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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.

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§ 1.954–0 Introduction.

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§ 1.954–1 Foreign base company income.

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§ 1.954–2 Foreign personal holding company income.

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[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, through its own officers or staff of employees, has manufactured or produced, or property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its officers or staff of employees, 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 through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, 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 either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of rents is determined based on all 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. In addition, for purposes of aircraft or vessels leased in foreign commerce, an organization will be considered substantial if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 10 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. For purposes of paragraphs (c)(1)(iv) and (c)(2) of this section and §1.956–2(b)(1)(vi), the term *aircraft or vessels* includes component parts, such as engines that are leased separately from an aircraft or vessel.

(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;

(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; and

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482–7(b)).

(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.

(v) *Leased in foreign commerce.* For purposes of paragraphs (c)(1)(iv) and (c)(2)(ii) of this section, an aircraft or vessel is considered to be leased in foreign commerce if the aircraft or vessel is used in foreign commerce and is used predominantly outside the United States. An aircraft or vessel is considered to be used in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and a port (or airport) in a foreign country or between foreign ports (or airports). An aircraft or vessel will be considered to be used predominantly outside the United States if more than 50 percent of the miles traversed during the taxable year in the use of the aircraft or vessel are traversed outside the United States or if the aircraft or vessel is located outside the United States more than 50 percent of the time during the taxable year.

(vi) *Leases acquired by the CFC lessor.* Except as provided in this paragraph (c)(2)(vi), the exception in paragraph (c)(1)(iv) of this section will also apply to rents from leases acquired from any person, if following the acquisition the lessor performs active and substantial management, operational, and remarketing (including remarketing for purposes of re-leasing or selling the property) functions with respect to the leased property. However, if any person is claiming a benefit with respect to an acquired lease pursuant to section 921

or 114 of the Internal Revenue Code or section 101(d) of the American Jobs Creation Act of 2004, (Pub. L. 108–357 (118 Stat. 1418) (2004)), the rents from such lease, notwithstanding paragraphs (b)(6) and (c) of this section, are ineligible for the exception in section 954(c)(2)(A).

(vii) *Marketing of leases.* Paragraph (c)(1)(iv) of this section can apply whether a lessor is engaged in the marketing of leases as a form of financing or is engaged in marketing the property as such, and regardless of whether the lease is classified as a finance lease or an operating lease for financial accounting purposes, so long as such lease is treated as a lease for Federal income tax purposes.

(viii) *Cost sharing arrangements (CSAs).* For purposes of paragraphs (c)(1)(i) and (iv) of this section, CST Payments or PCT Payments (as defined in §1.482–7(b)(1)) made by the lessor to another controlled participant (as defined in §1.482–7(j)(1)(i)) pursuant to a CSA (as defined in §1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.

(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).

Example 6. The facts are the same as in *Example 2,* except that controlled foreign corporation D purchases aircraft which it leases to others. If Corporation D incurs active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal to or in excess of 10 percent of its adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section, the organization maintained and operated by Corporation D in country X is substantial in relation to the amount of rents Corporation

D receives from leasing the aircraft. 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). If a particular aircraft subject to lease was not leased by the lessee corporation in foreign commerce, for example, because 50 percent or less of the miles during the taxable year were traversed outside the United States and the aircraft was located in the United States for 50 percent or more of the taxable year, Corporation D is not prevented from otherwise showing that it actively carries on a trade or business with regard to the rents derived from that aircraft under paragraph (c)(2)(ii) of this section, based on its facts and circumstances or a showing that active leasing expenses equal or exceed 25 percent of the adjusted leasing profit.

(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, through its own officers or staff of employees, has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its officers or staff of employees, is regularly engaged in the development, creation, or production of, or in the acquisition 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 through its own officers or staff of employees located in a foreign country or countries, if the licensor, through its officers or staff of employees, maintains and operates an organization either in such foreign country or in such foreign countries (collectively), as applicable, 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 either in a foreign country or in foreign countries (collectively) 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;

(D) Deductions for payments made to agents or independent contractors with respect to the licensed property; and

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482–7(b)).

(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.

(v) *Cost sharing arrangements (CSAs).* For purposes of paragraphs (d)(1)(i) and (ii) of this section, CST Payments or PCT Payments (as defined in §1.482–7(b)(1)) made by the licensor to another controlled participant (as defined in §1.482–7(j)(1)(i)) pursuant to a CSA (as defined in §1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.

(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 minimis 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 minimis 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.

(i) *Effective/applicability dates*—(1) *Paragraphs (c)(2)(v) through (vii).* Paragraphs (c)(2)(v) through (vii) of this section and *Example 6* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations beginning on or after May 2, 2006, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. Taxpayers may elect to apply paragraphs (c)(2)(v) through (vii) to taxable years of controlled foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. If an election is made to apply §1.956–2(b)(1)(vi) to taxable years beginning after December 31, 2004, then the election must also be made for paragraphs (c)(2)(v) through (vii) of this section.

(2) *Other paragraphs.* Paragraphs (c)(1)(i) and (d)(1)(i) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015. Paragraphs (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties are received or accrued on or after September 1, 2015. See §1.954–2(c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), and (d)(2)(iii), as contained in 26 CFR part 1 revised as of April 1, 2015, for rules applicable to

rents or royalties, as applicable, received or accrued before September 1, 2015.

[T.D. 8618, 60 FR 46517, Sept. 7, 1995]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.954–2, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 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 paragraphs (a)(2), (a)(3) and (a)(4) of this section, consist of gross income (whether in the form of profits, commissions, fees or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product. 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 a person that is not a related person, as defined in § 1.954–1(f), 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; 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 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 paragraph (a)(1)(i) includes a related person as defined in § 1.954–1(f).

(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	

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	

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES—Continued

Grapes	Tangelos
Grapefruit	Tangerines
Grass seed	Tobacco
Hay	Tomatoes
Honeydew melons	Walnuts
Hops	Watermelons
Lemons	Wheat

(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 to P, an unrelated 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, an unrelated person, articles manufactured in country Y and sells the articles 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 paragraph (a)(1) of this section 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 paragraphs (a)(4)(ii) and (a)(4)(iii) of this section apply under this paragraph (a)(2) in determining what constitutes the manufacture, production, or construction of personal property, excluding the requirement set forth in paragraph (a)(4)(i) of this section that the provisions of paragraphs (a)(4)(ii) and (a)(4)(iii) of this section may only be satisfied through the activities of employees of the corporation manufacturing, producing, or constructing the personal property. The principles of paragraph (a)(4)(iv) of this section apply under this paragraph (a)(2) in determining what constitutes the manufacture, production, or construction of personal property but only when the personal property is manufactured, produced, or constructed by a person related to the controlled foreign corporation within the meaning of §1.954–1(f). The application of this paragraph (a)(2) 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, produced, or constructed 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. A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees (as defined in §31.3121(d)–1(c) of this chapter) with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased. 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 paragraph (a)(5) of this section.

(ii) *Substantial transformation of property.* If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation. The application of this paragraph (a)(4)(ii) 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 assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and 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 paragraph (a)(4)(iii) 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).

(iv) *Substantial contribution to manufacturing of personal property*—(*a*) *In general.* If an item of personal property would be considered manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) prior to sale by the controlled foreign corporation had all of the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale been undertaken by the controlled foreign corporation through the activities of its employees, then this paragraph (a)(4)(iv) applies. If this paragraph (a)(4)(iv) applies and if the facts and circumstances evince that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold, then the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation.

(*b*) *Activities.* The determination of whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold involves, but will not necessarily be limited to, consideration of the following activities:

(*1*) Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section).

(*2*) Activities that are considered in, but that are insufficient to satisfy, the tests provided in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section.

(*3*) Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods.

(*4*) Management of manufacturing costs or capacities (for example, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs).

(*5*) Control of manufacturing related logistics.

(*6*) Quality control (for example, sample testing or establishment of quality control standards).

(*7*) Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.

(*c*) *Application of substantial contribution test.* When considering whether a controlled foreign corporation makes a substantial contribution to the manufacture, production, or construction of the personal property, the performance of any activity in paragraph (a)(4)(iv)(*b*) of this section will be taken into account. The performance or lack of performance of any particular activity in paragraph (a)(4)(iv)(*b*) of this section, or of a particular number of activities in (a)(4)(iv)(*b*) of this section, is not determinative. The weight accorded to the performance of any quantum of any activity (whether or not specified in paragraph (a)(4)(iv)(*b*) of this section) will vary with the facts and circumstances of the particular business. See paragraph (a)(4)(iv)(*d*) *Examples 8, 10* and *11* of this section. In determining whether the activities of the controlled foreign corporation constitute a substantial contribution,

there is no minimum performance threshold before an activity can be considered. The fact that other persons make a substantial contribution to the manufacture, production, or construction of the personal property prior to sale does not preclude the controlled foreign corporation from making a substantial contribution to the manufacture, construction, or production of that property through the activities of its employees. See paragraph (a)(4)(iv)(*d*) *Example 9* of this section.

(*d*) *Examples.* The rules of this paragraph (a)(4)(iv) are illustrated by the following examples:

Example 1. No substantial contribution to manufacturing. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Under the terms of the contract, FS retains the right to control the raw materials, work-in-process, and finished goods, and the right to oversee and direct the activities or process pursuant to which Product X is manufactured by CM. FS owns the intellectual property used in the manufacturing process. However, FS does not exercise, through its employees, its powers to control the raw materials, work-in-process, or finished goods, and FS does not exercise its powers of oversight and direction. Likewise, FS does not, through its employees, develop or direct the use or development of the intellectual property for the purpose of manufacturing Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual rights to control materials, contractual rights to oversee and direct the manufacturing activities or process pursuant to which the property is manufactured, and ownership of intellectual property are not sufficient to satisfy this paragraph (a)(4)(iv). Therefore, under the facts and circumstances of the business, FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 2. Substantial contribution to manufacturing. (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. FS, through its employees, engages in product design and quality control and controls manufacturing related logistics. Employees of FS exercise the right to oversee and direct the activities of CM in the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section. The analysis and conclusion would be the same if CM were related to FS because the relationship between CM and FS is irrelevant for purposes of applying paragraph (a)(4) of this section.

Example 3. Raw materials procured by contract manufacturer. (i) *Facts.* FS, a controlled foreign corporation, enters into a contract with CM to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS to a related person for use outside of FS's country of organization. Employees of FS select the materials that will be used to manufacture Product X. FS does not own the materials or work-in-process during the manufacturing process. FS, through its employees, exercises oversight and direction of the manufacturing process and provides quality control. FS manages the manufacturing costs and capacities with respect to Product X by managing the risk of loss and engaging in demand planning and production scheduling.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities

of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 4. Physical conversion by employees of a person other than the contract manufacturer. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. CM contracts with another corporation for its employees in order to operate CM's manufacturing plant and transform, assemble, or convert the raw materials into Product X. Apart from the physical performance of the substantial transformation, assembly, or conversion of the raw materials into Product X, employees of FS perform all of the other manufacturing activities required in connection with the manufacture of Product X (for example, oversight and direction of the manufacturing process; vendor selection; control of raw materials, work-in-process, and finished goods; control of manufacturing related logistics; and quality control).

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 5. Automated manufacturing supervised by another person. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation selected by FS, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS to related and unrelated persons for use outside of FS's country of organization. At all times, FS retains ownership of the raw materials, work-in-process, and finished goods. FS retains the right to oversee and direct the activities or process pursuant to which Product X is manufactured by CM, but does not exercise, through its employees, its powers of oversight and direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and apply any necessary patches or fixes. The software and network systems were developed by employees of DP, the U.S. corporate parent of FS. DP's employees supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including decisions related to acceptable performance of the manufacturing process, stoppages of that process, and decisions related to product and manufacturing process design. DP's employees develop and provide to FS all of the upgrades to the software and network systems. DP also has employees who direct and control other aspects of the manufacturing process such as vendor and material selection, management of the manufacturing costs and capacities, and the selection of CM. The need for DP's employees to direct the activities of the FS employees and otherwise contribute to the manufacturing process evinces that substantial operational responsibilities and decision making are required to be exercised by parties other than CM in order to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstance of the business, FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere ownership of materials and intellectual property along with contractual rights to exercise powers of direction and control are not sufficient to satisfy this paragraph (a)(4)(iv). The employees of FS do not perform the amount of activity necessary to constitute a substantial contribution. FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 6. Automated manufacturing supervised by FS. (i) *Facts.* Assume the same facts as in *Example 5,* except for the following. FS, through its employees, engages in the activities undertaken by DP's employees in *Example 5.* DP's employees also contribute to product and manufacturing process design,

