0074 |
| 301.7001–1 | 1545–0123 |
| 301.7101–1 | 1545–1029 |
| 301.7207–1 | 1545–0092 |
| 301.7216–2 | 1545–0074 |
| 301.7216–2(o) | 1545–1209 |
| 301.7425–3 | 1545–0854 |
| 301.7430–2(c) | 1545–1356 |
| 301.7507–8 | 1545–0123 |
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| 301.7513–1 | 1545–0429 |
| 301.7517–1 | 1545–0015 |
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| 301.7701–16 | 1545–0795 |
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| 301.7701(b)–6 | 1545–0089 |
| 301.7701(b)–7 | 1545–0089 |
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| 301.7805–1 | 1545–0805 |
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| 601.401 | 1545–0257 |
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| 601.702 | 1545–0429 |

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EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 602.101, see the List of CFR Sections Affected, which appears in the Findings Aids section of the printed volume and on GPO Access.

# List of CFR Sections Affected

All changes to sections of part 1 (§§ 1.851 to 1.1000) of title 26 of the Code of Federal Regulations that were made by documents published in the FEDERAL REGISTER since January 1, 2001, are enumerated in the following list. Entries indicate the nature of the changes effected. Page numbers refer to FEDERAL REGISTER pages. The user should consult the entries for chapters and parts as well as sections for revisions.

For the period before January 1, 2001, see the ''List of CFR Sections Affected, 1949–1963, 1964–1972, 1973–1985, and 1986–2000'' published in 11 separate volumes.

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