List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration amends part 39 of the Federal Aviation Regulations (14 CFR part 39) as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

2000–26–10 BAe Systems (Operations) Limited (Formerly British Aerospace Regional Aircraft): Amendment 39–12060. Docket 99–NM–249–AD.

Applicability: All Model ATP airplanes, certificated in any category.

Note 1: This AD applies to each airplane identified in the preceding applicability provision, regardless of whether it has been modified, altered, or repaired in the area subject to the requirements of this AD. For airplanes that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (c) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance: Required as indicated, unless accomplished previously.

To ensure continued structural integrity of these airplanes, accomplish the following:

Airworthiness Limitations Revision

(a) Within 30 days after the effective date of this AD, revise the Airworthiness Limitations Section (ALS) of the Instructions for Continued Airworthiness by incorporating Section 05–00–00, dated August 15, 1997, of the British Aerospace ATP Aircraft Maintenance Manual (AMM), dated October 15, 1999, into the ALS. This section references other chapters of the AMM. The applicable revision level of the referenced chapters is that in effect on the effective date of this AD.

(b) Except as provided by paragraph (c) of this AD: After the actions specified in paragraph (a) of this AD have been accomplished, no alternative inspections or inspection intervals may be approved for the structural elements specified in the document listed in paragraph (a) of this AD.

Alternative Methods of Compliance

(c) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, International Branch, ANM–116, FAA, Transport Airplane Directorate. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, International Branch, ANM–116.

Note 2: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the International Branch, ANM–116.

Special Flight Permits

(d) Special flight permits may be issued in accordance with §§ 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Effective Date

(e) This amendment becomes effective on February 7, 2001.

Issued in Renton, Washington, on December 22, 2000.

John J. Hickey,

Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 01–32 Filed 1–2–01; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8916]

RIN 1545–AY29

Application of Section 904 to Income Subject to Separate Limitations and Section 864(e) Affiliated Group Expense Allocation and Apportionment Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains Income Tax Regulations relating to the section 864(e)(5) and (6) rules on affiliated group interest and other expense allocation and apportionment and to the section 904(d) foreign tax credit limitation. Changes to the applicable laws were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1993, and the Taxpayer Relief Act of 1997. These regulations provide guidance needed to comply with those changes and affect individuals and corporations claiming foreign tax credits.

DATES: *Effective Date:* These regulations are effective January 3, 2001.

Applicability Dates: The specific dates of applicability of these regulations are as follows:

The amendments to §§ 1.861–9, 1.861–11, and 1.861–14 generally apply to taxable years beginning after December 31, 1989. The dates of applicability are stated in § 1.861–9(h)(5)(i) and (ii), § 1.861–11(d)(8), and § 1.861–14(d)(1), (d)(2)(i), and (d)(2)(ii).

The amendment to § 1.904–4(b)(1)(i) applies to taxable years beginning after December 31, 1992.

The amendments to § 1.904–4(e)(3)(ii) and (e)(3)(iv) apply to taxable years beginning after December 31, 2000.

The amendments to § 1.902–1(d)(3)(ii), § 1.904–4(c)(5)(v), (c)(6)(iv), (c)(7)(ii), (c)(7)(iii), (c)(8) Example 9, and (g)(3), and to § 1.904–5(d)(2) and (m) apply to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on § 1.904–4(c)(6)(iv) and (g)(3)(ii), (iii), and (iv) of regulations project REG–209527–92, INTL–1–92, published at 1992–1 C.B. 1209. See § 601.601(d)(2) of 26 CFR part 601 revised April 1, 2000.

The amendments to § 1.904–5(a)(3), (g), (h)(4), and (i)(1), (3), and (4) apply to taxable years beginning after December 31, 2000. However, taxpayers may choose to apply the rule of § 1.904–5(i)(3) in taxable years beginning after December 31, 1991, provided that the taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of the rule to taxable years that are not open for assessment.

ADDRESSES: Send submissions to: Regulations Unit CC (REG–106409–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to Regulations Unit CC (REG–106409–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the IRS Internet site at: *http://www.irs.gov/tax_regs/regslist.html.*

FOR FURTHER INFORMATION CONTACT: Bethany A. Ingwalson at (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On May 14, 1992, a notice of proposed rulemaking (INTL–1–92, 1992–1 C.B. 1209) was published in the **Federal Register** (57 FR 20660), proposing amendments to the temporary Income Tax Regulations (26 CFR part 1) under section 864(e)(5) and (6) and to the Income Tax Regulations (26 CFR part 1) under section 904(d). The proposed regulations under section 864(e)(5) and (6) concern the allocation and apportionment of interest expense and certain other expenses within an affiliated group for alternative minimum tax purposes. The proposed regulations under section 904(d) provide rules for determining a taxpayer's foreign tax credit limitation.

Also on May 14, 1992, final regulations (TD 8412, 1992–1 C.B. 271) under section 904(d) of the Internal Revenue Code of 1986 (Code) were published in the **Federal Register** (57 FR 20639). The final regulations added provisions that were reserved in final regulations (TD 8214, 1988–2 C.B. 220) published in the **Federal Register** (53 FR 27006) in 1988 and also made other changes to the 1988 final regulations. Written comments were received with respect to the final and proposed regulations and a public hearing was held on September 24, 1992.

On July 8, 1996, additional proposed amendments to the Income Tax Regulations under section 904 (REG–209750–95, 1996–2 C.B. 484) were published in the **Federal Register** (61 FR 35696), addressing the grouping rules under § 1.904–4(c). On January 11, 1999, final regulations (TD 8805, 1999–1 C.B. 371) were published in the **Federal Register** (64 FR 1505) finalizing these amendments and portions of the 1992 proposed regulations, with modifications.

The significant points raised by the comments to the 1992 final and proposed regulations and at the hearing, and the changes made to the proposed, temporary, and final regulations, are discussed in the remainder of the preamble. After consideration of the comments received, the below-described amendments to the 1992 final regulations under section 904 and to the final regulations under section 864 are adopted as modified by this Treasury decision.

Explanation of Provisions

I. Sections 1.861–9, 1.861–11, and 1.861–14

The proposed regulations under §§ 1.861–9, 1.861–11, and 1.861–14 are finalized substantially as proposed, and the corresponding provisions of the temporary regulations are removed. For purposes of the alternative minimum tax (AMT), for taxable years beginning after December 31, 1989, the dividends received deduction under section 243 does not apply to the portion of a dividend attributable to income that is exempt from tax under section 936 or 30A. See section 56(g)(4)(C). Therefore, the exempt portion of the dividend is, in effect, included in adjusted current earnings (ACE) for purposes of computing the dividend recipient's alternative minimum taxable income. Dividends from a corporation with respect to which an election is in effect under section 936 or 30A (a section 936 corporation) are eligible for the dividends received deduction for regular tax purposes. Section 243(b)(1)(B)(ii).