and provide support and oversight to FS in connection with functions performed by FS through its employees.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. Selection of the contract manufacturer, even though not specifically identified in paragraph (a)(4)(iv)(*b*) of this section, is considered under paragraph (a)(4)(iv)(*c*) of this section in determining whether FS makes a substantial contribution to the manufacture of Product X through its employees. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 7. Automated manufacturing supervised by FS with purchased intellectual property. (i) *Facts.* Assume the same facts as in *Example 6,* except for the following. The software and network systems, and the upgrades to those systems, were purchased by FS rather than developed by employees of FS.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The lack of performance of software and network system development activities is not determinative under the facts and circumstances of the business. Therefore, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 8. Manufacture without intellectual property. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. At all times, FS controls the raw materials, work-in-process, and finished goods. FS controls the manufacturing related logistics, manages the manufacturing costs and capacities, and provides quality control with respect to CM's manufacturing process and product. No intellectual property of significant value is required to manufacture Product X. FS does not own any intellectual property underlying Product X, or hold an exclusive or nonexclusive right to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Because use of intellectual property plays little or no role in the manufacture of Product X, it is not important to the substantial contribution analysis under paragraph (a)(4)(iv) of this section. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 9. Substantial contribution by more than one CFC. (i) *Facts.* FS1 and FS2, unrelated controlled foreign corporations, contract with CM, an unrelated corporation, to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS1's and FS2's respective countries of organization. Neither FS1 nor FS2 owns the materials or work-in-process during the manufacturing process. Product X is sold by FS1 and FS2 to persons related to FS1 and FS2, respectively, for disposition outside of FS1's and FS2's respective countries of organization. FS1, through its employees, designs Product X. FS1 directs the use of the product design and design specifications, and other intellectual property, for the purpose of manufacturing Product X. Employees of FS1 also select the materials that will be used to manufacture Product X, and the vendors that provide those materials. FS2, through its employees, designs the process for manufacturing Product X. FS2, through its employees, manages the manufacturing costs and capacities with respect to Product X. FS1 and FS2 each provide quality control and oversight and direction of CM's manufacturing activities with respect to different aspects of the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS1 or FS2 through the activities of their employees, FS1 or FS2 would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The fact that other persons make a substantial contribution to the manufacture of personal property does not preclude a controlled foreign corporation from making a substantial contribution to the manufacture of personal property through the activities of its employees. In the analysis of whether FS1 or FS2 make a substantial contribution to the manufacture of Product X, each company takes into account its individual activities, including those of providing quality control and oversight and direction of the manufacture of Product X. In addition, no threshold level of activity is required, including with respect to providing quality control or oversight and direction of the activities or process pursuant to which Product X is manufactured, before FS1 and FS2 can take into account their respective activities. Under the facts and circumstances of the business, both FS1 and FS2 satisfy the test under this paragraph (a)(4)(iv) because each independently makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS1 and FS2 are each considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 10. Manufacture of products designed by CFC. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Products in the X industry are distinguished (and vary widely in value) based on the raw materials used to make the product and the product design. FS designs the product and selects the materials that CM will use to manufacture Product X. FS also manages the manufacturing costs and capacities. Product X can be manufactured from the raw materials to FS's design specifications without significant oversight and direction, quality control, or control of manufacturing related logistics. The activities most relevant to the substantial contribution analysis under these facts are material selection, product design and management of the manufacturing costs and capacities.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS makes a substantial contribution through the activities of its employees to the manufacture of Product X. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 11. Direction and oversight of manufacturing and quality control through periodic visits. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. FS controls the raw material, work-in-process, and finished goods, manages the manufacturing costs and capacities, and provides oversight and direction of the manufacture of Product X. Employees of FS visit CM's manufacturing facility for one week each quarter and perform quality control tests on a random sample of the units of Product X produced during the week. In the X industry, quarterly visits to a manufacturing facility by qualified persons are sufficient to control the quality of manufacturing.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) with respect to Product X because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

(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)(i) of this section, only if the manufacturing exception of paragraph (a)(4)(i) 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 the employees of, and property owned by, the partnership.

(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, then paragraph (b)(1)(i)(*b*) of this section 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. See paragraph (b)(1)(ii)(*c*)(*1*) of this section for rules applicable to a controlled foreign corporation that carries on purchase or sales activities by or through one or more branches or similar establishments in addition to carrying on manufacturing activities by or through one or more branches or similar establishments.

(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 the foreign base company sales income of such corporation. See section 954(d)(2). The provisions of this paragraph (b)(1)(ii) will apply only if the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of paragraph (a)(4)(i) of this section, or carries on growing or extracting activities with respect to such personal property.

(*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 more than one branch—*(*1*) *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 paragraph (b)(1)(ii)(*b*) of this section 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. If this rule applies, the sales or purchase branch rules contained in paragraph (b)(1)(i) of this section do not apply. The application of this paragraph (b)(1)(ii)(*c*)(*1*) is illustrated by the following example:

Example. All activities of controlled foreign corporation conducted through sales branches and manufacturing branch. (i) *Facts.* FS, a controlled foreign corporation organized under the laws of country M, operates three branches. Branch A, located in country A, manufactures Product X under the principles of paragraph (a)(4)(i) of this section. Branch B, located in Country B, sells Product X manufactured by Branch A to customers for use outside of Country B. Branch C, located in Country C sells Product X manufactured by Branch A to customers for use outside of Country C. FS does not conduct any manufacturing or selling activities apart from the activities of Branches A, B and C. Country M imposes an effective rate of tax on sales income of 0%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 20%. Country C imposes an effective rate of tax on sales income of 18%.

(ii) *Result.* Pursuant to this paragraph (b)(1)(ii)(*c*)(*1*), paragraph (b)(1)(ii)(*b*) of this section is applied to the sales income derived by Branch B by treating Branch B as though it alone were the remainder of the controlled foreign corporation. The use of Branch B does not have the same tax effect as if Branch B were a wholly owned subsidiary of FS because the tax rate applicable to the income allocated to Branch B under paragraph (b)(1)(ii)(*b*) of this section (20%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of Country A (20%), the country in which Branch A is located. In addition, paragraph (b)(1)(ii)(*b*) of this section is applied separately to the sales income derived by Branch C by treating Branch C as though it alone were the remainder of the controlled foreign

corporation. The use of Branch C does not have the same tax effect as if Branch C were a wholly owned subsidiary of FS because the tax rate applicable to the income allocated to Branch C under paragraph (b)(1)(ii)(*b*) of this section (18%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of Country A (20%), the country in which Branch A is located. Pursuant to this paragraph (b)(1)(ii)(*c*)(*1*), the rules under paragraph (b)(1)(i) of this section for determining whether a sales or purchase branch is treated as a separate corporation from the remainder of the controlled foreign corporation do not apply.

(*2*) *Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities with respect to separate items of personal property 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, then paragraphs (b)(1)(ii)(*b*) and (*c*) of this section will be applied separately to each such branch or similar establishment (by treating such manufacturing branch or similar establishment as if it were the only such branch or similar establishment of the controlled foreign corporation and as if any other such branches or similar establishments were separate corporations) for purposes of 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. The application of this paragraph (b)(1)(ii)(*c*)(*2*) is illustrated by the following example:

Example. Multiple branches that satisfy paragraph (a)(4)(i). (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates two branches, Branch A and Branch B located in Country A and Country B, respectively. Branch A and Branch B each manufacture separate items of personal property (Product X and Product Y, respectively) within the meaning of paragraph (a)(4)(ii) or (iii) of this section. Raw materials used in the manufacture of Product X and Product Y are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X and Product Y to a related person for use, disposition or consumption outside of Country M. Employees of FS located in Country M perform only sales functions. The effective rate of tax imposed in Country M on the income from the sales of Product X and Product Y is 10%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 12%.

(ii) *Result.* Pursuant to this paragraph (b)(1)(ii)(*c*)(*2*), paragraph (b)(1)(ii)(*b*) of this section is applied separately to Branch A and Branch B with respect to the sales income of FS attributable to Product X (manufactured by Branch A) and Product Y (manufactured by Branch B). Because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (20%), the use of Branch A to manufacture Product X has substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS. Because the effective rate of tax on FS's sales income from the sale of Product Y in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch B is located (12%), the use of Branch B to manufacture Product Y does not have substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS. Consequently, only Branch A is treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income from the sales of Product X.

(*3*) *Use of more than one manufacturing branch, or one or more manufacturing branches and the remainder of the controlled foreign corporation, to manufacture, produce, or construct the same item of personal property*—(*i*) *In general.* This paragraph (b)(1)(ii)(*c*)(*3*) applies to determine the location of manufacture, production, or construction of personal property for purposes of applying paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section where more than one branch or similar establishment of a controlled foreign corporation, or one or more branches or similar establishments of a controlled foreign corporation and the remainder of the controlled foreign corporation, each engage in manufacturing, producing, or constructing activities with respect to the same item of personal property which is then sold by the controlled foreign corporation. This paragraph (b)(1)(ii)(*c*)(*3*) is applied

separately with respect to the income derived by each purchasing or selling branch or similar establishment or purchasing or selling remainder of the controlled foreign corporation as provided under paragraphs (b)(1)(i) and (b)(1)(ii) of this section. The location of manufacture, production, or construction is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*ii*) of this section if one or more branches or similar establishments or the remainder of the controlled foreign corporation independently satisfies paragraph (a)(4)(i) of this section with respect to an item of personal property. The location of manufacture, production, or construction is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section if none of the branches or similar establishments or the remainder of the controlled foreign corporation independently satisfies paragraph (a)(4)(i) of this section with respect to an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production or construction of that property within the meaning of paragraph (a)(4)(iv) of this section. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*), the location of any activity with respect to the manufacture, production, or construction of an item of personal property is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*iv*) of this section. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*), if multiple branches or similar establishments are located in a single jurisdiction, then the activities of those branches will be aggregated for purposes of determining whether a branch or remainder of the controlled foreign corporation satisfies paragraph (a)(4)(i) of this section.

(*ii*) *Manufacture, production, or construction in one or more locations.* If only one branch or similar establishment or only the remainder of a controlled foreign corporation independently satisfies paragraph (a)(4)(i) of this section with respect to an item of personal property, then that branch or similar establishment or the remainder of the controlled foreign corporation will be the location of manufacture, production, or construction of that property for purposes of applying paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section to the income from the sale of that property. See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Example 1* of this section. If more than one branch or similar establishment or one or more branches or similar establishments and the remainder of the controlled foreign corporation, each independently satisfy paragraph (a)(4)(i) of this section with respect to an item of personal property, then the location of manufacture, production, or construction of that property for purposes of applying paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section will be the location of that branch or similar establishment or the jurisdiction under the laws of which the remainder of the controlled foreign corporation is organized that satisfies paragraph (a)(4)(i) of this section and that would, after applying paragraph (b)(1)(ii)(*b*) of this section to such branch or similar establishment or paragraph (b)(1)(i)(*b*) of this section to the remainder of the controlled foreign corporation, impose the lowest effective rate of tax on the income allocated to such branch or the remainder of the controlled foreign corporation under such section (that is, either paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section). See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Example 2* of this section.

(*iii*) *No location independently satisfies manufacturing test.* If no branch or similar establishment or the remainder of the controlled foreign corporation independently satisfies paragraph (a)(4)(i) of this section with respect to an item of personal property but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production, or construction of that property within the meaning of paragraph (a)(4)(iv) of this section, then for purposes of applying paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section, the location of manufacture, production, or construction with respect to the income derived by a purchasing or selling branch or similar establishment or the purchasing or selling remainder of the controlled foreign corporation in connection with the purchase or sale of that property will be the ''tested manufacturing location'' unless the ''tested sales location'' provides a greater contribution to the manufacture, production, or

construction of the property. The tested manufacturing location is the location of any branch or similar establishment or remainder of the controlled foreign corporation that contributes to the manufacture, production, or construction of the personal property, if any, that would, after applying paragraph (b)(1)(ii)(*b*) of this section to such branch or similar establishment or paragraph (b)(1)(i)(*b*) of this section to the remainder of the controlled foreign corporation, be treated as a separate corporation and would impose the lowest effective rate of tax on the income allocated to such branch or similar establishment or to the remainder of the controlled foreign corporation under such section (that is, either paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section). The tested sales location is the location of the purchasing or selling branch or similar establishment or the remainder of the controlled foreign corporation by or through which the purchasing or selling activities are carried on with respect to the personal property. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*)(*iii*), the contribution to the manufacture, production, or construction of the personal property by the tested sales location will be deemed to include the activities of any branch or similar establishment or remainder of the controlled foreign corporation that would not be treated as a corporation separate from the tested sales location after the application of paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*)(*iii*), the contribution of the tested manufacturing location to the manufacture, production, or construction of the personal property will be deemed to include any activities of any branch or similar establishment or remainder of the controlled foreign corporation that would be treated as a corporation separate from the tested sales location after the application of paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section. Whether the tested sales location provides a greater contribution to the manufacture, production, or construction of the personal property is determined by weighing the relative contributions to the manufacture, production, or construction of that property by the tested sales location and the tested manufacturing location under the facts and circumstances test provided in paragraph (a)(4)(iv) of this section. See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Examples 3*, *4*, *5*, and *6* of this section. If the tested sales location provides a greater contribution to the manufacture, production, or construction of the personal property than the tested manufacturing location or if there is no tested manufacturing location, then the tested sales location is the location of manufacture, production, or construction of that property and the rules of paragraphs (b)(1)(i)(*a*) and (b)(1)(ii)(*a*) of this section will not apply with respect to the income derived by the tested sales location in connection with the purchase or sale of that property and the use of that purchasing or selling branch or similar establishment or the purchasing or selling remainder will not result in a branch being treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section.

(*iv*) *Location of activity.* For purposes of paragraph (b)(1)(ii)(*c*)(*3*) of this section, the location of any activity with respect to the manufacture, production, or construction of an item of personal property is the location where the employees of the controlled foreign corporation perform such activity. For example, the location of any activity concerning intellectual property is determined based on where employees of the controlled foreign corporation develop or direct the use or development of the intellectual property, not on the formal assignment of that intellectual property.

(*v*) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(ii)(*c*)(*3*):

Example 1. Multiple branches contribute to the manufacture of a single product only one branch satisfies paragraph (a)(4)(i). (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates three branches, Branch A, Branch B, and Branch C, located respectively in Country A, Country B, and Country C. Branch A, Branch B, and Branch C each performs different manufacturing activities with respect to the manufacture of Product X. Branch A, through the activities of employees of FS located in Country A, designs Product X. Branch B, through the activities of employees of FS located in Country B, provides quality control

and oversight and direction. Branch C, through the activities of employees of FS located in Country C, manufactures Product X (within the meaning of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) using the designs developed by Branch A and under the oversight of the quality control personnel of Branch B. The activities of Branch A and Branch B do not independently satisfy paragraph (a)(4)(i) of this section. Employees of FS located in Country M purchase the raw materials used in the manufacture of Product X from a related person and control the work-in-process and finished goods throughout the manufacturing process. Employees of FS located in Country M also manage the manufacturing costs and capacities related to Product X. Further, employees of FS located in Country M oversee the coordination between the branches. The activities of the remainder of FS in Country M do not independently satisfy paragraph (a)(4)(i) of this section. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. The sales income from the sale of Product X is taxed in Country M at an effective rate of tax of 10%. Country C imposes an effective rate of tax of 20% on sales income.

(ii) *Result.* Country C is the location of manufacture for purposes of applying paragraph (b)(1)(ii)(*b*) of this section because only the activities of Branch C independently satisfy paragraph (a)(4)(i) of this section. The use of Branch C has substantially the same tax effect as if Branch C were a wholly owned subsidiary corporation of FS because the effective rate of tax on the sales income (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch C is located (20%). Therefore, sales of Product X by the remainder of FS are treated as sales on behalf of Branch C. In determining whether the remainder of FS will qualify for the manufacturing exception under paragraph (a)(4)(iv) of this section, the activities of FS will include the activities of Branch A or Branch B, respectively, if each of those branches would not be treated as a separate corporation under paragraph (b)(1)(ii)(*b*) of this section, if that paragraph were applied independently to each of Branch A and Branch B. See paragraph (b)(2)(ii)(*a*) of this section.

Example 2. Multiple branches satisfy paragraph (a)(4)(i) with respect to the same product sold by the controlled foreign corporation. (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. In addition to the design of Product X, Branch A also performs in Country A other manufacturing activities, including those ascribed to FS in *Example 1*, that are sufficient to qualify as manufacturing under paragraph (a)(4)(iv) of this section with respect to Product X. Country A imposes an effective rate of tax of 12% on sales income.

(ii) *Result.* Branch A and Branch C through their activities each independently satisfy the requirements of paragraph (a)(4)(i) of this section. Therefore, paragraph (b)(1)(ii)(*b*) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the lowest effective rate of tax that would apply to the sales income in either Country A or Country C if paragraph (b)(1)(ii)(*b*) of this section were applied separately to Branch A and Branch C. Country A imposes the lower effective rate of tax, and therefore, Branch A is treated as the location of manufacture for purposes of applying paragraph (b)(1)(ii)(*b*) of this section. The effective rate of tax in Country B is not considered because Branch B does not satisfy paragraph (a)(4)(i) of this section. Neither Branch A nor Branch C is treated as a separate corporation because the effective rate of tax on the sales income of FS from the sale of Product X (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (12%). Sales of Product X by the remainder of the controlled foreign corporation are not treated as made on behalf of any branch.

Example 3. Determining the location of manufacture when manufacturing activities performed by multiple branches and no branch independently satisfies paragraph (a)(4)(i). (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion of the raw materials in Country C. FS has two branches, Branch A and Branch B, located in Country A and Country B respectively. Branch A, through the activities of employees of FS located in Country A, designs Product X. Branch B, through the activities of employees of FS located in Country B, controls manufacturing related logistics, provides oversight and direction during the manufacturing process, and controls the raw materials and work-in-process. FS manages the manufacturing costs and capacities related to the manufacture of Product X through employees located in Country M. Further, employees of FS located in Country M oversee the coordination between the branches. Employees of FS located in Country M also sell Product X to unrelated persons for use outside of Country M. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20%, and Country B imposes an effective

rate of tax on sales income of 24%. Neither the remainder of FS, nor any branch of FS independently satisfies paragraph (a)(4)(i) of this section. However, under the facts and circumstances of the business, FS as a whole provides a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section.

(ii) *Result.* Based on the facts, neither the remainder of FS (through the activities of its employees in Country M) nor any branch of FS independently satisfies paragraph (a)(4)(i) of this section with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provides a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the selling activities with respect to Product X are carried on by the remainder of FS. The location of Branch A is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%), and Country A has the lowest effective rate of tax among the manufacturing branches that would, after applying paragraph (b)(1)(ii)(*b*) of this section, be treated as a separate corporation. The activities of Branch B will be included in the contribution of Branch A for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%). Under the facts and circumstances of the business, the activities of the remainder of FS would not provide a greater contribution to the manufacture of Product X than the activities of Branch A and Branch B, considered together. Therefore, the location of manufacture is Country A, the location of Branch A.

Example 4. Manufacturing activities performed by multiple branches, no branch independently satisfies paragraph (a)(4)(i), selling activities carried on by remainder of the controlled foreign corporation, remainder contribution includes branch manufacturing activities. (i) *Facts.* The facts are the same as *Example 3,* except that the effective rate of tax on sales income in Country B is 12%. In addition, under the facts of the particular business, the activities of employees of FS located in Country B and Country M, if considered together, would provide a greater contribution to the manufacture of Product X than the activities of employees of FS located in Country A.

(ii) *Result.* Based on the facts, neither the remainder of FS (through activities of its employees in Country M) nor any branch of FS independently satisfies paragraph (a)(4)(i) of this section with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the selling activities with respect to Product X are carried on by the remainder of FS. The location of Branch A is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%), and Branch A is the only branch that would, after applying paragraph (b)(1)(ii)(*b*) of this section, be treated as a separate corporation. The activities of Branch B will be included in the contribution of the remainder of FS for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (12%). Under a facts and circumstances analysis, considered together, the activities of Branch B and the remainder of FS would provide a greater contribution to the manufacture of Product X than the activities of Branch A. Therefore, the rules of paragraph (b)(1)(ii)(a) of this section will not apply with respect to the income derived by the remainder of FS in connection with the sale of Product X, and neither Branch A nor Branch B will be treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section.

Example 5. Manufacturing activities performed by multiple branches, no branch independently satisfies paragraph (a)(4)(i), sales carried on by remainder of the controlled foreign corporation and a sales branch. (i) *Facts.* The facts are the same as *Example 3,* except that sales of Product X are also carried on through Branch D in Country D, and Country D imposes a 16% effective rate of tax on sales income. In addition, under the facts and circumstances of the business, the activities of employees of FS located in Country A and Country M, considered together, would provide a greater contribution to the manufacture of Product X than the activities of employees of FS located in Country B.

(ii) *Result.* Based on the facts, neither the remainder of FS nor any branch of FS independently satisfies paragraph (a)(4)(i) of this section with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. Further, pursuant to paragraph (b)(1)(ii)(*c*)(*1*) of this section, paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section must be applied separately to the sales income derived by the remainder of FS and Branch D respectively. The results with respect to the income derived by the remainder of FS in connection with the sale of Product X in this *Example 5* are the same as in *Example 3.* However, paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section must also be applied with respect to Branch D because the sale of Product X is also carried on through Branch D. Thus, for purposes of that sales income, the location of Branch D is the tested sales location. The location of Branch B is the tested manufacturing location because the effective rate of tax imposed on Branch D's sales income by Country D (16%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%), and Branch B is the only branch that would, after applying paragraph (b)(1)(ii)(*b*) of this section, be treated as a separate corporation. The manufacturing activities performed in Country M by the remainder of FS and the manufacturing activities performed in Country A by Branch A will be included in Branch D's contribution to the manufacture of Product X for purposes of determining the location of manufacture of Product X with respect to Branch D's sales income because the effective rate of tax imposed on the sales income by Country D (16%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country M (10%) and Country A (20%). Under the facts and circumstances of the business, the activities of Branch D, Branch A, and the remainder of FS, considered together, would provide a greater contribution to the manufacture of Product X than the activities of Branch B. Therefore, the rules of paragraph (b)(1)(ii)(*a*) of this section will not apply with respect to the income derived by Branch D in connection with the sale of Product X and the use of Branch D to sell Product X will not result in a branch being treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section.

Example 6. Determining the location of manufacture when employees of remainder of controlled foreign corporation travel to location of unrelated contract manufacturer to perform manufacturing activities. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion of the raw materials in Country C. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. Employees of FS located in Country M engage in product design, manage the manufacturing costs and capacities with respect to Product X, and direct the use of intellectual property for the purpose of manufacturing Product X. Quality control and oversight and direction of the manufacturing process are conducted in Country C by employees of FS who are employed in Country M but who regularly travel to Country C. Branch A, located in Country A, is the only branch of FS. Product design with respect to Product X conducted by employees of FS located in Country A is supplemental to the bulk of the design work, which is done by employees of FS located in Country M. At all times, employees of Branch A control the raw materials, work-in-process and finished goods. Employees of FS located in Country A also control manufacturing related logistics with respect to Product X. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20%. Neither the remainder of FS nor Branch A independently satisfies paragraph (a)(4)(i) of this section. However, under the facts and circumstance of the business, FS as a whole (including Branch A) provides a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section.

(ii) *Result.* Based on the facts, neither the remainder of FS nor Branch A independently satisfies paragraph (a)(4)(i) of this section with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS and Branch A each provide a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the selling activities with respect to Product X are carried on by the remainder of FS. The tested manufacturing location is the location of Branch A because the effective rate of tax imposed on the remainder of FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would

apply to such income in Country A (20%), and Branch A is the only branch that would, after applying paragraph (b)(1)(ii)(*b*) of this section, be treated as a separate corporation. Although the activities of traveling employees are considered in determining whether FS, as a whole, makes a substantial contribution to the manufacture of Product X under paragraph (a)(4)(iv) of this section, the activities of the employees of FS that are performed in Country C are not taken into consideration in determining whether Country M, the jurisdiction under the laws of which FS is organized, is the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. Activities of employees performed outside the jurisdiction in which the controlled foreign corporation is organized and outside a location in which the controlled foreign corporation maintains a branch or similar establishment, are not considered in determining the location of manufacture. Under the facts and circumstances of the business, the activities of employees of FS performed in Country M do not provide a greater contribution to the manufacture of Product X than the activities of employees of FS performed in Country A. Therefore, the location of manufacture is Country A, the location of Branch A.

(*4*) *Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property.* For purposes of paragraphs (b)(1)(ii)(*c*)(*2*) and (b)(1)(ii)(*c*)(*3*) of this section, an item of personal property refers to an individual unit of personal property rather than a type or class of personal property.

(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 the remainder of corporation.* (*1*) With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will, with respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation, be treated as performed on behalf of the remainder of the controlled foreign corporation.

(*2*) With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will, with respect to personal property (other than property described in paragraph (b)(2)(i)(*b*)(*1*) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder 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*) [Reserved] For further guidance, see §1.954–3T(b)(2)(i)(*d*).

(*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. For purposes of applying the rules of this paragraph (b)(2)(ii), a branch or similar establishment of a controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of the remainder of the controlled foreign corporation under paragraph (b)(2)(ii)(*b*) of this section, or the remainder of the controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of a branch or similar establishment of the controlled foreign corporation under paragraph (b)(2)(ii)(*c*) of this section, will include the activities of any other branch or similar establishment or remainder of the controlled foreign corporation that would not be treated as a separate corporation (apart from the branch or similar establishment of a controlled foreign corporation that is treated as performing purchasing or selling activities on behalf of the remainder of the controlled foreign corporation under paragraph (b)(2)(ii)(*b*) of this section or the remainder of the controlled foreign corporation that is treated as performing purchasing or selling activities on behalf of the branch or similar establishment under paragraph (b)(2)(ii)(*c*) of this section) if the effective rate of tax imposed on the income of the purchasing or selling branch or similar establishment, or purchasing or selling remainder of the controlled foreign corporation, were tested under the principles of paragraph (b)(1)(i)(*b*) or (b)(1)(ii)(*b*) of this section against the effective rate of tax that would apply to such income if it were considered derived by such other branch or similar establishment or the remainder of the controlled foreign corporation.

(*b*) *Activities treated as performed on behalf of the remainder of corporation.* (*1*) With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will, with respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation, be treated as performed on behalf of the remainder of the controlled foreign corporation.

(*2*) With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will, with respect to personal property (other than property described in paragraph (b)(2)(ii)(*b*)(*1*) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder 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*) [Reserved]

(*e*) *Comparison with ordinary treatment.* Income derived by a branch or similar establishment, or by the remainder of the controlled foreign corporation, will not be foreign base company sales income under paragraph (b) of this section if the income would not be foreign base company sales income 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 (b) 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. (i) *Facts.* Corporation E, a controlled foreign corporation incorporated under the laws of foreign Country X, is a wholly owned subsidiary of Corporation D, also a controlled foreign corporation 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, Corporation E's sole activity, carried on through Branch B, consists of the purchase of articles manufactured in Country X by Corporation D, a related person, and the sale of the articles through Branch B to unrelated persons. One hundred percent of the articles sold through Branch B are sold for use outside Country X and 90% are also sold for use outside of Country Y. The income of Corporation E derived by Branch B from such transactions is taxed to Corporation E by Country X only at the time Corporation E distributes such income to Corporation D and is taxed on the basis of what the tax (a 40% effective rate) would have been if the income had been derived in 1964 by Corporation E 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% 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% rate since under the laws of such country, only 10% of Branch B's income is derived from sources within such country. Corporation E makes no distributions to Corporation D in 1964.

(ii) *Result.* In determining foreign base company sales income of Corporation E for 1964, Branch B is treated as a separate wholly owned subsidiary corporation of Corporation E, the 5% rate of tax being less than 90% of, and at least 5 percentage points less than the 40% rate. Income derived by Branch B, treated as a separate corporation, from the purchase from a related person (Corporation D), of personal property manufactured outside of Country Y and sold for use, disposition, or consumption outside of Country Y constitutes foreign base company sales income. If, instead, Corporation D were unrelated to Corporation E, none of the income would be foreign base company sales income because Corporation E would be purchasing from and selling to unrelated persons and if Branch B were treated as a separate corporation it would likewise be purchasing from and selling to unrelated persons. Alternatively, if Corporation D were related to Corporation E, but Branch B manufactured the articles prior to sale under the principles of paragraph (a)(4)(iv) of this section, the income would not be foreign base company sales income because Branch B, treated as a separate corporation, would qualify for the manufacturing exception under paragraph (a)(4) of this section.

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	
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.

Examples 6–7 [Reserved]

Example 8. Uniformly applicable incentive tax rate in one country. (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates one branch, Branch A, located in Country A. Branch A manufactures Product X within the meaning of paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Raw materials used in the manufacture of Product X are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X to a related person for use outside of Country M. Employees of FS located in Country M carry on only sales functions. The effective rate imposed in Country M on the income from the sale of Product X is 10%. Country A generally imposes an effective rate of tax on income of 20%, but imposes a uniformly applicable incentive rate of tax of 10% on manufacturing income and related sales income.

(ii) *Result.* The use of Branch A to manufacture Product X does not have substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (10%). Consequently, pursuant to paragraph (b)(1)(ii)(*b*) of this section, Branch A is not treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income.

