

corrections do not affect the substance of the amendments.

EFFECTIVE DATE: January 2, 1997.

FOR FURTHER INFORMATION CONTACT: Robert C. Ashby, Deputy Assistant General Counsel for Regulation and Enforcement, Department of Transportation, 400 7th Street, S.W., Room 10424, Washington, D.C., 20590. (202) 366-9306 (voice); (202) 755-7687 (TDD)

SUPPLEMENTARY INFORMATION:

Background

The Department is making editorial corrections to its November 1, 1996, final rule (61 FR 56409), amending 49 CFR parts 27 and 14 CFR part 382, which implement section 504 of the Rehabilitation Act and the Air Carrier Access Act. The final rule concerned such subjects as lifts for small commuter aircraft, airport terminal accessibility, and passengers with communicable diseases.

Need for Correction

As published, the document contains errors which may prove to be misleading and are in need of correction. First, the title of an amendment to the Air Carrier Access Act regulation's "Provision of services and equipment" section is misnumbered (61 FR 56422). It reads "§ 382.49"; it should read "§ 382.39." Second, in the amendment to § 382.39(a)(2) (61 FR 56423), the word "commuter" in the final sentence is unnecessary and may be confusing, and should be deleted. In the same sentence, the words "fewer than 30" should be changed to "30 or fewer." Third, in the amendment to the section 504 rule (61 FR 56424), § 27.72(c)(2) inadvertently included the word "rule" in three places, and we are deleting it.

Correction of Publication

Accordingly, the publication on November 1, 1996, of the final regulations amending 14 CFR part 382 and 49 CFR part 27, which were the subject of FR Doc. 96-28084, is corrected as follows:

1. On page 56422, in the third column, following amendatory instruction 4, the title of the amended section is corrected to read as follows:

§ 382.39 Provision of services and equipment.

2. On page 56423, in the first column, the last sentence of the amended § 382.39(a)(2) is corrected by removing the word "commuter" and changing the words "fewer than 30" to "30 or fewer."

3. On page 56424, in the third column, the first sentence of new

§ 27.72(c)(2) is corrected by removing the word "rule" in three places: after the words "December 2, 1998", after the words "December 2, 1999", and after the words "December 4, 2000."

Robert C. Ashby,

Deputy Assistant General Counsel for Regulation and Enforcement.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8704]

RIN 1545-AR31

Definition of Foreign Base Company Income and Foreign Personal Holding Company Income of a Controlled Foreign Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definitions of subpart F income and foreign personal holding company income of a controlled foreign corporation and the allocation of deficits for purposes of computing the deemed-paid foreign tax credit. These regulations are necessary to provide guidance that coordinates with previously published guidance under section 954. These regulations will affect United States shareholders of controlled foreign corporations.

DATES: These regulations are effective January 2, 1997.

For specific dates of applicability, see §§ 1.952-1(f)(5), 1.952-2(c)(1), 1.954-2(b)(3) and 1.960-1(i)(6).

FOR FURTHER INFORMATION CONTACT: Valerie Mark, (202) 622-3840 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On September 7, 1995, proposed regulations (IL-75-92) amending the Income Tax Regulations (26 CFR Part 1) under sections 952, 954(c) and 960 of the Internal Revenue Code (Code) were published in the Federal Register (60 FR 46548). In final regulations under section 954 (TD 8618), also published on that date (60 FR 46500), a provision relating to the treatment of tax-exempt interest under the foreign personal holding company income rules was reserved. The proposed regulations provided rules for the treatment of tax-

exempt interest and also provided guidance under sections 952 and 960 to coordinate with the final regulations. No public hearing was requested or held. One written comment was received on the proposed regulations. After consideration of this comment, the proposed regulations are adopted as final regulations without amendment.

Explanation of Provisions

Sections 1.952-1(e) and (f) and 1.960-1(i)

Sections 1.952-1(e) and (f) and 1.960-1(i) are unchanged from the proposed regulations.

Sections 1.952-2(c)(1) and 1.954-2(b)(3)

Under § 1.954-2T(b)(6), interest income that was exempt from tax under section 103 was included in the foreign personal holding company income of the controlled foreign corporation. However, the net foreign base company income that was attributable to tax-exempt interest was treated as tax-exempt interest in the hands of the United States shareholder upon a deemed distribution under subpart F and therefore excluded for regular tax purposes but potentially subject to the alternative minimum tax. Section 1.954-2(b)(3), as proposed and finalized, amends the rule in the temporary regulations to provide that foreign personal holding company income includes interest income that is exempt from tax under section 103. The tax-exempt interest would not retain its character as such in the hands of the United States shareholder upon a deemed distribution under subpart F. As a result of the treatment of tax-exempt interest in these final regulations, Rev. Rul. 72-527 (1972-2 C.B. 456) is obsolete.

A commentator argued that treatment of tax-exempt interest in the proposed regulations was contrary to section 103. This comment was rejected. The Code does not specifically address how section 103 applies in the context of subpart F. Although § 1.952-2 provides that, in general, U.S. tax principles apply in computing subpart F income, this regulation makes certain Code provisions inapplicable when necessary to serve the purposes of subpart F. See § 1.952-2(c)(1).