To the extent included in income, dividends from a section 936 corporation to an affiliated United States corporation do not qualify for look-through treatment under section 904(d)(3) and § 1.904–5. Under sections 904, 861(a)(2)(A), and 862(a)(2), such amounts generally are treated as foreign source passive income (except as otherwise provided in section 904(g)). For taxable years beginning after December 31, 1993, section 56(g)(4)(C)(iii)(IV), added to the Code as part of the Revenue Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 312)(RRA 1993), creates an AMT foreign tax credit separate limitation for dividend income attributable to income that is exempt from tax under section 936 or 30A. The separate limitation applies solely for AMT purposes.

Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, the portion of the dividends from section 936 corporations that are added back into alternative minimum taxable income as ACE adjustments are subject to the separate limitation for passive income under section 904(d)(2) for AMT foreign tax credit purposes. For taxable years beginning after December 31, 1993, dividends from section 936 corporations are subject to a separate AMT foreign tax credit limitation. In addition, for taxable years beginning after December 31, 1995, corporations eligible for a credit under section 30A are treated as section 936 corporations, under sections 30A(e) and 56(g)(4)(C)(iii)(VI).

Treasury and the IRS proposed changes to the temporary regulations in order to exclude section 936 corporations from the affiliated group solely for purposes of allocating expenses in determining the amount of the group's foreign source alternative minimum taxable income, which affects the AMT foreign tax credit. This change has the effect of increasing the amount of interest and other expenses apportioned to dividend income from a section 936 corporation. The regulations were intended to mitigate the treatment, for AMT foreign tax credit purposes, of section 936 corporation dividends as passive income and would similarly mitigate the treatment of such dividends as separate limitation income in post-1993 taxable years.

Commentators wrote and testified at the public hearing that Treasury and the IRS do not have statutory authority to issue regulations under section 864(e)(5) excluding section 936 corporations from the affiliated group solely for AMT purposes. They contended that the AMT and regular tax systems must remain parallel unless a deviation is appropriate for simplification purposes. However, the enactment of a separate limitation category for certain portions of dividends from section 936 corporations for AMT purposes, effective for taxable years beginning after 1993, demonstrates that, because of the ACE adjustment, the AMT and regular tax foreign tax credit systems cannot operate exactly alike with respect to dividend income from section 936 corporations.

The amendments were proposed to apply to taxable years beginning after December 31, 1991. In response to a comment, the applicability date of the amendments to the regulations under §§ 1.861–9, 1.861–11, and 1.861–14 has been changed to taxable years beginning after December 31, 1989, to conform to the effective date of the statutory change. The regulations also provide a definition of section 936 corporations that reflects the enactment of section 30A.

In addition, the regulations move the flush text at the end of § 1.861–11T(d)(6) to a new § 1.861–11(d)(7). The new paragraph (d)(7) provides, among other things, that the attribution rules of section 1563(e) rather than the rules of section 318 will apply to determine indirect ownership for purposes of § 1.861–11T(d)(6). The change in the regulations to refer to section 1563(e) is consistent with paragraph 7 of Notice 89–91 (1989–2 C.B. 408), which stated that the IRS intends that the reference in § 1.861–11T(d)(6) to section 318 should instead be a reference to section 1563(e), effective for all post-1986 taxable years.

II. Section 1.904

A. Changes to the 1992 Proposed Regulations

1. Distributions From Controlled Foreign Corporations That Are Not Eligible for Look-Through Treatment

Section 1.904–4(g)(3)(i) provides that distributions made by a controlled foreign corporation (CFC) from earnings and profits accumulated before the distributing corporation became a CFC are treated as dividends from a noncontrolled section 902 corporation. The final regulations reorganize the provisions of § 1.904–4(g)(3) and include a reserved paragraph at § 1.904–4(g)(3)(i)(C). The regulations are proposed to be amended in a separate document (REG–104683–00) published elsewhere in this issue of the **Federal Register** to address the effect of an intervening period when the corporation was not a CFC on the eligibility of the distributions for look-through treatment.

Prior to amendment by the Taxpayer Relief Act of 1997 (Public Law 105–34, 107 Stat. 312) (TRA 1997), section 904(d)(2)(E)(i) provided that a CFC would not be treated as a noncontrolled section 902 corporation with respect to distributions from earnings and profits that were accumulated while the corporation was a CFC and, except as provided in regulations, the taxpayer was a United States shareholder in such corporation. The rule limiting look-through treatment to earnings and profits accumulated while the taxpayer was a United States shareholder was repealed by TRA 1997, applicable for distributions after August 5, 1997.

With respect to distributions before August 6, 1997, § 1.904–4(g)(3)(ii) through (iv) of the proposed regulations significantly limited the circumstances under which a dividend paid to a new United States shareholder by a CFC out of earnings and profits accumulated while it was a CFC (but before the recipient became a United States shareholder) would be treated as dividends from a noncontrolled section 902 corporation. The final regulations at § 1.904–4(g)(3)(ii)(A) retain the proposed rule denying look-through treatment only to new United Sates shareholders that acquire more than 90 percent of a CFC. This rule relaxed the statutory limitation to the extent necessary to avoid the administrative burdens that would arise if more than one United States shareholder were entitled to look-through treatment on distributions of post-1986 undistributed earnings but the look-through pools for each new shareholder began in different years.

Commentators argued that the regulations should be further expanded to allow look-through on pre-acquisition earnings for all new shareholders that acquire at least 10 percent of the voting power of the stock of a CFC, that is, to all new shareholders entitled to compute a credit for deemed-paid taxes under section 902 and section 960. Treasury and the IRS declined to adopt the suggestion, because the proposed regulations already relaxed the statutory requirement to an appropriate extent.

A commentator suggested that the intra-group acquisition rule in § 1.904–4(g)(3)(ii)(C) of the proposed regulations (paragraph (g)(3)(ii)(B) of the final regulations) should be revised to apply when the new and old shareholders of a CFC are related under the attribution rules of sections 318 and 958, rather than only to transfers within an affiliated group. Other commentators requested that the exception be expanded to apply to nontaxable transfers of stock in which the new and old shareholders cease to be members of the same affiliated group. Treasury and the IRS decline to expand the scope of the intra-group exception to the 90-percent shareholder rule, which applies only for distributions prior to August 6, 1997. The final regulations clarify the rule of the proposed regulations that the dividend recipient and the immediately preceding owner (or owners) must be members of the same affiliated group both when the recipient acquires the stock of the distributing corporation from the immediately preceding owner and when the recipient receives the dividend.