Example 9. Manufacturing activities performed by multiple branches, no branch independently satisfies paragraph (a)(4)(i), selling activities carried on by remainder of the controlled foreign corporation, some branch manufacturing activities included in remainder contribution. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, has three branches, Branch A, Branch B, and Branch C, located in Country A, Country B, and Country C respectively. FS purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. FS manages the manufacturing costs and capacities with respect to the manufacture of Product X through employees located in Country M. Further, employees of FS located in Country M oversee the coordination between the branches. Branch A, through the activities of employees of FS located in Country A, designs Product X, controls manufacturing related logistics, and controls the raw materials and work-in-process during the manufacturing process. Branch B, through the activities of employees of FS located in Country B, provides quality control. Branch C, through the activities of employees of FS located in Country C, provides oversight and direction during the manufacturing process. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 12%, Country B imposes an effective rate of tax on sales income of 24%, and Country C imposes an effective rate of tax on sales income of 25%. None of the remainder of FS, Branch A, Branch B, or Branch C independently satisfies paragraph (a)(4)(i) of this section. However, under the facts and circumstances of the business, FS, as a whole, provides a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section. Under the facts and circumstances of the business, the activities of the remainder of FS and Branch A, if considered together, would not provide a greater contribution to

the manufacture of Product X than the activities of Branch B and Branch C, if considered together. Under the facts and circumstances of the business, however, the activities of the employees of the remainder of FS and Branch A, if considered together, would constitute a substantial contribution to the manufacture of Product X.

(ii) *Result.* Based on the facts, neither the remainder of FS (through activities of its employees in Country M) nor any branch of FS independently satisfies paragraph (a)(4)(i) of this section with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, Branch B, and Branch C each provide a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the selling activities with respect to Product X are carried on by the remainder of FS. The location of Branch B is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%), and Country B has the lowest effective rate of tax among the manufacturing branches that would, after applying paragraph (b)(1)(ii)(*b*) of this section, be treated as a separate corporation. The manufacturing activities performed in Country A by Branch A will be included in the contribution of the remainder of FS for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (12%). The manufacturing activities performed in Country C by Branch C will be included in the contribution of Branch B for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country C (25%). Under the facts and circumstances of the business, the manufacturing activities of the remainder of FS and Branch A, considered together, would not provide a greater contribution to the manufacture of Product X than the activities of Branch B and Branch C, considered together. Therefore, the location of manufacture is Country B, the location of Branch B. In determining that Country B is the location of manufacture, it was determined that after applying paragraph (b)(1)(ii)(*b*) of this section Branch B would be treated as a separate corporation under paragraph (b)(1)(ii)(*a*) of this section for purposes of determining foreign base company sales income. To determine whether income from the sale of Product X is foreign base company sales income, the remainder of FS takes into account the activities of Branch A because, under paragraph (b)(2)(ii)(*a*) of this section, Branch A would not be treated as a separate corporation apart from FS. The remainder of FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section because the manufacturing activities of the remainder of FS and Branch A, considered together, would make a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section. Therefore, income derived from the sale of Product X by the remainder of FS does not constitute foreign base company sales income.

(c) *Effective/applicability date.* Paragraphs (a)(1)(i), (a)(1)(iii) *Example 1*, (a)(1)(iii) *Example 2*, (a)(2), (a)(4)(i), (a)(4)(ii), (a)(4)(iii), (a)(4)(iv), (a)(6)(i), (b)(1)(i)(*c*), (b)(1)(ii)(*a*), (b)(1)(ii)(*c*), (b)(2)(i)(*b*), (b)(2)(ii)(*a*), (b)(2)(ii)(*b*), (b)(2)(ii)(*e*), and (b)(4) *Example 3*, (b)(4) *Example 8*, and (b)(4) *Example 9* of this section shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

(d) *Application of regulations to earlier taxable years.* A taxpayer may choose to apply these regulations retroactively with respect to its open taxable years that began prior to July 1, 2009. The taxpayer may so choose if and only if the taxpayer and all members of the taxpayer's affiliated group (within the meaning of section 1504(a)) apply these regulations, in their entirety, to the earliest taxable year of each controlled foreign corporation that ends with or within an open taxable year of the taxpayer and to all subsequent taxable years.

[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; T.D. 9438, 73 FR 79344, T.D. 9438, Dec. 29, 2008; 74 FR 11844, Mar. 20, 2009; T.D. 9563, 76 FR 78546, Dec. 19, 2011]

§ 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. $(.60 \times \$80) + (.30 \times \$20)$, 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 income 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

	X	Y	Z	Group
(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
(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)(3).* 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 the average of the amounts of United States property held by a controlled foreign corporation.

(a) *In general.* Subject to the provisions of section 951(a) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in gross income the amount determined under section 956 with respect to the shareholder for the taxable year but only to the extent not excluded from gross income under section 959(a)(2) and the regulations thereunder.

(b) *Amount of United States property held indirectly by a controlled foreign corporation*—(1) *General rule.* For purposes of section 956, United States property held indirectly by a controlled foreign corporation includes—

(i) United States property held on behalf of the controlled foreign corporation by a trustee or a nominee;

(ii) United States property acquired by any other foreign corporation that is controlled by the controlled foreign corporation if a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation; and

(iii) Property acquired by a partnership that is controlled by the controlled foreign corporation if the property would be United States property if held directly by the controlled foreign corporation, and a principal purpose of creating, organizing, or funding by any

means (including through capital contributions or debt) the partnership is to avoid the application of section 956 with respect to the controlled foreign corporation.

(2) *Control.* For purposes of paragraphs (b)(1)(ii) and (iii) of this section, a controlled foreign corporation controls a foreign corporation or partnership if the controlled foreign corporation and the other foreign corporation or partnership are related within the meaning of section 267(b) or section 707(b). For this purpose, in determining whether two 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 for the purposes of section 1563(e)(1), and stock owned with the application of section 267(c).

(3) *Coordination rule.* Paragraph (b)(1)(iii) of this section applies only to the extent that the amount of United States property that is treated under that paragraph as held indirectly by a controlled foreign corporation through the partnership exceeds the sum of—

(i) The amount of United States property described in paragraph (b)(1)(iii) of this section that is treated as held by the controlled foreign corporation as a result of the application of §1.956–4(b) with respect to the partnership; and

(ii) The amount of United States property that is treated as held by the controlled foreign corporation as a result of the application of §1.956–4(c) with respect to any portion of an obligation attributable to the funding described in paragraph (b)(1)(iii) of this section of the partnership by the controlled foreign corporation.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example, P is a domestic corporation that wholly owns two controlled foreign corporations, FS1 and FS2.

Example 1. (i) *Facts.* FS1 sells inventory to FS2 in exchange for trade receivables due in 60 days. Avoiding the application of section 956 with respect to FS1 was not a principal purpose of establishing the trade receivables. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits. FS2 makes a loan to P equal to the amount it owes FS1 under the trade receivables. FS2 pays the trade receivables according to their terms.

(ii) *Result.* FS1 will not be considered to indirectly hold United States property under this paragraph (b) because the funding of FS2 through the sale of inventory in exchange for the establishment of trade receivables was not undertaken with a principal purpose of avoiding the application of section 956 with respect to FS1.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(4), except that, with a principal purpose of avoiding the application of section 956 with respect to FS1, FS1 and FS2 agree to defer FS2's payment obligation, and FS2 does not timely pay the receivables.

(ii) *Result.* FS1 is considered to hold indirectly United States property under this paragraph (b) and §1.956–2(a) because there was a funding of FS2, a principal purpose of which was to avoid the application of section 956 with respect to FS1.

Example 3. (i) *Facts.* FS1 has $100x of post-1986 undistributed earnings and profits and $100x post-1986 foreign income taxes, but does not have any cash. FS2 has earnings and profits of at least $100x, no post-1986 foreign income taxes, and substantial cash. Neither FS1 nor FS2 has earnings and profits described in section 959(c)(1) or section 959(c)(2). FS2 loans $100x to FS1. FS1 then loans $100x to P. An income inclusion by P of $100x under sections 951(a)(1)(B) and 956 with respect to FS1 would result in foreign income taxes deemed paid by P under section 960. A principal purpose of funding FS1 through the loan from FS2 is to avoid the application of section 956 with respect to FS2.

(ii) *Result.* Under paragraph (b)(1)(ii) of this section, FS2 is considered to indirectly hold the $100x obligation of P that is held by FS1. As a result, P has an income inclusion of $100x under sections 951(a)(1)(B) and 956 with respect to FS2, and the foreign income taxes deemed paid by P under section 960 is $0. P does not have an income inclusion under sections 951(a)(1)(B) and 956 with respect to FS1 related to the $100x loan from FS1 to P.

Example 4. (i) *Facts.* FS1 deposits $100x with BK, an unrelated foreign financial institution. FS2 subsequently borrows $100x from BK. BK would not have loaned the $100x to FS2 on the same terms absent FS1's deposit. FS2 loans the $100x borrowed from BK to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits. A principal purpose for the transactions is to avoid the application of section 956 with respect to FS1.

(ii) *Result.* FS1 is considered to hold indirectly United States property under this paragraph (b) and §1.956–2(a) because FS1's deposit with BK, which facilitates BK's loan to FS2, is considered a funding by FS1 of FS2, a principal purpose of which was to avoid the application of section 956 with respect to FS1.

Example 5. (i) *Facts.* FS1 sells inventory to FS2 in exchange for $100x. The sale occurred in the ordinary course of FS1's trade or business and FS2's trade or business, and the terms of the sale are consistent with terms that would be observed among parties dealing at arm's length. FS1 makes a $100x loan to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits.

(ii) *Result.* FS2 will not be considered to indirectly hold United States property under this paragraph (b) because a sale in the ordinary course of business for cash on terms that are consistent with those that would be observed among parties dealing at arm's length does not constitute a funding.

Example 6. (i) *Facts.* In Year 1, FS2 loans $100x to FS1 to finance FS1's trade or business. The terms of the loan are consistent with those that would be observed among parties dealing at arm's length. In Year 2, FS1 repays the loan in accordance with the terms of the loan. Immediately after the repayment by FS1, FS2 loans $100x to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits.

(ii) *Result.* FS1 will not be considered to indirectly hold United States property under this paragraph (b) because a repayment of a loan that has terms that are consistent with those that would be observed among parties dealing at arm's length and that is repaid consistent with those terms does not constitute a funding.

Example 7. (i) *Facts.* FS1 has substantial earnings and profits. P and FS1 are the only partners in FPRS, a foreign partnership. FS1 contributes $600x cash to FPRS in exchange for a 60% interest in the partnership, and P contributes real estate located outside the United States ($400x value) to FPRS in exchange for a 40% interest in the partnership. There are no special allocations in the FPRS partnership agreement. FPRS lends $100x to P. Under §1.956–4(b) and §1.956–2(a), FS1 is treated as holding United States property of $60x (60% x $100x) as a result of the FPRS loan to P. A principal purpose of creating, organizing, or funding FPRS is to avoid the application of section 956 with respect to FS1.

(ii) *Result.* Before taking into account paragraph (b)(3) of this section, because FS1 controls FPRS and a principal purpose of creating, organizing, or funding FPRS was to avoid the application of section 956 with respect to FS1, FS1 is considered under paragraph (b)(1)(iii) of this section to indirectly hold the $100x obligation of P that would be United States property if held directly by FS1. However, under paragraph (b)(3) of this section, FS1 is treated as holding United States property under paragraph (b)(1)(iii) only to the extent the amount held indirectly under paragraph (b)(1)(iii) of this section exceeds the sum of the amount of the United States property that FS1 is treated as holding as a result of the application of §1.956–4(b) with respect to FPRS. The amount of United States property that FS1 is treated as indirectly holding under paragraph (b)(1)(iii) of this section and §1.956–2(a) ($100x) exceeds the amount determined under §1.956–4(b) ($60x) by $40x. Thus, FS1 is considered to hold United States property within the meaning of section 956(c) in the amount of $100x ($60x under §1.956–4(b) and $40x under paragraphs (b)(1)(iii) and (b)(3) of this section).

Example 8. (i) *Facts.* FS1 and FS2 have substantial earnings and profits. P and FS1 are the only partners in FPRS, a foreign partnership. There are no special allocations in the FPRS partnership agreement. P's liquidation value percentage with respect to FPRS is 40%, and FS1's liquidation value percentage with respect to FPRS is 60%. FS2 lends $100x to FPRS, and FPRS lends $100x to P. Under §1.956–4(c) and §1.956–2(a), FS2 is treated as holding United States property of $40x (40% x $100x) as a result of its loan to FPRS. A principal purpose of funding FPRS is to avoid the application of section 956 with respect to FS2.

(ii) *Result.* Before taking into account paragraph (b)(3) of this section, because FS2 controls FPRS and a principal purpose of funding FPRS was to avoid the application of section 956 with respect to FS2, FS2 is considered under paragraph (b)(1)(iii) of this section to indirectly hold the $100x obligation of P that would be United States property if held directly by FS2. However, under paragraph (b)(3) of this section, FS2 is treated as holding United States property under paragraph (b)(1)(iii) only to the extent the amount held indirectly under paragraph (b)(1)(iii) of this section exceeds the amount of United States property that FS2 is treated as holding as a result of the application of §1.956–4(c) with respect to the obligation with which FS2 funds FPRS. The amount of United States property that FS2 is treated as indirectly holding under paragraph (b)(1)(iii) of this section and §1.956–2(a) ($100x) exceeds the amount determined under §1.956–4(c) ($40x) by $60x. Thus, FS2 is considered to hold United States property within the meaning of section 956(c) in the amount of $100x ($40x under §1.956–4(c) and $60x under paragraphs (b)(1)(iii) and (b)(3) of this section). P does not have an income inclusion under sections 951(a)(1)(B) and 956 with respect to FS1 related to the P obligation held by FPRS.

(c)–(d) [Reserved]

(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. See §1.956–1(e)(6) for a special rule for determining amounts attributable to United States property acquired as the result of certain nonrecognition transactions.

