

(a)(1) of this section unless the purchaser of the inventory property or services is a resident of a possession.

(ii) *Eligibility determination.* Notwithstanding the limitation on the availability of the section 936 credit for income described in paragraph (a)(1) of this section, if income treated as interest income under paragraph (a)(1) of this section is derived from sources within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(A). If such income is derived from the active conduct of a trade or business within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(B). (These rules apply for purposes of determining whether a corporation is eligible to elect the credit provided under section 936(a).)

(iii) *Example.* The following example illustrates the application of paragraph (e)(3) of this section.

Example. Corporation X is operating in a possession as a possessions corporation. In 1985, X earned \$50,000 from the active conduct of a business in the possession, including \$5,000 from trade or service receivables acquired from a related party. Obligors under the receivables acquired by X are not residents of the possession. Corporation X also earned \$20,000 from activities other than its active conduct of business in the possession. The \$5,000 derived by X from the receivables is not eligible for the section 936 credit. However, the \$5,000 may be used by X to meet the percentage tests under section 936(a)(2) to the extent that such income is considered to be derived from sources within the possession (for purposes of section 936(a)(2)(A)) or is considered to be derived from the active conduct of a trade or business in the possession (for purposes of section 936(a)(2)(B)), in either case determined without regard to the characterization of such income under this section.

(f) *Effective date.* The provisions of this section shall apply with respect to accounts receivable and evidences of indebtedness transferred after March 1, 1984 and are effective June 14, 1988.

[T.D. 8209, 53 FR 22166, June 14, 1988]

§ 1.865-1 Loss with respect to personal property other than stock.

(a) *General rules for allocation of loss—*
 (1) *Allocation against gain.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. For purposes of this section, loss includes bad debt deductions under section 166 and loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale or worthlessness of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in

a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904-4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application—(1) Depreciable property.* In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument.* Loss described in the last sentence of § 1.1275-4(b)(9)(iv)(A) that is recognized with respect to a contingent payment debt instrument to which § 1.1275-4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory

groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions—(1) Foreign currency and certain financial instruments.* This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory.* This section does not apply to loss recognized with respect to property described in section 1221(a)(1).

(3) *Interest equivalents and trade receivables.* Loss subject to § 1.861-9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of § 1.861-9T and not under the rules of this section.

(4) *Unamortized bond premium.* If a taxpayer recognizing loss with respect to a bond (within the meaning of § 1.171-1(b)) did not amortize bond premium to the full extent permitted by section 171 and the regulations thereunder, then, to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer, loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest.* Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§ 1.61-7(d) and 1.446-2(e).

(6) *Anti-abuse rules*—(i) *Transactions involving built-in losses.* If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one

or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to personal property (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. For an example illustrating a similar rule with respect to stock loss, see § 1.865-2(b)(4)(iv) *Example 3*.

(d) *Definitions*—(1) *Contingent payment debt instrument.* A contingent payment debt instrument is any debt instrument that is subject to § 1.1275-4.

(2) *Depreciable personal property.* Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in § 1.861-8.* See § 1.861-8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

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

Example 1. On January 1, 2000, A, a domestic corporation, purchases for \$1,000 a machine that produces widgets, which A sells in the United States and throughout the world. Throughout A's holding period, the machine is located and used in Country X. During A's holding period, A incurs depreciation deductions of \$400 with respect to the machine. Under § 1.861-8, A allocates and apportions depreciation deductions of \$250 against foreign source general limitation income and \$150 against U.S. source income. On December 12, 2002, A sells the machine for \$100 and recognizes a loss of \$500. Because the machine was used predominantly outside the United States, under sections 865(c)(1)(B) and 865(c)(3)(B)(ii) gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire \$500 loss is allocated against foreign source general limitation income.

Example 2. On January 1, 2002, A, a domestic corporation, loans \$2,000 to N, its wholly-

owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to § 1.1275-4(b). During 2002 through 2004, *A* accrues and receives interest income of \$630, \$150 of which is foreign source general limitation income and \$480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to § 1.1275-4(b)(6) in 2002 through 2004. On January 1, 2005, *A* disposes of the debt instrument and recognizes a \$770 loss. Under § 1.1275-4(b)(8)(ii), \$630 of the loss is treated as ordinary loss and \$140 is treated as capital loss. Assume that \$140 of interest income earned in 2005 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under § 1.1275-4(b)(9)(iv), \$150 of the ordinary loss is allocated against foreign source general limitation income and \$480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the \$140 capital loss is allocated against foreign source passive income.

Example 3. (i) On January 1, 2003, *A*, a domestic corporation, purchases for \$1,200 a taxable bond maturing on December 31, 2008, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Interest payments for 2003 and 2004 are timely made. *A* does not elect to amortize its bond premium under section 171 and the regulations thereunder, which would have permitted *A* to offset the \$100 of interest income by \$28.72 of bond premium in 2003, and by \$30.42 in 2004. On January 1, 2005, *A* sells the bond and recognizes a \$100 loss. Under paragraph (c)(4) of this section, \$59.14 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining \$40.86 of the loss is allocated against U.S. source income.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that *A* made the election to amortize its bond premium effective for taxable year 2004 (see § 1.171-4(c)). Under paragraph (c)(4) of this section, \$28.72 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining \$71.28 of the loss is allocated against U.S. source income.

Example 4. On January 1, 2002, *A*, a domestic corporation, purchases for \$1,000 a bond maturing December 31, 2014, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 2002 and 2006, *A* accrues and receives foreign source interest income of \$500 with respect to the

bond. On January 1, 2007, *A* sells the bond and recognizes a \$500 loss. Under paragraph (a)(1) of this section, the \$500 loss is allocated against U.S. source income.

Example 5. On January 1, 2002, *A*, a domestic corporation on the accrual method of accounting, purchases for \$1,000 a bond maturing December 31, 2012, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 2002, after *A* has accrued \$44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. *A* sells the bond (including the accrued interest) for \$20. Assuming that *A* properly accrued \$44 of interest income, *A* treats the \$20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a \$1,000 loss with respect to the bond principal and a \$24 loss with respect to the accrued interest. See § 1.61-7(d). Under paragraph (a)(1) of this section, the \$1,000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the \$24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section is applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* See § 1.865-2(e)(3) for examples illustrating an applicability

date provision similar to the applicability date provided in this paragraph (f).

[T.D. 8973, 66 FR 67083, Dec. 28, 2001]

§ 1.865-2 Loss with respect to stock.

(a) *General rules for allocation of loss with respect to stock*—(1) *Allocation against gain.* Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). For purposes of this section, loss includes loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) *Stock attributable to foreign office.* Except as otherwise provided in paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*—(i) *In general.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains

in the foreign country is at least 10 percent.

(ii) *Bona fide residents of Puerto Rico.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income. If gain from a sale of such stock would give rise to income exempt from tax under section 933, the loss with respect to such stock shall be allocated to amounts that are excluded from gross income under section 933(1) and therefore shall not be allowed as a deduction from gross income. See section 933(1) and § 1.933-1(c).

(4) *Stock constituting a United States real property interest.* Loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904-4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general.* If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares