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
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.