(2) *Rule for pledges and guarantees.* For purposes of this section, the amount of an obligation treated as held (before application of §1.956–4(b)) as a result of a pledge or guarantee described in §1.956–2(c) is the unpaid principal amount of the obligation on the applicable determination date.

(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.

(5) [Reserved] For further guidance, see §1.956–1T(e)(5).

(6) *Adjusted basis of property acquired in certain nonrecognition transactions*—(i) *Scope.* This paragraph (e)(6) provides rules for determining, solely for purposes of applying section 956, the adjusted basis of specified United States property acquired by a controlled foreign corporation pursuant to an exchange in which the controlled foreign corporation's basis in such specified United States property is determined under section 362(a). This paragraph (e)(6) also applies if specified United States property, the adjusted basis in which has been determined under these regulations, is transferred (in one or more subsequent exchanges) to a related person (within the meaning of section 954(d)(3)), pursuant to one or more exchanges in which the related person's adjusted basis in such property is determined, in whole or in part, by reference to the transferor controlled foreign corporation's adjusted basis in such property.

(ii) *Definition of specified United States property.* For purposes of this paragraph (e)(6), *specified United States property* is stock of a domestic corporation described in section 956(c)(1)(B) or an obligation of a domestic corporation described in section 956(c)(1)(C) that is acquired by a controlled foreign corporation from the domestic issuing corporation. Specified United States property does not include property described in section 956(c)(2).

(iii) *Adjusted basis of specified United States property.* Solely for purposes of applying section 956, the adjusted basis of specified United States property acquired by a controlled foreign corporation in connection with an exchange to which this paragraph (e)(6) applies

shall be no less than the fair market value of any property transferred by the controlled foreign corporation in exchange for such specified United States property. For purposes of this paragraph (e)(6), the term *property* has the meaning set forth in section 317(a), but also includes any liability that is assumed by the controlled foreign corporation in connection with the exchange notwithstanding the application of section 357(a). The assumption of a liability by the controlled foreign corporation in connection with the exchange will be considered the transfer of property. The fair market value of such property will be the amount of the liability assumed. The fair market value of any property transferred by the controlled foreign corporation in exchange for the specified United States property shall be determined at the time of the exchange.

(iv) *Timing.* For purposes of §1.956–2(d)(1)(i)(a), a controlled foreign corporation that acquires specified United States property in an exchange to which this paragraph (e)(6) applies acquires an adjusted basis in such property at the time of the controlled foreign corporation's exchange of property for such specified United States property.

(v) *Transfers to related persons.* If a controlled foreign corporation transfers specified United States property, the adjusted basis in which has been determined under this paragraph (e)(6), to a related person (within the meaning of section 954(d)(3)) (related person transferee) in one or more exchanges pursuant to which the related person transferee's adjusted basis in such specified United States property is determined, in whole or in part, by reference to the controlled foreign corporation's adjusted basis in such specified United States property, then, solely for purposes of applying section 956 following such exchange, the controlled foreign corporation's adjusted basis in any United States property received in the exchange (or exchanges) shall be no less than the aggregate adjusted basis of the specified United States property as determined under paragraph (e)(6)(iii) of this section, and the related person transferee's adjusted basis in such specified United States property shall be no less than the adjusted basis of such specified United States property in the hands of the controlled foreign corporation as determined under paragraph (e)(6)(iii) of this section. This paragraph (e)(6)(v) shall also apply in the case of one or more successive transfers of the specified United States property by a related person transferee to one or more persons related to the controlled foreign corporation (within the meaning of section 954(d)(3)). This paragraph (e)(6)(v) shall apply regardless of whether a subsequent transfer was part of a plan (or series of related transactions) that includes the controlled foreign corporation's acquisition of the specified United States property.

(vi) *Examples.* The rules of this paragraph (e)(6) are illustrated by the following examples:

Example 1. (i) *Facts.* USP, a domestic corporation, is the common parent of an affiliated group that joins in the filing of a consolidated return. USP owns 100 percent of the stock of US1 and US2, both domestic corporations and members of the USP consolidated group. US1 owns 100 percent of the stock of CFC, a controlled foreign corporation. US2 issues $100x of its stock to CFC in exchange for $10x of CFC stock and $90x cash. US2's transfer of its stock to CFC is described in section 351, US2 recognizes no gain in the exchange under section 1032(a), and CFC's basis in the US2 stock acquired in the exchange is determined under section 362(a).

(ii) *Analysis.* The US2 stock acquired by CFC in the exchange constitutes specified United States property under paragraph (e)(6)(ii) of this section because CFC acquires the US2 stock from US2, the issuing corporation. Therefore, because CFC's adjusted basis in the US2 stock is determined under section 362(a), then for purposes of applying section 956, CFC's adjusted basis in the US2 stock shall, under paragraph (e)(6)(iii) of this section, be no less than $90x, the fair market value of the property exchanged by CFC for the US2 stock (the $10x of CFC stock issued in the exchange does not constitute property for purposes of paragraph (e)(6)(iii) of this section). Pursuant to paragraph (e)(6)(iv) of this section, for purposes of §1.956–2(d)(1)(i)(a) CFC shall be treated as acquiring its adjusted basis of no less than $90x in the US2 stock at the time of its transfer of property to US2 in exchange for the US2 stock. The result would be the same if, instead of CFC transferring $90x of cash to US2 in the exchange, CFC assumes a $90x liability of US2.

Example 2. (i) *Facts.* USP, a domestic corporation, owns 100 percent of the stock of USS, a domestic corporation. USP also owns 100 percent of the stock of CFC, a controlled foreign corporation. USP's adjusted basis in its USS stock equals the fair market value of the USS stock, or $100x. USP transfers its USS stock to CFC in exchange for $100x of CFC stock. USP's transfer of its USS stock to CFC is described in section 351, USP recognizes no gain in the exchange under section 351(a), and CFC's adjusted basis in the USS stock acquired in the exchange, determined under section 362(a), equals $100x.

(ii) *Analysis.* The USS stock acquired by CFC in the exchange does not constitute specified United States property under paragraph (e)(6)(ii) of this section because CFC acquires the USS stock from USP. Therefore, CFC's adjusted basis in the USS stock, for purposes of section 956, is not determined under this paragraph (e)(6). Instead, CFC's adjusted basis in the USS stock is determined under the general rule of section 956(a) and under paragraphs (e)(1) through (4) of this section. As determined under section 362(a), CFC's adjusted basis in the USS stock is $100x.

Example 3. (i) *Facts.* USP, a domestic corporation, owns 100 percent of the stock of CFC1, a controlled foreign corporation. CFC1 holds specified United States property (within the meaning of paragraph (e)(6)(ii) of this section) with an adjusted basis of $30x for purposes of applying section 956 that was determined under paragraph (e)(6)(iii) of this section. CFC1 owns 100 percent of the stock of CFC2, a controlled foreign corporation. CFC1 transfers the specified United States property to CFC2 in an exchange described in section 351. CFC2's adjusted basis in the specified United States property is determined under section 362(a).

(ii) *Analysis.* In the section 351 exchange, CFC1 transferred specified United States property to CFC2 with an adjusted basis that was determined under paragraph (e)(6)(iii) of this section. Further, CFC2's adjusted basis in the specified United States property is determined under section 362(a) by reference, in whole or in part, to CFC1's adjusted basis in such property. Therefore, for purposes of applying section 956, pursuant to paragraph (e)(6)(v) of this section CFC2's adjusted basis in the specified United States property shall be no less than $30x. Paragraph (e)(6)(v) of this section would also apply if CFC2 subsequently transfers the specified United States property to another person related to CFC1 (within the meaning of section 954(d)(3)) if such related person's adjusted basis in the specified United States property is determined by reference, in whole or in part, to CFC2's adjusted basis in such property. See also §1.956–1T(b)(4) if one of the principal purposes of CFC1's transfer of property to CFC2 was the avoidance of the application of section 956 with respect to CFC1.

(f) [Reserved]. For further guidance, see §1.956–1T(f).

(g) *Effective/applicability date.* (1) Paragraph (a) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and to taxable years of United States shareholders in which or with which such taxable years end.

(2) Paragraph (b) of this section applies to taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after September 1, 2015. See paragraph (b)(4) of §1.956–1T, as contained in 26 CFR part 1 revised as of April 1, 2015, for the rules applicable to taxable years of controlled foreign corporations ending before September 1, 2015, and property acquired before September 1, 2015. For purposes of this paragraph (g)(2), a deemed exchange of property pursuant to section 1001 on or after September 1, 2015 constitutes an acquisition of the property on or after that date.

(3) Paragraph (e)(2) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (g)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(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; T.D. 9402, 73 FR 35582, June 24, 2008; T.D. 9630, 76 FR 36994, June 24, 2011; T.D. 9733, 80 FR 52981, Sept. 2, 2015; 80 FR 66416, Oct. 29, 2015; T.D. 9792, 81 FR 76505, Nov. 3, 2016]

§ 1.956–1T Shareholder's pro rata share of the average of the amounts of United States property held by a controlled foreign corporation (temporary).

(a)–(e)(4) [Reserved]

(5) *Exclusion for certain recourse obligations.* 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 (f) 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.

(e)(6) [Reserved]. For further guidance, see § 1.956–1(e)(6).

(f) *Effective/applicability date.* Paragraph (e)(5) of this section applies to investments made on or after June 14, 1988.

(g)–(h) [Reserved]

[T.D. 9792, 81 FR 76507, Nov. 3, 2016; 81 FR 95471, Dec. 28, 2016]

§ 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) *Treatment of disregarded entities.* For purposes of section 956, an obligation of a business entity (as defined in §301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes under §§301.7701–1 through 301.7701–3 of this chapter is treated as an obligation of its owner.

(4) [Reserved] For further guidance, see §1.956–2T(a)(4).

(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 paragraph (b)(1)(vi) is used in foreign commerce and predominantly outside the United States is to be determined from all the facts and circumstances of 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. Notwithstanding the above, an aircraft or vessel, including component parts, is excluded from United States property if the aircraft or vessel is leased in foreign commerce (as the term is defined in §1.954–2(c)(2)(v)) and rents derived from leasing such aircraft or vessel are excluded from foreign personal holding company income under section 954(c)(2)(A).

(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.

(xi) [Reserved] For further guidance, see §1.956–2T(b)(1)(xi).

(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 paragraph (c)(4) of this section, for purposes of section 956, any

obligation of a United States person with respect to which a controlled foreign corporation or a partnership is a pledgor or guarantor will be considered to be held by the controlled foreign corporation or the partnership, as the case may be. See §1.956–1(e)(2) for rules that determine the amount of the obligation treated as held by a pledgor or guarantor under this paragraph (c). For rules that treat an obligation of a foreign partnership as an obligation of the partners in the foreign partnership for purposes of section 956, see §1.956–4(c).

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation or a partnership 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 or partnership will be considered a pledgor or guarantor of that obligation. If a partnership is considered a pledgor or guarantor of an obligation, a controlled foreign corporation that is a partner in the partnership will not also be treated as a pledgor or guarantor of the obligation solely as a result of its ownership of an interest in the partnership. For purposes of this paragraph, a pledge of stock of a controlled foreign corporation representing at least 66⅔ percent of the total combined voting power of all classes of voting stock of such corporation will be considered an indirect pledge of the assets of the controlled foreign corporation if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion to dispose of assets and/or incur liabilities other than in the ordinary course of business. See §1.956–4(d) for guidance on the treatment of indirect pledges or guarantees of an obligation of a partnership attributed to its partners under §1.956–4(c).

(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.

Example 4. (i) *Facts.* USP, a domestic corporation, owns 70% of the stock of FS, a controlled foreign corporation, and a 90% interest in FPRS, a foreign partnership. X, an unrelated foreign person, owns 30% of the stock of FS. Y, an unrelated foreign person, owns a 10% interest in FPRS. There are no special allocations in the FPRS partnership agreement. FPRS borrows $100x from Z, an unrelated person. FS pledges its assets as security for FPRS's performance of its obligation to repay the $100x loan. USP's share of the $100x FPRS obligation, determined in accordance with its liquidation value percentage, is $90x. Under §1.956–4(c), $90x of the FPRS obligation is treated as an obligation of USP for purposes of section 956.

(ii) *Result.* For purposes of section 956, under paragraph (c)(1) of this section, FS is considered to hold an obligation of USP in the amount of $90x, and thus is treated as holding United States property in the amount of $90x.

(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.

(5) [Reserved] For further guidance, see §1.956–2T(c)(5).

(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] For further guidance, see §1.956–2T(d)(2).

(e) *Effective/applicability date.* The last sentence of paragraph (b)(1)(vi) of this section applies to taxable years of controlled foreign corporations beginning on or after May 2, 2006, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. Taxpayers may elect to apply the rule of the last sentence of paragraph (b)(1)(vi) of this section to taxable years of controlled foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within

which such taxable years of the controlled foreign corporations end. If an election is made to apply the last two sentences of §1.954–2(c)(2)(ii) and §1.954–2(c)(2)(v) through (vii) to taxable years of a controlled foreign corporation beginning after December 31, 2004, then the election must also be made for the last sentence of paragraph (b)(1)(vi) of this section.

(f)–(g) [Reserved]

(h) *Effective/applicability date.* (1) Paragraph (a)(3) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after November 3, 2016.

(2) Paragraphs (c)(1), (c)(2), and *Example 4* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges and guarantees entered into on or after September 1, 2015. For purposes of this paragraph (h)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(i) [Reserved] For further guidance, see §1.956–2T(i).

(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; T.D. 9406, 73 FR 38117, July 3, 2008; T.D. 9525, 76 FR 26181, May 6, 2011; T.D. 9589, 77 FR 27614, May 11, 2012; T.D. 9761, 81 FR 20886, Apr. 8, 2016; T.D. 9792, 81 FR 76507, Nov. 3, 2016]

§1.956–2T Definition of United States Property (temporary).

(a)(1) through (a)(3) [Reserved] For further guidance, see §1.956–2(a) through (b)(1)(x).