In response to a comment, the regulations clarify the LIFO ordering rule in § 1.904–4(g)(3)(iii) of the proposed regulations (paragraph (g)(3)(ii)(C) of the final regulations) for determining whether a distribution from a CFC is attributable to the period after a more-than-90-percent United States shareholder became a United States shareholder. The final regulations state that such a distribution comes first from the pool of post-acquisition undistributed earnings, next from the 10/50 pool of post-1986 undistributed earnings attributable to the pre-acquisition period, if any, and finally on a LIFO basis from any pre-acquisition earnings and profits attributable to pre-1987 accumulated profits.

To reflect the amendments made to section 904(d)(2)(E)(i) by TRA 1997, the final regulations provide at § 1.904–4(g)(3)(ii)(D) that the denial of look-through treatment to new more-than-90-percent shareholders for distributions of earnings and profits accumulated before the recipient became a United States shareholder applies only to distributions made before August 6, 1997. Section 1.904–4(g)(3) has been reorganized to separate the rules under section 904(d)(2)(E) that are applicable to distributions after August 5, 1997, from the rules that are applicable only to distributions on or before that date.

Rules substantially identical to the proposed section 904 regulations were proposed in 1995 under section 902. See Prop. Reg. § 1.902–1(d)(2)(ii) through (iv) (69 FR 2049; 1995–1 C.B. 959, 970), and the reserved paragraph at § 1.902–1(d)(3)(ii)(1997). A commentator noted that the effective date included in the proposed section 902 regulations applied to taxable years beginning after December 31, 1986, while the proposed applicability date for the substantially identical regulations proposed under section 904(d) applied to taxable years beginning after December 31, 1991. Since section 904(d)(2)(E)(i) applies to all taxable years beginning after 1986, the final regulations adopt the earlier applicability date, and amend the reserved paragraph at § 1.902–1(d)(3)(ii) to add a cross reference to the final section 904 regulations.

2. Succeeding Shareholders' Treatment of Additional Taxes on Previously Taxed Income Recognized by Prior Shareholders

In response to a comment, § 1.904–4(c)(6)(iv) of the proposed regulations is revised. Section 1.904–4(c)(6) provides rules for applying the high-tax kick-out from the passive limitation category when additional taxes are paid or deemed paid with respect to a distribution of previously taxed passive income that had been included in income in an earlier year under section 951(a)(1). Paragraph (c)(6)(iv) applies when a new shareholder acquires stock in a controlled foreign corporation after income has been included in the prior shareholder's income under section 951(a)(1) but before the income is distributed and subjected to additional foreign tax.

As proposed, paragraph (c)(6)(iv) provided that new shareholders entitled to look-through treatment on distributions of pre-acquisition earnings (U.S. shareholders that acquired 90 percent or less of the distributing corporation) would place the additional taxes in the general limitation category. However, new shareholders who were not entitled to look-through treatment (because the shareholder acquired more than 90 percent of the distributing corporation) would place the taxes in the general limitation or noncontrolled section 902 corporation category, depending on whether or not the associated income inclusion of the prior shareholder was high-taxed income.

A commentator argued that the latter rule's dependence on whether income was high-taxed or not in the hands of the previous shareholder, for purposes of determining the treatment of the taxes in the hands of a new 90-percent shareholder, added unnecessary complexity. In response to the comment, the regulations amend § 1.904–4(c)(6)(iv) to provide that a shareholder not entitled to look-through on pre-acquisition earnings must treat the additional taxes as allocable to the noncontrolled section 902 corporation dividend category. The revised rule applies to taxable years beginning after December 31, 1991. However, taxpayers may rely on the proposed regulations for taxable years beginning before January 1, 2001.

The final regulations adopt the proposed rule that a shareholder entitled to look-through treatment on pre-acquisition earnings treats additional taxes imposed on distributions of previously taxed passive income as allocable to the general limitation category. This rule applies to all distributions of previously taxed passive income after August 5, 1997.

3. Special Rules for Dividends Between CFCs

Section 1.904–5(i)(3) of the proposed regulations, reducing to ten percent the common ownership threshold for dividends between CFCs to qualify for look-through treatment, is finalized as proposed, applicable to taxable years beginning after December 31, 2000. However, taxpayers may choose to apply the rule to taxable years beginning after December 31, 1991, so long as appropriate adjustments are made to eliminate any double benefit arising from the application of the rule to taxable years that are not open for assessment. *Example 2* of proposed § 1.904–5(i)(4) is also finalized, with modifications described in II B.4 of this preamble, below, relating to changes to correct errors in *Example 1* in the 1992 final regulations.

B. Changes to the 1992 Final Regulations

1. Passive Limitation FOGEI Income

Section 1.904–4(b)(1)(i) is amended to clarify that, for taxable years beginning after December 31, 1992, passive income does not exclude foreign oil and gas extraction income (as defined in section 907(c)). This amendment reflects the repeal of section 904(d)(2)(A)(iii)(IV), which excluded FOGEI from the definition of passive income, by section 13235(a)(2) of RRA 1993.

2. High-Tax Kickout

Section 1.904–4(c)(4)(ii) is revised to reflect the addition of § 1.904–4(c)(3)(iv).

3. Reduction in Tax on Distribution of Previously Taxed Income

The 1992 final regulations, which generally look to foreign law rules for purposes of determining the year or years to which a reduction in foreign tax relates, were intended to apply LIFO default rules in order to avoid multiple redeterminations under section 905(c) in situations where a tax reduction applies to a distribution of previously taxed income that is treated under foreign law as made out of a multi-year pool of income. See § 1.905–3T(f) (requiring a redetermination of deemed paid taxes, in lieu of a pooling adjustment, when corporate tax is reduced in connection with a distribution of previously taxed income).

In response to a comment, § 1.904–4(c)(7)(ii) and § 1.904–4(c)(8) *Example 9* are revised to clarify that if a foreign country's law allocates a foreign tax reduction to a pool or group containing income from more than one taxable year, and that pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than based on the taxable year in which the income is derived, then foreign law is not considered to specify a year or years to which the tax reduction applies and the last-in first-out (LIFO) default rule applies.