Section 1.954-1(d)(4)(iii)

The example in § 1.954-1(d)(4)(iii) is amended to correct a mathematical error.

Section 1.954-2(g)(2)

The regulations are amended to clarify that income derived in the trade or business of trading foreign currency

is not excluded from foreign personal holding company income under the business needs exception. A technical correction is made to § 1.954-2(g)(2)(ii)(B)(2).

Section 1.957-1(c)

Technical corrections are made to § 1.957-1(c) *Examples 8 and 9*.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Barbara Felker and Valerie Mark of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.960-1 also issued under 26 U.S.C. 960(a). * * *

Par. 2. Section 1.952-1 is amended by adding paragraphs (e) and (f) to read as follows:

§ 1.952-1 Subpart F income defined.

* * * * *

(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 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.

Par. 3. In § 1.952-2, paragraph (c)(1) is revised to read as follows:

§ 1.952-2 Determination of gross income and taxable income of a foreign corporation.

* * * * *

(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.

* * * * *

Par. 4. In § 1.954-1, the *Example* in paragraph (d)(4)(iii) is revised to read as follows:

§ 1.954-1 Foreign base company income.

* * * * *

- (d) * * *
(4) * * *
(iii) * * *

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.

* * * * *

Par. 5. In § 1.954-2, paragraphs (b)(3), (g)(2)(ii)(B)(I)(i) and (g)(2)(ii)(B)(2) are revised to read as follows:

§ 1.954-2 Foreign personal holding company income.

* * * * *

(b) * * *

(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)).

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(B) * * *

(I) * * *

(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;

* * * * *

(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)(I)(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)(7) 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)(I)(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.

* * * * *

Par. 6. Section 1.957-1 is amended by:

1. Removing the last sentence of paragraph (c) *Example 8* and adding two sentences in its place.

2. Revising the last sentence of paragraph (c) *Example 9*.

The addition and revision read as follows:

§ 1.957-1 Definition of controlled foreign corporation.

* * * * *

(c) * * *

Example 8. * * * 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. * * * 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).

* * * * *

Par. 7. In § 1.960-1, paragraph (i) is added to read as follows:

§ 1.960-1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

* * * * *

(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.S. 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.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: December 11, 1996.

Donald C. Lubick,

Assistant Secretary of the Treasury.

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26 CFR Parts 31 and 602

[TD 8706]

RIN 1545-AR67

Electronic Filing of Form W-4

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to Form W-4, Employee's Withholding Allowance Certificate. The final regulations authorize employers to establish electronic systems for use by employees in filing their Forms W-4. The regulations provide employers and

employees with guidance necessary to comply with the law. The regulations affect employers that establish electronic systems and their employees.

EFFECTIVE DATE: These final regulations are effective January 2, 1997.

FOR FURTHER INFORMATION CONTACT: Karin Loverud, (202) 622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1435. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent is 20 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On April 15, 1994, a notice of proposed rulemaking [EE-45-93] containing proposed regulations relating to Form W-4, Employee's Withholding Allowance Certificate, was published in the Federal Register (59 FR 18057).

On December 21, 1994, temporary regulations (TD 8577) clarifying the existing proposed regulations were published in the Federal Register (59 FR 65712). A notice of proposed rulemaking (EE-45-93) cross-referencing the temporary regulations was published in the Federal Register for the same day (59 FR 65740).

Written comments responding to these notices were received. Public hearings were requested and were held on July 15, 1994, and November 7, 1995.

After consideration of all the comments, the proposed regulations under section 3402(f) are adopted as revised by this Treasury decision. The comments and revisions are discussed below.

Explanation of Revisions and Summary of Comments

1. Relationship between paper and electronic Forms W-4

A withholding exemption certificate (Form W-4) may be in either paper or electronic form. Therefore, an employee will furnish a Form W-4 to the employer either on paper or electronically. To clarify that an electronic Form W-4 has the same status as a paper Form W-4, the final regulations make minor revisions to § 31.3402(f)(5)-1, Form and contents of withholding exemption certificates. Further, the final regulations appear as § 31.3402(f)(5)-1(c), rather than in a separate regulations section limited to electronic forms.

2. Electronic filing by all employees.

The existing proposed and temporary regulations require employers that establish electronic systems to provide employees with the option of filing paper or electronic Forms W-4. Several commentators requested that employers be allowed to adopt systems under which all employees file Forms W-4 electronically. These commentators stated that a system under which all employees file electronically would reduce employer burden in terms of costs and time (for example, eliminate maintenance of duplicative paper and electronic systems). Similarly, it would reduce employee burden in terms of time and choosing a filing option.

The IRS and Treasury want to assist in reducing burdens on both employers and employees and to make it as easy as possible for employers to adopt less burdensome systems. The final regulations permit an employer to adopt a system under which all employees file Forms W-4 electronically. The IRS and Treasury expect, however, that an employer will make a paper option reasonably available upon request to any employee who has a serious objection to using the electronic system or whose access to, or ability to use, the system may be limited (for example, as a result of a disability). The paper option would be satisfied, for example, if the employer informs employees how they can obtain a paper Form W-4 and where they should submit the completed paper Form W-4. The IRS and Treasury also expect that employers will comply with all applicable law