(4) *Certain foreign stock and obligations held by expatriated foreign subsidiaries following an inversion transaction*—(i) *General rule.* Except as provided in paragraph (a)(4)(ii) of this section, for purposes of section 956 and §1.956–2(a), United States property includes an obligation of a foreign person and stock of a foreign corporation when the following conditions are satisfied—

(A) The obligation or stock is held by a controlled foreign corporation that is an expatriated foreign subsidiary, regardless of whether, when the obligation or stock was acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary;

(B) The foreign person or foreign corporation is a non-CFC foreign related person, regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person; and

(C) The obligation or stock was acquired—

(*1*) During the applicable period; or

(*2*) In a transaction related to the inversion transaction.

(ii) *Exceptions.* For purposes of section 956 and §1.956–2(a), United States property does not include—

(A) Any obligation of a non-CFC foreign related person arising in connection with the sale or processing of property if the amount of the obligation at no time during the taxable year exceeds the amount that 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 non-CFC foreign related person had the sale or processing transaction been made between unrelated persons; and

(B) Any obligation of a non-CFC foreign related person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities.

(iii) *Definitions.* The definitions in §1.7874–12T apply for the purposes of the application of paragraphs (a)(4), (c)(5), and (d)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (a)(4). For purposes of the examples, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015.

Example 1. (A) *Facts.* FT acquired an obligation of FS on January 31, 2015.

(B) *Analysis.* Pursuant to §1.7874–12T, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a non-CFC foreign related person. In addition, FT acquired the FS obligation during the applicable period. Thus, as of January 31, 2015, the obligation of FS is United States property with respect to FT for purposes of section 956(a) and §1.956–2(a).

Example 2. (A) *Facts.* The facts are the same as in *Example 1* of this paragraph (a)(4)(iv), except that on February 15, 2015, FT contributed assets to FS in exchange for 60% of the stock of FS, by vote and value.

(B) *Analysis.* As a result of the transaction on February 15, 2015, FS becomes a controlled foreign corporation with respect to which an expatriated entity, DT, is a United States shareholder. Accordingly, under §1.7874–12T(a)(9), FS is an expatriated foreign subsidiary, and is therefore not a non-CFC foreign related person. Thus, as of February 15, 2015, the stock and obligation of FS are not United States property with respect to FT for purposes of section 956(a) and §1.956–2(a). FS is not excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874–12T(a)(9)(ii) because FS was not a CFC on the completion date.

Example 3. (A) *Facts.* Before the inversion transaction, FA also wholly owns USP, a domestic corporation, which, in turn, wholly owns, LFS, a foreign corporation that is a controlled foreign corporation. DT was not a United States shareholder of LFS on or before the completion date. On January 31, 2015, FT contributed assets to LFS in exchange for 60% of the stock of LFS, by vote and value. FT acquired an obligation of LFS on February 15, 2015.

(B) *Analysis.* LFS is a foreign related person. Because LFS was a controlled foreign corporation and a member of the EAG with respect to the inversion transaction on the completion date, and DT was not a United States shareholder with respect to LFS on or before the completion date, LFS is excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874–12T(a)(9)(ii). Thus, pursuant to §1.7874–12T(a)(16), LFS is a non-CFC foreign related person, and the stock and obligation of LFS are United States property with respect to FT for purposes of section 956(a) and §1.956–2(a). The fact that FT contributed assets to LFS in exchange for 60% of the stock of LFS does not change this result.

Example 4. (A) *Facts.* The facts are the same as in *Example 3* of this paragraph (a)(4)(iv), except that on February 10, 2015, LFS organized a new foreign corporation (LFSS), transferred all of its assets to LFSS, and liquidated, in a transaction treated as a reorganization described in section 368(a)(1)(F), and FT acquired an obligation of LFSS, instead of LFS, on February 15, 2015. On March 1, 2015, LFSS acquired an obligation of FS.

(B) *Analysis.* LFS is a controlled foreign corporation with respect to which USP, an expatriated entity, is a United States shareholder. USP is an expatriated entity because on the completion date, USP and DT became related to each other within the meaning of section 267(b). Because LFSS was not a member of the EAG with respect to the inversion transaction on the completion date, LFSS is not excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874–12T(a)(9)(ii). Accordingly, under §1.7874–12T(a)(9)(i), LFFS is an expatriated foreign subsidiary and is therefore not a non-CFC foreign related person. Thus, the stock and obligation of LFSS are not United States property with respect to FT for purposes of section 956(a) and §1.956–2(a). However, because LFSS is an expatriated foreign subsidiary, pursuant to §1.7874–12T(a)(9), the obligation of FS, a non-CFC foreign related person, is United States property with respect to LFSS for purposes of section 956(a) and §1.956–2(a).

(b)(1) introductory text through (b)(1)(x) [Reserved] For further guidance, see §1.956–2(a) through (b)(1)(x).

(xi) An obligation of a United States person arising from a nonperiodic payment by a controlled foreign corporation (within the meaning of section 957(a)) with respect to a notional principal contract described in §1.446–3T(g)(4)(ii)(B)(*1*) or (*2*) if the following conditions are satisfied—

(A) The controlled foreign corporation that makes the nonperiodic payment is either a dealer in securities (within the meaning of section 475(c)(1)) or a dealer in commodities; and

(B) The conditions set forth in §1.446–3T(g)(4)(ii)(C)(*1*) (relating to full margin or collateral in cash) are satisfied.

(C) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(xi):

Example 1. Full margin—cleared contract. (i) A domestic corporation (U.S.C.) wholly owns a controlled foreign corporation (CFC) that is a dealer in securities under section 475(c)(1). CFC enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). CFC is not a member of the DCO. CFC uses a U.S. affiliate (CM), which is a member of the DCO, as its clearing member to submit the contract to be cleared. CM is a domestic corporation that is wholly owned by U.S.C.. The standardized terms of the contract provide that, for a term of X years, CFC will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of $Y. When CFC and B enter into the contract, the market coupon for similar interest rate swaps is 2% per year. The DCO requires CFC to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and CFC makes the upfront payment in cash. CFC makes the upfront payment through CM to the DCO, which then makes the payment to B. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, which is received by CFC (through DCO and CM), and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in §1.446–3T(g)(4)(ii)(B)(*1*). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of CM arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

Example 2. Full margin—uncleared contract. (i) Assume the same facts as in *Example 1*, except for the following. CFC's counterparty to the contract is U.S.C., CM is not involved, and the contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. The contract requires CFC to make an upfront payment to compensate U.S.C. for the below-market annual coupon payments that U.S.C. will receive, and CFC makes the upfront payment in U.S. dollars. Pursuant to the requirements of a federal regulator, U.S.C. is obligated to post initial variation margin with CFC in an amount equal to CFC's upfront payment, and U.S.C. and CFC are obligated to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. U.S.C. posts the initial variation margin in U.S. dollars, which is received by CFC, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in §1.446–3T(g)(4)(ii)(B)(*2*). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of U.S.C. arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

(b)(2)–(c)(4) [Reserved] For further guidance, see §1.956–2(b)(2) through (d)(1).

(5) *Special guarantee and pledge rule for expatriated foreign subsidiaries*—(i) *General rule.* In applying §1.956–2(c)(1) and (2) to a controlled foreign corporation that is an expatriated foreign subsidiary, the phrase ''of a United States person or a non-CFC foreign related person'' is substituted for the phrase ''of a United States person'' each place it appears.

(ii) *Additional rules.* The rule in paragraph (c)(5)(i) of this section—

(A) Applies regardless of whether, when the pledge or guarantee was entered into or treated as entered into, the controlled foreign corporation was a controlled foreign corporation or an expatriated foreign subsidiary, or a foreign person whose obligation is subject to the pledge or guarantee, or deemed pledge or guarantee, was a non-CFC foreign related person; and

(B) Applies to pledges or guarantees entered into, or treated pursuant to §1.956–2(c)(2) as entered into—

(*1*) During the applicable period; or

(*2*) In a transaction related to the inversion transaction.

(d) introductory text through (d)(1) [Reserved] For further guidance, see §1.956–2(b)(2) through (d)(1).

(2) *Obligation defined.* For purposes of section 956 and §1.956–2, 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 the term does not include—

(i) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of §1.956–2(a)(1) or §1.956–2T(a);

(ii) 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 the 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 the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iii) Any obligation of a non-CFC foreign related person arising in connection with the provision of services by an expatriated foreign subsidiary to the non-CFC foreign related person if the amount of the obligation outstanding at any time during the taxable year of the expatriated foreign subsidiary does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the expatriated foreign subsidiary and the non-CFC foreign related person if they were unrelated. The amount of the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iv) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(v) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 30 days from the time it is incurred (a *30-day obligation*), unless the controlled foreign corporation that holds the 30-day obligation holds for 60 or more calendar days during the taxable year in which it holds the 30-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(iv), would constitute United States property within the meaning of section 956 and §1.956–2(a); or

(v) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(iv) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 60 days from the time it is incurred (a *60-day obligation*), unless the controlled foreign corporation that holds the 60-day obligation holds for 180 or more calendar days during the taxable year in which it holds the 60-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(v), would constitute United States property within the meaning of section 956 and §1.956–2(a).

(e) [Reserved] For further guidance see §1.956–2(e).

(f) *Effective/applicability date.* Paragraph (b)(1)(xi) of this section applies to payments described in §1.956–2T(b)(1)(xi) made on or after May 8, 2015. Taxpayers may apply the rules of paragraph (b)(1)(xi) to payments made before May 8, 2015.

(g) *Expiration date.* The applicability of paragraph (b)(1)(xi) of this section expires on May 7, 2018.

(h) [Reserved]

(i) *Effective/applicability date.* (1) Except as otherwise provided in this paragraph (i)(1), paragraphs (a)(4) and (c)(5) of this section apply to obligations or stock acquired or to pledges or guarantees entered into, or treated as entered into, on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. The phrase ‘‘, regardless of whether, when the obligation or stock was acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary’’ in paragraph (a)(4)(i)(A) of this section, the phrase ‘‘regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person’’ in paragraph (a)(4)(i)(B) of this section, and paragraphs (a)(4)(i)(C)(*2*), (c)(5)(ii)(A), and (c)(5)(ii)(B)(*2*) of this section apply to obligations or stock acquired or pledges or guarantees entered into or treated as entered into on

or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (a)(4)(ii) of this section applies to obligations acquired on or after April 4, 2016. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (a)(4)(ii) of this section to an obligation acquired before April 4, 2016. For purposes of paragraph (a)(4)(i) of this section and this paragraph (i)(1), a deemed exchange of an obligation or stock pursuant to section 1001 constitutes an acquisition of the obligation or stock. For purposes of paragraph (c)(5) of this section and this paragraph (i)(1), a pledgor or guarantor or deemed pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor or is treated as a pledgor or guarantor.

(2) Paragraphs (d)(2)(i) and (ii) of this section are effective June 14, 1988, with respect to investments made on or after June 14, 1988.

(3) Paragraph (d)(2)(iii) of this section applies to obligations acquired on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (d)(2)(iii) of this section to an obligation acquired on or after September 22, 2014, and before *April 4, 2016*. For purposes of paragraph (d)(2)(iii) of this section and this paragraph (i)(3), a significant modification, within the meaning of §1.1001–3(e), of an obligation on or after April 4, 2016, constitutes an acquisition of an obligation on or after April 4, 2016.

(4) Paragraph (d)(2)(iv) of this section applies to obligations held on or after September 16, 1988.

(5) Paragraph (d)(2)(v) of this section applies to the first three taxable years of a foreign corporation ending after October 3, 2008, other than taxable years of a foreign corporation beginning on or after January 1, 2011, as well as the fourth taxable year of a foreign corporation, if any, when the foreign corporation's third taxable year (including any short taxable year) ended after October 3, 2008, and on or before December 31, 2009.

(j) *Expiration date.* The applicability of paragraphs (a)(4), (c)(5), and (d)(2) of this section expires on or before April 4, 2019.

[T.D. 8209, 53 FR 22171, June 14, 1988, as amended at T.D. 9406, 73 FR 38117, July 3, 2008; T.D. 9525, 76 FR 26181, May 6, 2011; T.D. 9589, 77 FR 27614, May 11, 2012; T.D. 9719, 80 FR 26442, May 8, 2015; T.D. 9761, 81 FR 20886, Apr. 8, 2016; T.D. 9761, 81 FR 46833, July 19, 2016]

§1.956–3 Certain trade or service receivables acquired from United States persons.

(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) from a related person who is a United States person (as defined in section 7701(a)(30)) (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 is considered to be United States property notwithstanding the exceptions (other than subparagraph (H)) contained in section 956(c)(2). The terms ''trade or service receivable'' and ''related person'' have the respective meanings given to the terms by section 864(d) and the regulations thereunder, including §1.864–8T(b). For purposes of this section, the exception in §1.956–2T(d)(2)(ii) does not apply to trade or 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) apply 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 is considered acquired from a related person when it is acquired from an unrelated person who acquired (directly or indirectly) the receivable from a person who is a related person to the acquiring person.

(ii) *Acquisition by nominee, pass-through entity, or related foreign corporation.* A controlled foreign corporation

is treated as holding a trade or service receivable that is held by a nominee on its behalf, or by a simple trust or other pass-through entity (other than a partnership) to the extent of its direct or indirect ownership or beneficial interest in such simple trust or other pass-through entity. See §§1.956–1(b) and 1.956–4(b) for rules that may treat a controlled foreign corporation as indirectly holding a trade or service receivable held by a foreign corporation or partnership. A controlled foreign corporation that is treated as holding a trade or service receivable held by another person (the *direct holder*) (or that would be treated as holding the receivable if the receivable were United States property or would be United States property if held directly by the controlled foreign corporation) is considered to have acquired the receivable from the person from whom the direct holder acquired the receivable. This paragraph (b)(2)(ii) does not limit the application of paragraph (b)(2)(iii) of this section. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. (i) *Facts.* A domestic corporation, P, wholly owns a controlled foreign corporation, FS, with substantial earnings and profits. FS contributes $200x of cash to a partnership, PRS, in exchange for an 80% partnership interest. An unrelated foreign person contributes real estate located in a foreign country with a fair market value of $50x to PRS for the remaining 20% partnership interest. There are no special allocations in the PRS partnership agreement. PRS uses the $200x of cash received from FS to purchase trade receivables from P. The obligors with respect to the trade receivables are United States persons that are not related to any partner in PRS. The liquidation value percentage, as determined under §1.956–4(b), for FS with respect to PRS is 80%. A principal purpose of funding PRS (through FS's cash contribution) is to avoid the application of section 956 with respect to FS.