In response to a comment, a new paragraph (c)(5)(v) has been added to § 1.904–4 to supply a cross-reference to the rule that, pursuant to the general rule of section 904(d)(3)(E), passive income excluded from foreign personal holding company income under the subpart F high tax exception of section 954(b)(4) will be treated as general limitation income at the CFC level unless the special rule in § 1.904–4(c)(7)(iii) applies.

4. Examples Illustrating Look-Through Rules for Dividends and Interest

In response to comments, § 1.904–5(i)(4) *Example 1* and Prop. § 1.904–5(i)(4) *Example 2* are revised. The 1992 version of *Example 1* was erroneous because, although the first-tier CFC in that example owns only 40 percent of the second-tier CFC, the second-tier CFC owns 100 percent of the third-tier CFC. Therefore, the second- and third-tier CFCs are related look-through entities and the look-through rules of § 1.904–5(i)(1) apply to interest payments between them. The section 904(d)(3)(B) look-through rule for subpart F inclusions applies to the U.S. parent's recognition of subpart F income of the second-tier CFC, attributable to the interest paid by the third-tier CFC.

Example 2 of the proposed regulations reached the correct result but applied an incorrect rationale. Just as in *Example 1,* on the facts of proposed *Example 2,* the related look-through entity rules of § 1.904–5(i)(1) would apply to distributions between the second- and third-tier CFCs even without the application of the special rule for dividends in proposed § 1.904–5(i)(3). *Examples 1* and *2* are revised to illustrate the different ownership thresholds that are required in order for the look-through rules to apply to interest and dividends paid between CFCs. The regulations also add a new *Example 3* to further clarify the application of § 1.904–5(i).

5. Treatment of Section 951(a)(1)(B) Inclusions as Dividends

Paragraph (m)(4) of § 1.904–5 is amended to clarify that, for purposes of the section 904(g) re-sourcing rules, section 951(a)(1)(B) inclusions are treated as dividends sourced under the pro rata rule of section 904(g)(4) and § 1.904–5(m)(4). Section 904(g)(2) provides a rule for sourcing section 951(a) inclusions, which literally include section 956 inclusions described in section 951(a)(1)(B). Section 904(g)(2) treats an amount described in section 951(a) as U.S. source income to the extent it is attributable to items of U.S. source income of the foreign corporation. Inclusions under section 951(a)(1)(A) are measured by tracing the inclusion directly to the items of income received by a CFC. Like an actual dividend, an increase in earnings invested in U.S. property that is included in income under section 951(a)(1)(B) is treated as paid pro rata out of all of the CFC's earnings and profits. See § 1.904–5(c)(4)(i). The final regulations amend § 1.904–5(m)(4)(i) to clarify that section 904(g)(2) sources section 951(a)(1)(B) inclusions by applying the pro rata rules of section 904(g)(4).

6. Treatment of Base Differences in the Case of Financial Services Entities

A commentator requested that § 1.904–6(a)(1)(iv) be revised to provide that, in the case of a financial services entity, if foreign taxes are imposed on amounts that are not income under United States tax rules (a base difference), the foreign taxes will be placed in the limitation category for financial services income rather than the general limitation category. The commentator argued that financial services entities typically have no general limitation income, and that the financial services category essentially serves as the residual basket for financial services entities.

Treasury and the IRS decline to adopt the suggested change. Treasury and the IRS believe that most cases in which foreign tax is imposed in the absence of a concurrent associated income inclusion in the United States are properly analyzed as involving a timing difference rather than a base difference. A timing difference occurs when foreign tax is imposed on an item that would be income under United States tax principles if it were recognized for U.S. tax purposes in the same year. Treasury and the IRS believe that base differences (in which foreign tax is imposed on an amount that the United States would never recognize as income, such as a gift) rarely occur. Accordingly, a special rule for base differences of financial services entities is not required.

However, Treasury and the IRS are considering whether additional rules are needed to clarify the operation of § 1.904–6(a)(1)(iv). For example, Treasury and the IRS are considering whether the regulations should be revised to address explicitly situations in which a foreign country and the United States recognize different amounts of income or characterize the income differently, for example, as a result of differences in calculating basis. Other issues under consideration include the appropriate treatment of situations in which a timing difference occurs but there is more than one possible characterization of the income that might be recognized in the future for U.S. tax purposes, and situations in which the United States and another country perceive different taxpayers as realizing the same income (with or without a timing or characterization difference). Comments are requested on the appropriate scope and content of additional guidance on these types of issues.

Treasury and the IRS are also considering clarifying § 1.904–6(a)(1), which provides rules for allocating foreign taxes to separate categories. The current regulations determine the income to which the foreign taxes relate by reference to foreign law (taxes are related to income if the income is included in the tax base upon which the foreign tax is imposed). Foreign taxes are allocated and apportioned to separate categories by reference to the separate categories to which the income taxed under foreign law would be assigned under U.S. tax principles. See § 1.904–6(c) *Example 5.* Comments are requested on the manner in which the regulations could be made easier to understand and apply.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has 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 the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Rebecca I. Rosenberg of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, 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 citations for §§ 1.861–9, 1,861–11, and 1.861–14 to read as follows:

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

Section 1.861–9 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). * * *

Section 1.861–11 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). Section 1.861–14 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). * * *

Par. 2. Section 1.861–9 is added to read as follows:

§ 1.861–9 Allocation and apportionment of interest expense.

(a) through (h)(4) [Reserved]. For further guidance, see § 1.861–9T(a) through (h)(4).

(h)(5) *Characterizing stock in related persons*—(i) *General rule.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax.* For purposes of characterizing stock in a related section 936 corporation in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a), the rules of § 1.861–9T(g)(3) shall apply and § 1.861–9(h)(5)(i) shall not apply. Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, stock in a related section 936 corporation is characterized for alternative minimum tax purposes as a foreign source passive asset because the stock produces foreign source passive dividend income under sections 861(a)(2)(A), 862(a)(2), and 904(d)(2)(A) and the regulations under those sections. For taxable years beginning after December 31, 1993, stock in a related section 936 corporation would be characterized for alternative minimum tax purposes as an asset subject to the separate limitation for section 936 corporation dividends because the stock produces foreign source dividend income that, for alternative minimum tax purposes, is subject to a separate foreign tax credit limitation under section 56(g)(4)(C)(iii)(IV). However, stock in a section 936 corporation is characterized as a U.S. source asset to the extent required by section 904(g). For the definition of the term *section 936 corporation* see § 1.861–11(d)(2)(ii).

(iii) *Effective date.* This paragraph (h)(5) applies to taxable years beginning after December 31, 1989.

