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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.