(ii) *Result.* Under §1.956–4(b)(1), FS is treated as holding 80% of the trade receivables acquired by PRS from P, with a basis equal to $160x (80% × $200x, PRS's basis in the trade receivables). However, because FS controls PRS and a principal purpose of FS funding PRS was to avoid the application of section 956 with respect to FS, under §1.956–1(b), if the trade receivables would be United States property if held directly by FS, FS additionally would be treated as holding the trade receivables to the extent that they exceed the amount of the receivables it holds under §1.956–4(b), which is $40x ($200x − $160x). Accordingly, under this paragraph (b)(2)(ii), FS is treated as having acquired from P, a related United States person, the trade receivables that it is treated as holding with a basis equal to $200x ($160x + $40x). Thus, FS is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

Example 2. (i) *Facts.* A domestic corporation, P, wholly owns a controlled foreign corporation, FS1, that has earnings and profits of at least $300x. FS1 organizes a foreign corporation, FS2, with a $200x cash contribution. FS2 uses the cash contribution to purchase trade receivables from P. The obligors with respect to the trade receivables are unrelated United States persons. A principal purpose of funding FS2 (through FS1's cash contribution) is to avoid the application of section 956 with respect to FS1.

(ii) *Result.* Under §1.956–1(b), if the trade receivables held by FS2 were United States property, FS1 would be treated as holding the trade receivables held by FS2 because FS1 controls FS2 and a principal purpose of FS1 funding FS2 was to avoid the application of section 956 with respect to FS1. Accordingly, under this paragraph (b)(2)(ii), FS1 is treated as having acquired from P, a related United States person, the trade receivables that it would be treated as holding with a basis equal to $200x. Thus, FS1 is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

(iii) *Swap or pooling arrangements.* A trade or service receivable of a United States person is considered to be a trade or service receivable acquired from a related United States person and subject to the rules of this section when it is acquired in accordance with an arrangement that involves two or more groups of related persons, if the groups are unrelated to each other and the effect of the arrangement is that one or more persons in each group acquire (directly or indirectly) trade or service receivables from one or more unrelated United States persons who are also parties to the arrangement in exchange for reciprocal purchases of receivables from related United States persons. The following example illustrates the application of this paragraph (b)(2)(iii):

Example. (i) *Facts.* 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 from 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.

(ii) *Result.* The effect of the prearranged plan is that each of A, B, C, and D acquires trade or service receivables of United States persons from one or more unrelated United States persons who are also parties to the arrangement, in exchange for reciprocal purchases of receivables from a related United States person. Accordingly, each of A, B, C, and D is treated as holding a trade or service receivable acquired from a related United States person and is subject to the rules of this section. As a result, each of A, B, C, and D is treated as holding an amount of United States property equal to its adjusted basis in the receivables acquired pursuant to the arrangement with respect to 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(a)(1) (*inventory property*) or services from a related United States person, or to any person who purchases from a related United States person trade or service receivables under which the obligor is a United States person, or to a person who is a related person with respect to the purchaser, and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation is 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 from a related United States person. The amount to be taken into account with respect to the United States property treated as held by a controlled foreign corporation as a result of the application of this paragraph (b)(2)(iv) is the lesser of the amount lent pursuant to a lending transaction described in this paragraph (b)(2)(iv) and the purchase price of the inventory property, services, or trade or service receivables. The following examples illustrate the application of this paragraph (b)(2)(iv):

Example 1. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. P sells inventory property for $200x to X, an unrelated United States person. FS1 makes a $100x 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 inventory property.

(ii) *Result.* FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv). Thus, FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section. That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. As a result, FS1 is treated as holding United States property in the amount of $100x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(2)(iv), except that instead of loaning money to X directly, FS1 deposits $300x with an unrelated financial institution that loans $200x to X in order for X to purchase P's inventory property. The loan would not have been made or maintained on the same terms but for the corresponding deposit.

(ii) *Result.* FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section because FS1 indirectly participates in a lending transaction described in this paragraph (b)(2)(iv). See Rev. Rul. 87–89, 1987–2 CB 195. That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. Thus, FS1 is treated as holding United States property in the amount of $200x.

Example 3. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. FS1 makes a $300x loan to U, an unrelated foreign corporation, in connection with U's purchase from P of receivables from the sale of inventory property by P to United States obligors for $200x.

(ii) *Result.* FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv). That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. Thus, FS1 is treated as holding United States property in the amount of $200x.

(c) *Substitution of obligor.* For purposes of this section, the substitution of another person for a United States obligor is disregarded, 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 (c):

Example. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation with substantial accumulated earnings and profits. P sells inventory property to X, a domestic corporation unrelated to P. To pay for the inventory property, X arranges for a foreign financing entity to issue a note to P. P then sells the note to FS1. P and X cannot demonstrate that the primary purpose for X's assignment of the payment obligation to the foreign financing entity was not the avoidance of section 956.

(ii) *Result.* The substitution of the foreign financing entity for X is disregarded, and FS1 is treated as holding an obligation of a United States person acquired from a related United States person. Thus, FS1 is treated as holding United States property in the amount of the purchase price of the note.

(d) *Effective/applicability date.* (1) Except as provided in paragraph (d)(2) of this section, this section applies to trade or service receivables acquired (directly or indirectly) after March 1, 1984.

(2) Paragraph (b)(2)(ii) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to trade or service receivables acquired on or after September 1, 2015. For purposes of this paragraph (d), a significant modification, within the meaning of §1.1001–3(e), of a trade or service receivable on or after September 1, 2015, constitutes an acquisition of the trade or service receivable on or after that date.

[T.D. 9792, 81 FR 76508, Nov. 3, 2016]

§ 1.956–4 Certain rules applicable to partnerships.

(a) *Overview.* This section provides rules concerning the application of section 956 to certain obligations of and property held by a partnership. Paragraph (b) of this section provides rules concerning United States property held indirectly by a controlled foreign corporation through a partnership. Paragraph (c) of this section provides rules that generally treat obligations of a foreign partnership as obligations of the partners in the foreign partnership, as well as a special rule that treats a partner that is a United States person as owing additional amounts of a partnership obligation in certain circumstances. Paragraph (d) of this section sets forth a rule concerning the application of the indirect pledge or guarantee rule to obligations of partnerships. Paragraph (e) of this section provides that obligations of a domestic partnership are obligations of a United States person. Paragraph (f) of this section provides effective and applicability dates. See §§1.956–1(b) and 1.956–2(c) for additional rules applicable to partnerships.

(b) *Property held indirectly through a partnership*—(1) *General rule.* For purposes of section 956, a partner in a partnership is treated as holding its attributable share of any property held by the partnership (including an obligation that the partnership is treated as holding as a result of the application of §1.956–2(c)). A partner's attributable share of partnership property is determined under the rules set forth in paragraph (b)(2) of this section. An upper-tier partnership's attributable share of the property of a lower-tier partnership is treated as property of the upper-tier partnership for purposes of applying this paragraph (b)(1) to the partners of the upper-tier partnership. For purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property, as determined under the rules set forth in paragraph (b)(2) of this section, taking into account any adjustments to basis under section 743(b) (with respect to the partner) or section 734(b) or any similar adjustments to basis. The rules in §1.956–1(e)(2) apply to determine the amount of an obligation treated as held by a partnership as a result of the application of §1.956–2(c). See §1.956–1(b) for special rules that may treat a controlled foreign corporation as holding a greater amount of United States property held by a partnership than the amount determined under this section.

(2) *Methodology*—(i) *Liquidation value percentage*—(A) *Calculation.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, for purposes of

paragraph (b)(1) of this section, a partner's attributable share of partnership property is determined in accordance with the partner's liquidation value percentage. For purposes of this paragraph (b)(2)(i) and paragraph (c)(1) of this section, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, on the applicable determination date, as provided in paragraph (b)(2)(i)(B) of this section, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752–7), paid an unrelated third party to assume all of its §1.752–7 liabilities in a fully taxable transaction, and then liquidated. A partner's liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership.

(B) *Determination date.* The *determination date* with respect to a partnership is the most recent of—

(*1*) The formation of the partnership;

(*2*) An event described in §1.704–1(b)(2)(iv)(*f*)(*5*) or §1.704–1(b)(2)(iv)(*s*)(*1*) (a *revaluation event*), irrespective of whether the capital accounts of the partners are adjusted in accordance with §1.704–1(b)(2)(iv)(*f*); or

(*3*) The first day of the partnership's taxable year, as determined under section 706, provided the liquidation value percentage determined for any partner on that day would differ from the most recently determined liquidation value percentage of that partner by more than 10 percentage points.

(ii) *Special allocations.* For purposes of paragraph (b)(1) of this section, if a partnership agreement provides for the allocation of book income (or, where appropriate, book gain) from a subset of the property of the partnership to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year (a *special allocation*), then the partner's attributable share of that property is determined solely by reference to the partner's special allocation with respect to the property, provided the special allocation will be respected for federal income tax purposes under section 704(b) and the regulations thereunder and does not have a principal purpose of avoiding the purposes of section 956.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. The remaining interest in FPRS is owned by an unrelated foreign person. FPRS holds nondepreciable property with an adjusted basis of $100x (the ''FPRS property'') that would be United States property if held by FS directly. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, for FS with respect to FPRS is 25%. There are no special allocations in the FPRS partnership agreement.

(ii) *Result.* Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of the property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in such property. Under paragraph (b)(2) of this section, FS's attributable share of property held by FPRS is determined in accordance with FS's liquidation value percentage, which is 25%. Thus, FS's attributable share of the FPRS property is 25%, and its attributable share of FPRS's basis in the FPRS property is $25x. Accordingly, for purposes of determining the amount of United States property held by FS as of the close of quarter 1 of year 1, FS is treated as holding United States property with an adjusted basis of $25x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(3), except that the FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to the FPRS property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result.* Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in such property. In general, FS's attributable share of property held by FPRS is determined in accordance with FS's liquidation value percentage. However, because the special allocation does not have a principal purpose of avoiding the purposes of section 956, under paragraph (b)(2)(ii) of this section, FS's attributable share of the FPRS property is determined by

reference to its special allocation. FS's special allocation percentage for the FPRS property is 80%, and thus FS's attributable share of the FPRS property is 80% and its attributable share of FPRS's basis in the FPRS property is $80x. Accordingly, for purposes of determining the amount of United States property held by FS as of the close of quarter 1 of year 1, FS is treated as holding United States property with an adjusted basis of $80x.

Example 3. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. USP owns the remaining interest in FPRS. FPRS holds property (the ''FPRS property'') that would be United States property if held by FS directly. The FPRS property has an adjusted basis of $100x and is anticipated to appreciate in value but generate relatively little income. The FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to the FPRS property to USP and 80% of the gain with respect to the disposition of FPRS property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result.* Because the special allocation does not have a principal purpose of avoiding the purposes of section 956, under paragraph (b)(2)(ii) of this section, FS's attributable share of the FPRS property is determined by reference to a special allocation with respect to the FPRS property. Given the income and gain anticipated with respect to the FPRS property, it is appropriate to determine FS's attributable share of the property in accordance with the special allocation of gain. Accordingly, for purposes of determining the amount of United States property held by FS in each year that FPRS holds the FPRS property, FS's attributable share of the FPRS property is 80% and its attributable share of FPRS's basis in the FPRS property is $80x. Thus, FS is treated as holding United States property with an adjusted basis of $80x.

(c) *Obligations of a foreign partnership*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, for purposes of section 956, an obligation of a foreign partnership is treated as a separate obligation of each of the partners in the partnership to the extent of each partner's share of the obligation. A partner's share of the partnership's obligation is determined in accordance with the partner's liquidation value percentage, as determined under the rules set forth in paragraph (b)(2)(i) of this section, without regard to the rules set forth in paragraph (b)(2)(ii) of this section. An upper-tier partnership's share of an obligation of a lower-tier partnership is treated as an obligation of the upper-tier partnership for purposes of applying this paragraph (c)(1) to the partners of the upper-tier partnership.

(2) *Exception for obligations of partnerships in which neither the lending controlled foreign corporation nor any person related to the lending controlled foreign corporation is a partner.* For purposes of applying section 956 with respect to a controlled foreign corporation, an obligation of a foreign partnership is treated as an obligation of a foreign partnership, and not as an obligation of its partners, if neither the controlled foreign corporation nor any person related to the controlled foreign corporation within the meaning of section 954(d)(3) is a partner in the partnership. For purposes of section 956, an obligation treated as an obligation of a foreign partnership pursuant to this paragraph (c)(2) is not an obligation of a United States person.

(3) *Special obligor rule in the case of certain partnership distributions*—(i) *General rule.* For purposes of determining a partner's share of a foreign partnership's obligation under section 956, if the foreign partnership distributes an amount of money or property to a partner that is related to a controlled foreign corporation within the meaning of section 954(d)(3) and whose obligation would be United States property if held (or if treated as held) by the controlled foreign corporation, and the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the controlled foreign corporation, notwithstanding §1.956–1(e), the partner's share of the partnership obligation is the greater of—

(A) The partner's share of the partnership obligation as determined under paragraph (c)(1) of this section; and

(B) The lesser of the amount of the distribution to the partner that would not have been made but for the funding of the partnership and the amount of the obligation (as determined under §1.956–1(e)).

(ii) *Deemed treatment.* (A) For purposes of applying paragraph (c)(3)(i) of

this section, in the case of a distribution of liquid assets by a foreign partnership to a partner, the foreign partnership is treated as if it would not have made the distribution of liquid assets to the partner but for the funding of the partnership through an obligation or obligations held (or treated as held) by the controlled foreign corporation to the extent the foreign partnership does not have sufficient liquid assets to make the distribution immediately prior to the distribution, without taking into account the obligation or obligations.