Par. 3. In § 1.861–9T, paragraph (h)(5) is revised to read as follows:

§ 1.861–9T Allocation and apportionment of interest expense (temporary).

* * * * *

(h) * * *

(5) [Reserved]. For further guidance, see § 1.861–9(h)(5).

* * * * *

Par. 4. Section 1.861–11 is added to read as follows:

§ 1.861–11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

(a) through (c) [Reserved]. For further guidance, see § 1.861–11T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, in general, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to the other members of the group.

(2) *Inclusion of section 936 corporations*—(i) *Rule*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(i)(B) of this section, the exclusion of section 936 corporations from the affiliated group under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is a member of the affiliated group.

(B) *Exception for purposes of alternative minimum tax.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(ii) *Section 936 corporation defined.* For purposes of this section, § 1.861–9, and § 1.861–14, the term *section 936 corporation* means, for any taxable year, a corporation with an election in effect to be eligible for the credit provided under section 936(a)(1) or section 30A for the taxable year.

(iii) *Example.* This example illustrates the provisions of paragraph (d)(2)(i) of this section:

Example —(A) *Facts.* X owns all of the stock of Y. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. In 2000, Y owns all of the stock of Z, a section 936 corporation. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. For purposes of section 904, Z's qualified possessions source investment income constitutes foreign source passive income. In computing the section 30A benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) *Analysis for regular tax.* Assume first that X has no alternative minimum tax liability. Under paragraph (d)(2) of this section, Z is treated as a member of the XY affiliated group for purposes of allocating and apportioning interest expense for regular tax purposes. As provided in § 1.861–11T(b)(2), section 864(e)(1) and (5) do not apply in computing the combined taxable income of Y and Z under section 936, but these rules do apply in computing the foreign source taxable income of the XY affiliated group. The effect of including Z in the affiliated group is that X, the only debtor corporation in the group, must, under the asset method described in § 1.861–9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(f), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(C) *Analysis for alternative minimum tax.* Assume, alternatively, that X is liable to pay the alternative minimum tax. Pursuant to section 59(a), X must compute its alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income. Under paragraph (d)(2)(i)(B) of this section, for purposes of the apportionment of interest expense in determining alternative minimum taxable income within each limitation category, Z is not considered a member of the XY affiliated group. Thus, the stock (and not the assets) of Z are included in computing the group apportionment fractions. Pursuant to sections 59(g)(4)(C)(iii)(IV), 861(a)(2)(A), and 862(a)(2), dividends paid by a section 936 corporation are foreign source income subject to a separate foreign tax credit limitation for alternative minimum tax purposes. Thus, under § 1.861–9T(g)(3), the stock of Z must be considered attributable solely to the statutory grouping consisting of foreign source dividends from Z. The effect of excluding Z from the affiliated group is that X must apportion a part of its interest expense to the separate category for foreign source dividends from Z in computing alternative minimum taxable income within each separate category. If, as a result, under section 904(f), X has a separate limitation loss or an overall foreign loss in the category for dividends from Z for alternative minimum tax purposes, then that loss must be allocated against X's other income (separate limitation or United States source, as the case may be). The loss must be recaptured in subsequent years under the rules of section 904(f) for purposes of the alternative minimum tax foreign tax credit.

* * *

(iv) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (6) [Reserved]. For further guidance see § 1.861–11T(d)(3) through (6).

(7) *Special rules for the application of § 1.861–11T(d)(6).* The attribution rules of section 1563(e) and the regulations under that section shall apply in determining indirect ownership under § 1.861–11T(d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in § 1.861–11T(d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under § 1.861–11T(g). The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of § 1.861–11T(g). For taxable years beginning after December 31, 1989, § 1.861–11T(d)(6)(i) shall not apply in determining foreign source alternative minimum taxable income within each

separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a) to the extent that such application would result in the inclusion of a section 936 corporation within the affiliated group. This paragraph (d)(7) applies to taxable years beginning after December 31, 1986.

(e) through (g) [Reserved]. For further guidance, see § 1.861–11T(e) through (g).

Par. 5. Section 1.861–11T is amended by:

1. Revising paragraphs (d)(1) and (d)(2).
2. Removing the concluding text following (d)(6)(ii).
3. Adding paragraph (d)(7).

The revisions and additions read as follows:

§ 1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

* * * * *

(d)(1) and (2) [Reserved]. For further guidance, see § 1.861–11(d)(1) and (2).

* * * * *

(7) *Special rules for the application of § 1.861–11T(d)(6).* [Reserved]. For special rules for the application of § 1.861–11T(d)(6), see § 1.861–11(d)(7).

* * * * *

Par. 6. Section 1.861–14 is added to read as follows:

§ 1.861–14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

(a) through (c) [Reserved]. For further guidance, see § 1.861–14T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations (as defined in § 1.861–11(d)(2)(ii)) are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80% stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the expenses incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, the apportionment factor chosen shall relate only to the period of membership. For example, if apportionment on the basis of assets is chosen, the average amount of assets (tax book value or fair market value) for the taxable year shall be multiplied by a fraction, the numerator of which is the number of months of the corporation's taxable year during which the corporation was a member of the affiliated group, and the denominator of which is the number of months within the corporation's taxable year. If apportionment on the basis of gross income is chosen, only gross income generated during the period of membership shall be taken into account. If apportionment on the basis of units sold or sales receipts is chosen, only units sold or sales receipts during the period of membership shall be taken into account. Expenses incurred by the group member during its taxable year, but not during the period of membership, shall be allocated and apportioned without regard to other members of the group. This paragraph (d)(1) applies to taxable years beginning after December 31, 1989.

(2) *Inclusion of section 936 corporations*—(i) *General rule.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is a member of the affiliated group.

(ii) *Exception for purposes of alternative minimum tax.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(iii) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (j) [Reserved]. For further guidance see § 1.861–14T(d)(3) through (j).

Par. 7. In § 1.861–14T, paragraph (d) is revised to read as follows:

§ 1.861–14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (temporary).

* * * * *

(d)(1) and (2) [Reserved]. For further guidance, see § 1.861–14(d)(1) and (2).

* * * * *

Par. 8. Section 1.902–1(d)(3)(ii) is amended by adding text to read as follows:

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

* * * * *

(d) * * *

(3) * * *

(ii) * * * For rules regarding dividend distributions before August 6, 1997, to certain more-than-90-percent United States shareholders of a controlled foreign corporation, see § 1.904–4(g)(3)(ii).

* * * * *

Par. 9. Section 1.904–0 is amended as follows:

1. Amending the entries for § 1.904–4 by:

a. Adding entries for paragraphs (c)(5)(v), (c)(6)(iv)(A), and (c)(6)(iv)(B).

b. Adding an entry for paragraph (g)(2)(v).

c. Revising the entries for paragraphs (g)(3) and (g)(3)(i).

d. Adding entries for paragraphs (g)(3)(i)(A), (g)(3)(i)(B), (g)(3)(i)(C), and (g)(3)(i)(D).

e. Revising the entry for paragraph (g)(3)(ii).

f. Adding entries for paragraphs (g)(3)(ii)(A), (g)(3)(ii)(B), (g)(3)(ii)(C), (g)(3)(ii)(D), and (g)(3)(ii)(E).

g. Revising the entries for paragraphs (g)(3)(iii) and (g)(3)(iv).

h. Adding an entry for paragraph (g)(3)(v).

i. Removing the entry for paragraph (g)(4).

The revisions and additions read as follows:

§ 1.904–0 Outline of regulation provisions for section 904.

* * * * *

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(c) * * *

(5) * * *

(v) Coordination with section 954(b)(4).

(6) * * *

(iv) * * *

(A) General rule.

(B) Exception for U.S. shareholders not entitled to look-through.

* * * * *

(g) * * *
(2) * * *
(v) Examples.
(3) Special rule for dividends paid by a controlled foreign corporation.
(i) Distributions out of earnings and profits accumulated when the distributing corporation was not a controlled foreign corporation.
(A) General rule.
(B) Ordering rule.
(C) Effect of intervening noncontrolled status.
(D) Examples.
(ii) Pre-August 6, 1997, dividend distributions out of earnings and profits accumulated before a more-than-90-percent United States shareholder became a United States shareholder.
(A) General rule.
(B) Exception for intra-group acquisitions.
(C) Ordering rule.
(D) Distributions after August 5, 1997.
(E) Examples.
(iii) Treatment of earnings and profits for transition year.
(iv) Definitions.
(v) Effective date.

* * * * *

Par. 10. Section 1.904–4 is amended by:

1. Revising the second sentence in paragraph (b)(1)(i)(B).
2. Revising paragraph (c)(4)(ii).
3. Adding a new paragraph (c)(5)(v).
4. Adding the text to paragraph (c)(6)(iv).
5. Adding a new sentence at the end of paragraph (c)(7)(ii).
6. Revising the second sentence of paragraph (c)(7)(iii).
7. Amending paragraph (c)(8) by revising the fifth sentence of paragraph (i) of *Example 9,* and the fifth sentence of paragraph (ii) of *Example 9.*
8. Revising paragraph (e)(3)(ii).
9. Adding the text to paragraph (e)(3)(iv) *Example 2.*
10. Redesignating paragraph (g)(4) as paragraph (g)(2)(v).
11. Revising the heading for paragraph (g)(3) and revising paragraph (g)(3)(i).
12. Revising the paragraph headings and adding the text to paragraphs (g)(3)(ii) through (iv).
13. Adding paragraph (g)(3)(v).

The revisions and additions read as follows:

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(b) * * * (1) * * * (i) * * *

(B) * * * Passive income does not include any income that is also described in section 904(d)(1)(B) through (H), any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section, or, for taxable years beginning before January 1, 1993, any foreign oil and gas extraction income (as defined in section 907(c)). * * *

* * * * *

(c) * * *

(4) * * *

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the tax imposed on that income as provided in paragraphs (c)(3)(i) through (iv) of this section.

* * * * *

(5) * * *

(v) *Coordination with section 954(b)(4).* For rules relating to passive income of a controlled foreign corporation that is exempt from subpart F treatment because the income is subject to high foreign tax, see section 904(d)(3)(E), § 1.904–4(c)(7)(iii), and § 1.904–5(d)(2).

(6) * * *

(iv) *Increase in taxes paid by successors*—(A) *General rule.* Except as provided in paragraph (c)(6)(iv)(B) of this section, if passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid or accrued, on that distribution shall be treated as taxes related to general limitation income, regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(B) *Exception for U.S. shareholders not entitled to look-through.* In the case of a United States shareholder that, by reason of paragraph (g)(3)(ii) of this section (relating to distributions prior to August 6, 1997, to new shareholders acquiring more than 90 percent of a controlled foreign corporation), is not entitled to look-through treatment with respect to pre-acquisition earnings and profits of the distributing corporation, the increase in foreign taxes described in paragraph (c)(6)(iv)(A) of this section shall be treated as taxes related to the noncontrolled section 902 corporation income of the distributing corporation.

(C) *Effective date.* This paragraph (c)(6)(iv) applies to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on § 1.904–4(c)(6)(iv) of regulations project INTL–1–92, published at 1992–1 C.B. 1209. See § 601.601(d)(2) of this chapter.

(7) * * *

(ii) * * * For purposes of this paragraph (c)(7)(ii), foreign law is not considered to attribute a reduction in tax to a particular year or years if foreign law attributes the tax reduction to a pool or group containing income from more than one taxable year and such pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than on the taxable year in which the income is derived.

(iii) * * * If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then, notwithstanding the general rule of § 1.904–5(d)(2), the income shall be considered to be passive income until distribution of that income.* * *

(8) * * *

Example 9. (i) * * * Under country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50% tax rate. * * *

(ii) * * * Country G treats the distribution of earnings as out of the 50% tax rate pool of earnings accumulated in 1987 and 1988. * * *

* * * * *

(e) * * *

(3) * * *

(ii) *Special rule for affiliated groups.* In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group, such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), affiliated group means an affiliated group as defined in section 1504(a), determined without regard to section 1504(b)(3). In counting the income of the group for purposes of determining whether the group meets the requirements of paragraph (e)(3)(i) of this section, the following rules apply. Only the income of group members that are United States corporations or foreign corporations that are controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock shall be included. For purposes of this paragraph (e)(3)(ii), indirect ownership shall be determined under section 318 and the regulations under that section. The income of the group will not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii). This paragraph (e)(3)(ii) applies to taxable years beginning after December 31, 2000.