(B) If the controlled foreign corporation holds (or is treated as holding) multiple obligations of the foreign partnership, paragraph (c)(3)(ii)(A) of this section applies to the obligations in reverse chronological order starting with the obligation that was acquired (or the obligation with respect to which a pledge or guarantee was entered into) closest in time to the distribution. Paragraph (c)(3)(ii)(A) of this section applies to an obligation only to the extent that the full amount of the distribution is not otherwise treated, pursuant to paragraph (c)(3)(ii)(A) of this section, as if it would not have been made but for the funding of the partnership through one or more other obligations.

(C) For purposes of paragraph (c)(3)(ii) of this section, a significant modification, within the meaning of §1.1001–3(e), of an obligation constitutes an acquisition of the obligation on or after that date, and a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor.

(D) For purposes of paragraph (c)(3)(ii) of this section, liquid assets means cash or cash equivalents, marketable securities within the meaning of section 453(f)(2), or an obligation owed by a related person (within the meaning of section 954(d)(3)).

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, and owns an interest in FPRS, a foreign partnership. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2)(i) of this section, for USP with respect to FPRS is 90%. X, a foreign person that is unrelated to USP or FS, owns the remaining interest in FPRS. FPRS borrows $100x from FS. FS's basis in the FPRS obligation is $100x.

(ii) *Result.* Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP and X) in proportion to each partner's liquidation value percentage with respect to FPRS. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Based on its liquidation value percentage, USP's share of the FPRS obligation is $90x. Accordingly, for purposes of section 956, $90x of the FPRS obligation held by FS is treated as an obligation of USP and is United States property within the meaning of section 956(c). Therefore, on the date the loan is made, FS is treated as holding United States property of $90x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c)(4), except that USP owns 40% of the stock of FS and is not a related person (as defined in section 954(d)(3)) with respect to FS. Y, a United States person that is unrelated to USP or X, owns the remaining 60% of the stock of FS.

(ii) *Result.* Because neither FS nor any person related to FS within the meaning of section 954(d)(3) is a partner in FPRS, the exception in paragraph (c)(2) of this section applies to treat the FPRS obligation as an obligation of a foreign partnership and not an obligation of a United States person. Therefore, paragraph (c)(1) of this section does not apply, and FS is not treated as holding United States property.

Example 3. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP and FS own interests in FPRS, a foreign partnership. USP's liquidation value percentage with respect to FPRS is 60%, and FS's liquidation value percentage with respect to FPRS is 30%. USP2, a domestic corporation that is unrelated to USP and FS, also owns an interest in FPRS; its liquidation value percentage is 10%. FPRS borrows $100x from an unrelated person. FS guarantees the FPRS obligation.

(ii) *Result.* Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP, FS, and USP2) in proportion to each partner's liquidation value percentage. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), and because FS is a partner in FPRS, the exception in paragraph (c)(2) of this section does not apply. Based on their liquidation value percentages, USP's share of

the FPRS obligation is $60x, and USP2's share of the FPRS obligation is $10x. For purposes of section 956, $60x of the FPRS obligation is treated as an obligation of USP, and $10x of the FPRS obligation is treated as an obligation of USP2. Under §1.956–2(c)(1), FS is treated as holding the obligations of USP and USP2 that FS guaranteed. All of the exceptions to the definition of United States property contained in section 956 and §1.956–2 must be considered to determine whether the obligations of USP and USP2 that are treated as held by FS constitute United States property. Accordingly, the obligation of USP2 is not United States property under section 956(c)(2)(F) and §1.956–2(b)(1)(viii). The obligation of USP, however, is United States property within the meaning of section 956(c). Therefore, on the date the guarantee is made, FS is treated as holding United States property of $60x.

Example 4. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP owns an interest in FPRS, a foreign partnership; its liquidation value percentage with respect to FPRS is 70%. A domestic corporation that is unrelated to USP and FS owns the remaining interest in FPRS; its liquidation value percentage is 30%. FPRS borrows $100x from FS and makes a distribution of $80x to USP. FPRS would not have made the distribution to USP but for the funding of FPRS by FS.

(ii) *Result.* Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Moreover, an obligation of USP held by FS would be United States property. USP's share of the FPRS obligation as determined under paragraph (c)(1) of this section in accordance with USP's liquidation value percentage is $70x. Under paragraph (c)(3) of this section, USP's share of the FPRS obligation is the greater of (i) USP's attributable share of the obligation, $70x, or (ii) the lesser of the amount of the distribution, $80x, or the amount of the obligation, $100x. For purposes of section 956, therefore, $80x of the FPRS obligation is treated as an obligation of USP and is United States property within the meaning of section 956(c). Thus, on the date the loan is made, FS is treated as holding United States property of $80x.

(d) *Limitation on a partner's indirect pledge or guarantee.* For purposes of section 956 and §1.956–2(c), a controlled foreign corporation that is a partner in a partnership is not considered a pledgor or guarantor of the portion of an obligation of the partnership attributed to its partners that are United States persons under paragraph (c) of this section solely as a result of the attribution of a portion of the partnership's assets to the controlled foreign corporation under paragraph (b) of this section.

(e) *Obligations of a domestic partnership.* For purposes of section 956, an obligation of a domestic partnership is an obligation of a United States person. See section 956(c)(2)(L) for an exception from the treatment of such an obligation as United States property.

(f) *Effective/applicability dates.* (1) Paragraph (b) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after November 3, 2016. For purposes of this paragraph (f)(1), a deemed exchange of property pursuant to section 1001 on or after November 3, 2016, constitutes an acquisition of the property on or after that date. See §1.956–2(a)(3), as contained in 26 CFR part 1 revised as of April 1, 2016, for the rules applicable to taxable years of a controlled foreign corporation beginning on or after July 23, 2002, and ending before November 3, 2016, and with respect to property acquired before November 3, 2016, to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(2) Except as otherwise provided in this paragraph (f)(2), paragraph (c) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015, and, for purposes of paragraph (c)(3) of this section, in the case of distributions made on or after September 1, 2015. Paragraph (c)(3)(ii) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015, and distributions made

on or after November 3, 2016. For purposes of this paragraph (f)(2), a significant modification, within the meaning of §1.1001–3(e), of an obligation on or after September 1, 2015 constitutes an acquisition of the obligation on or after that date. Furthermore, for purposes of this paragraph (f)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015. See §1.956–1T(b)(5), as contained in 26 CFR part 1 revised as of April 1, 2016, for rules applicable to taxable years of controlled foreign corporations ending on or after September 1, 2015, and before November 3, 2016, and to taxable years of United States shareholders in which or with which such taxable years end, in the case of distributions made on or after September 1, 2015.

(3) Paragraph (d) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (f)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(4) Paragraph (e) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after November 3, 2016.

[T.D. 9792, 81 FR 76509, Nov. 3, 2016; 81 FR 95471, Dec. 28, 2016]

§ 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.

(a) *Basic rule*—(1) *In general.* The term *United States person* has the same meaning for purposes of sections 951 through 965 that it has under section 7701(a)(30) and the regulations under that section,

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 Puerto Rico or any section 931 possession;

(ii) The term *section 931 possession* has the same meaning that it has under §1.931–1(c)(1);

(iii) The rules of §1.937–1 will apply for determining whether an individual is a bona fide resident of a possession of the United States;

(iv) Except as provided in paragraph (b)(2) of this section, the rules of §1.937–2 will apply for determining whether income is from sources within a possession of the United States; and

(v) The rules of §1.937–3 will 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) will 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 that 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. For purposes of this paragraph (b)(2), the rules of §1.937–2(g)(1) will not apply.

(c) *Section 931 possession corporation and resident.* An individual (who, without regard to this paragraph (c), is a United States person) will 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 that 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/applicability date.* This section applies to taxable years ending after April 9, 2008.

[T.D. 9391, 73 FR 19375, Apr. 9, 2008]

§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		

	Amount	Year	Allocation of distributions under section 959
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.

(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

Total taxes deemed paid by N Corporation under section 960(a)(1) $32.50

Foreign income taxes deemed paid by N Corporation under section 902(a):

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)		10.71
(for formula see § 1.960–2(g)(1)(i)(A))		

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) (for formula see § 1.960–2(g)(2)(ii)(B)(*1*))	6.80	
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:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}}{\text{Earnings and profits of A Corporation included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on dividends received by A Corporation from earnings included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

($116/$116 × $29)	$29.00

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:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to A Corporation or lower tiers}}{\text{Earnings and profits of A Corporation not included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on earnings not included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

($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)(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—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation' s gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corpation' s gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax deemed paid by sec ond-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corpporations which is deemed paid by first-tier corporation}$$

(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	
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

1980	
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

1978		
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	
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	
	50	1966	(c)(1) taxable section 962.
			(c)(2) non-section 962.
Total	200		

Distribution	Amount	Year	Classification of distributions under sections 959 and 962(d)
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 ($0.30 \times 51.50$) 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 \times 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 \times 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 \times $85)	68		
($0.60 \times $75)	.....	45	
($0.70 \times $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 \times [$68/$85])	12		
($25 \times [$45/$75])	.....	15	
($35 \times [$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 \times 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		

	Controlled foreign corporations			
	A	B	C	Total
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
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%

	A	B	Total
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%

	A	B	Branch C	Total
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%

	A	B	Total
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		

1966

	A	B	Total
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

1963		
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

	A	B	Total
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
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

1963

	A	B	C	Total
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		
($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%
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 × 0.52 × $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				
($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			

1963

	A	B	C	D	Total
($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
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: d = $27.46 − 0.20d − 0.40 ($27.46 − d). d = $27.46 − 0.20d − $10.98 + 0.40d. d = $16.48 + 0.20d. 0.80d = $16.48. 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%
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:

$(75\% \times 31 \div 365) + (72\% \times 181 \div 365) + (69\% \times 153 \div 365) = 71\%$.

[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 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). For taxable years beginning after December 31, 1986, except as otherwise provided in the Code and regulations, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall be computed for all Federal income tax purposes 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.

(3) *Translation into dollars.* In the case of a 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 foreign corporation's earnings and profits into dollars.

(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 as prescribed in section 988 and the regulations under that 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.

(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 under that section.

(vi) *Applicable requirements.* Except as provided in paragraphs (c)(2) and (c) (3) of this section, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting or taxable year 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 or taxable year is to be taken into account in the computation of its earnings and profits.

(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 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. Adjustments to the appropriate separate category (as defined in §1.904–5(a)(1)) of earnings and profits and income of the foreign corporation shall be required under section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any change in a method of accounting. *See* paragraph (c)(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) 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* paragraph (c)(6) 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. *See also* §§1.985–5, 1.985–6, and 1.985–7 relating to adjustments to earnings and profits of a QBU required when the QBU changes its functional currency or begins to use the dollar approximate separate transactions method of accounting.

(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 under those sections, 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 under that section 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 (or its common parent) shall file the statement with, and on or before the due date (including extensions) of, 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. In the case of a controlling domestic shareholder that is the sole shareholder of a controlled foreign corporation, no separate statement need be filed if the information described in this paragraph (c)(3)(ii) is included on Form 5471 and Form 3115 or 1128, as applicable, filed with respect to the controlled foreign corporation with the shareholder's return for such taxable year.

(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*—(i) *In general.* Any election, or adoption or change of method of accounting or taxable year made by the controlling domestic shareholders on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section or any other provision of the regulations (for example, §1.985–2(c)(2) or (3)) 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 federal income tax liability of the domestic shareholders of the foreign corporation. Any such action shall bind both the foreign corporation and its domestic shareholders as to the computation of the foreign corporation's earnings and profits for 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 and in subsequent taxable years unless the Commissioner consents to a change. The preceding sentence shall apply regardless of—

(A) When the action was taken;

(B) Whether the foreign corporation was a controlled foreign corporation or a noncontrolled section 902 corporation at the time the action was taken;

(C) When ownership was acquired; or

(D) Whether the domestic shareholder received the written notice required by paragraph (c)(3)(iii) of this section.

(ii) *Inaction or untimely action.* 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. 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 not shown to the satisfaction of the Commissioner to be due to reasonable cause, 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 the purpose of accounting to its shareholders had been adopted. 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. Thereafter, any change in a particular accounting method or methods or taxable year may be made by, or on behalf of, the foreign corporation only with the Commissioner's consent.

(iii) *Computation of earnings and profits by a minority shareholder prior to majority election or significant event.* A shareholder of a foreign corporation may be required to compute the foreign corporation's earnings and profits before the foreign corporation or its controlling domestic shareholders make, or are required under this section to make, an election or adopt a method of accounting for federal income tax purposes. In such a case, the 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 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 foreign corporation shall not be treated as a change in accounting method.

(5) *Controlling domestic shareholders*—(i) *Controlled foreign corporations.* For purposes of this paragraph (c), 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 (c), 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 §1.964–1(c)(5)). The filing of the information return required by section 6038 shall not itself constitute a significant event. For taxable years beginning after April 25, 2006, events that cause a foreign corporation's earnings and profits to have United States tax significance include, without limitation:

(A) A distribution from the foreign corporation to its shareholders with respect to their stock.

(B) An amount is includible in gross income with respect to such corporation under section 951(a).

(C) An amount is excluded from subpart F income of the foreign corporation or another foreign corporation by reason of section 952(c).

(D) Any event making the foreign corporation subject to tax under section 882.

(E) 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).

(F) 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.

(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) [Reserved]

(d) *Effective/applicability dates.* Paragraphs (c)(1)(v) through (c)(6) of this section apply to taxable years ending on or after April 20, 2009. *See* 26 CFR §§1.964–1T(c)(1)(v) through (c)(6) (revised as of April 1, 2009) for rules applicable to taxable years beginning after April 25, 2006, and ending before April 20, 2009. However, taxpayers may choose to apply paragraphs (c)(1)(v) through (c)(6) of this section in their entirety in lieu of 26 CFR §§1.964–1T(c)(1)(v) through (c)(6) for periods covered by the temporary regulations, provided that appropriate adjustments are made to eliminate duplicate benefits arising from the application of paragraphs (c)(1)(v) through (c)(6) of this section to taxable years that are not open for assessment.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.964–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.964–2 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