* * * * *

(iv) * * *

Example 2. Foreign corporation A, which is not a controlled foreign corporation, owns 100 percent of the stock of domestic corporation B, which owns 100 percent of the stock of domestic corporation C. A also owns 100 percent of the stock of foreign corporation D. D owns 100 percent of the stock of domestic corporation E, which owns 100 percent of the stock of controlled foreign corporation F. All of the corporations are members of an affiliated group within the meaning of section 1504(a) (determined without regard to section 1504(b)(3)). Pursuant to paragraph (e)(3)(ii) of this section, however, only the income of B, C, E, and F is counted in determining whether the group meets the requirements of paragraph (e)(3)(i) of this section. For the 2001 taxable year, B's income consists of $95 of active financing income and $5 of passive non-active financing income. C has $40 of active financing income and $20 of passive non-active financing income. E has $70 of active financing income and $15 of passive non-active financing income. F has $10 of passive income. B and E qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. Therefore, B and E are financial services entities without regard to whether the group as a whole is a financial services entity and all of the income of B and E shall be treated as financial services income. C and F do not qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. However, under the affiliated group test of paragraph (e)(3)(ii) of this section, C and F are financial services entities because at least 80 percent of the group's total income consists of active financing income ($205 of active financing income is 80.4 percent of $255 total income). B's and E's passive income is not treated as active financing income for purposes of the affiliated group test of paragraph (e)(3)(ii) of this section even though it is treated as financial services income without regard to whether the group satisfies the affiliated group test. Once C and F are determined to be financial services entities under the affiliated group test, however, all of the passive income of the group is treated as financial services income. Thus, 100 percent of the income of B, C, E, and F for 2001 is financial services income.

* * * * *

(g) * * *

(3) *Special rule for dividends paid by a controlled foreign corporation*—(i) *Distributions out of earnings and profits accumulated when the distributing corporation was not a controlled foreign corporation*—(A) *General rule.* Distributions from a controlled foreign corporation shall be treated as dividends from a noncontrolled section 902 corporation, and therefore not subject to the look-through rules of § 1.904–5, to the extent that the distribution is out of earnings and profits accumulated during periods when the distributing corporation was not a controlled foreign corporation.

(B) *Ordering rule.* The determination of the earnings to which a distribution from a controlled foreign corporation is attributable shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from post-1986 undistributed earnings attributable to the period after the distributing corporation became a controlled foreign corporation (look-through pools), next from the non-look-through pool of post-1986 undistributed earnings, if any, and finally on a LIFO basis from pre-1987 accumulated profits.

(C) *Effect of intervening noncontrolled status.* [Reserved]

(D) *Examples.* The following examples illustrate the application of paragraph (g)(3)(i):

Example 1. S is a foreign corporation formed in 1980. Until 1992, S had no United States shareholders. In 1992, P, a domestic corporation, acquires 10 percent of the stock of S. Thus, for 1992 and subsequent years, S is a noncontrolled section 902 corporation. Because the 10-percent ownership requirement of section 902(a) was not satisfied until 1992, earnings accumulated by S before 1992 will be treated as pre-1987 accumulated profits for purposes of section 902, and the amount of foreign taxes deemed paid with respect to any distribution out of such pre-1987 accumulated profits will be computed on a year-by-year basis under the rules of section 902(c)(6)(A) and § 1.902–1(b)(3). In 2000, P acquires an additional 45% of the stock of S. Thus, for 2000 and subsequent years, S is a controlled foreign corporation. In 2000, S has no earnings and profits and pays a dividend out of prior years' earnings and profits. Pursuant to paragraph (g)(3)(i) of this section, because S was not a controlled foreign corporation before 2000, the dividend to P will be treated as a dividend from a noncontrolled section 902 corporation. The dividend is treated as paid first out of S's non-look-through pool of post-1986 undistributed earnings to the extent thereof, and then out of S's pre-1987 accumulated profits on a LIFO basis. The entire dividend will be subject to a single separate limitation for dividends from a noncontrolled section 902 corporation.

Examples 2 through 4. [Reserved]

(ii) *Pre-August 6, 1997, dividend distributions out of earnings and profits accumulated before a more-than-90-percent United States shareholder became a United States shareholder*—(A) *General rule.* Look-through principles do not apply to distributions made before August 6, 1997, to a more-than-90-percent United States shareholder in the distributing corporation, to the extent the distributions are made from earnings and profits accumulated before the taxpayer became a United States shareholder of the distributing corporation (pre-acquisition earnings). Therefore, in the case of a distribution made before August 6, 1997, a dividend shall be treated as a dividend from a noncontrolled section 902 corporation, and the look-through rules of section 904(d)(3) and § 1.904–5 shall not apply, if—

(*1*) The distribution is received by a United States shareholder, or by an upper-tier controlled foreign corporation of a United States shareholder, at a time when such United States shareholder is a more-than-90-percent United States shareholder of the distributing corporation; and

(*2*) The more-than-90-percent United States shareholder was not a United States shareholder at the time the distributed earnings and profits were accumulated by the distributing corporation.

(B) *Exception for certain intra-group acquisitions.* Notwithstanding paragraph (g)(3)(ii)(A) of this section, a dividend recipient shall be entitled to look-through treatment on a distribution out of pre-acquisition earnings if—

(*1*) The dividend recipient is a United States shareholder of the distributing corporation;

(*2*) The immediately preceding owner or owners were entitled to look-through treatment on distributions from the distributing corporation (determined after the application of paragraphs (g)(3)(i) and (g)(3)(ii)(A) of this section); and

(*3*) Both at the time of such distribution and at the time that the dividend recipient acquired its interest from such immediately preceding owner or owners, such recipient and such preceding owner or owners are members of the same affiliated group (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)).

(C) *Ordering rule.* If, under paragraph (g)(3)(ii) of this section (or under paragraphs (g)(3)(i)(A) and (g)(3)(ii) of this section), a shareholder is not entitled to look-through treatment, the determination whether a distribution from its controlled foreign corporation is attributable to pre-acquisition earnings shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from the post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation, and then from pre-acquisition earnings, in the order described in paragraph (g)(3)(i)(B) of this section.

(D) *Distributions after August 5, 1997.* Look-through principles shall apply to distributions made after August 5, 1997, to a distribution from a controlled foreign corporation to a more-than-90-percent United States shareholder out of pre-acquisition earnings that were accumulated in years during which the corporation was a controlled foreign corporation. Post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation and other post-1986 undistributed earnings accumulated while the distributing corporation was a controlled foreign corporation shall be combined into a single set of post-1986 undistributed earnings pools for each separate category described in § 1.904–5(a)(1) as of August 6, 1997.

(E) *Examples.* The following examples illustrate the application of this paragraph (g)(3)(ii):

Example 1. (i) P, a domestic corporation, owns 100 percent of the stock of U, a controlled foreign corporation. In 1992, P sells 100 percent of the stock of U to T, an unrelated domestic corporation. In 1992, U has no earnings and pays a dividend to T out of earnings and profits attributable to prior years. T is not related to P and P's ownership of U will not be attributed to T. Because the dividend to T in 1992 is out of post-1986 undistributed earnings that are pre-acquisition earnings, the dividend will be treated as a dividend from a noncontrolled section 902 corporation. In 1993, U pays a dividend to T out of current earnings and profits. T is entitled to look-through treatment on the dividend.

(ii) In September 1997, U pays a dividend to T out of both post-acquisition earnings and pre-acquisition earnings accumulated while U was a controlled foreign corporation. Under paragraph (g)(3)(ii)(D) of this section, T is entitled to look-through treatment on the full amount of the dividend.

Example 2. (i) Domestic corporation P has owned 95 percent of the stock of S, a controlled foreign corporation, from the time of S's organization in 1990. Domestic corporation R owns the remaining 5 percent of the stock of S. On December 1, 1996, T, an unrelated domestic corporation, acquires P's 95 percent interest in S. On December 31, 1996, S pays a dividend out of current and prior years' earnings and profits. T is a more-than-90-percent United States shareholder of S at the time it receives the dividend, but was not a United States shareholder at the time the distributed earnings were accumulated. Under this paragraph (g)(3)(ii), the portion of the dividend to T attributable to pre-acquisition earnings will be treated as a dividend from a noncontrolled section 902 corporation. Under paragraph (g)(3)(iii) of this section, T will be entitled to look-through treatment on the portion of the dividend attributable to 1996 earnings and profits. Under paragraph (g)(3)(ii)(C) of this section, the dividend received by T will be treated as coming first from S's post-1986 undistributed earnings attributable to 1996, and then from pre-acquisition earnings.

(ii) On December 31, 1997, S pays a second dividend out of current and prior years' earnings and profits. Under paragraph (g)(3)(ii)(D) of this section, T will be entitled to look-through treatment on the full amount of the dividend because all of S's earnings and profits were accumulated in years during which S was a controlled foreign corporation. The dividends to R will be treated as passive income because R owns less than 10 percent of the stock of S and, therefore, is not entitled to look-through treatment.

Example 3. The facts are the same as in *Example 2* except that R, rather than T, acquires from P an 86 percent interest in S in 1996. Although R was a shareholder of S before the acquisition, it was not a United States shareholder because it did not own 10 percent of the voting stock of S. Thus, because R owns more than 90 percent of the stock of S, and received a distribution of earnings before August 7, 1997, that were accumulated before it became a United States shareholder of S, this paragraph (g)(3)(ii) applies and R is not entitled to look-through treatment on the 1996 dividend. R is entitled to look-through treatment on the 1997 dividend.

Example 4. Since its organization in 1980, S, a controlled foreign corporation, has been owned 60 percent by domestic corporation P and 40 percent by domestic corporation R. On November 15, 1996, domestic corporation T acquires R's 40 percent interest in the stock of S. S has no income in 1996 and pays a dividend on December 15, 1996, out of prior years' earnings and profits. This paragraph (g)(3)(ii) does not apply because T acquired less than 90 percent of the stock of S. Thus, T is entitled to look-through treatment on dividends distributed out of pre-acquisition earnings, because such earnings are attributable to periods in which S was a controlled foreign corporation.

(iii) *Treatment of earnings and profits accumulated in a transition year.* Earnings and profits accumulated in the taxable year in which a corporation became a controlled foreign corporation or in which a more-than-90-percent United States shareholder became a United States shareholder shall be considered earnings and profits accumulated after the corporation became a controlled foreign corporation or the shareholder became a United States shareholder, respectively.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (g)(3):

(A) *More-than-90-percent United States shareholder.* The term *more-than-90-percent United States shareholder* means, with respect to any controlled foreign corporation, a United States shareholder that owns more than 90 percent of the total combined voting power of all classes of stock entitled to vote of the controlled foreign corporation. In determining ownership for purposes of this definition, the indirect stock ownership rules of sections 958 and 318 and the regulations under those sections shall apply.

(B) *Non-look-through pool.* Except as otherwise provided, the term *non-look-through pool* means post-1986 undistributed earnings accumulated during periods in which the distributing corporation was a noncontrolled section 902 corporation that was not a controlled foreign corporation.

(C) *Post-1986 undistributed earnings.* The term *post-1986 undistributed earnings* has the meaning set forth in § 1.902–1(a)(9).

(D) *Pre-1987 accumulated profits.* The term *pre-1987 accumulated profits* has the meaning set forth in § 1.902–1(a)(10).

(E) *Upper tier controlled foreign corporation.* The term *upper tier controlled foreign corporation* of a United States shareholder means a controlled foreign corporation in which the taxpayer is a United States shareholder and which is an upper-tier corporation as defined in § 1.902–1(a)(6) with respect to the distributing corporation.

(v) *Effective date.* The provisions of this paragraph (g)(3) apply to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on § 1.904–4(g)(3)(ii), (iii) and (iv) of regulations project INTL–1–92, published at 1992–1 C.B. 1209. See § 601.601(d)(2) of this chapter.

* * * * *

Par. 11. Section 1.904–5 is amended as follows:

1. The last sentence in paragraph (a)(3) is revised and one new sentence is added.

2. Paragraph (d)(2) is amended by removing the word ''For'' at the beginning of the first sentence and adding the language ''Except as provided in § 1.904–4(c)(7)(iii) (relating to reductions in tax upon distribution), for'' in its place.

3. Paragraph (g) is revised.

4. Paragraph (h)(4) is amended by adding three new sentences at the end.

5. Paragraph (i)(1) is amended by:

a. Revising the third sentence.

b. Adding a new sentence at the end.

6. The text to paragraph (i)(3) is added.

7. Paragraph (i)(4) *Example 1* is revised.

8. The text to paragraph (i)(4) *Example 2* is added.

9. Paragraph (i)(4) *Example 3* is added.

10. The second and third sentences of paragraph (m)(1) are revised.

11. Paragraph (m)(4)(i) is revised.

12. Paragraph (m)(5) is amended by removing the language ''951(a)'' from the first sentence and adding the language ''951(a)(1)(A)'' in its place.

The revisions and additions read as follows:

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) * * *

(3) * * * For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that ''more than 50 percent'' shall be substituted for ''at least 80 percent'' wherever it appears in section 1504(a)(2). For taxable years beginning before January 1, 2001, the preceding sentence shall be applied by substituting ''50 percent'' for ''more than 50 percent''.

* * * * *

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents and royalties paid by a United States corporation to a related corporation. For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock of the other corporation or more than 50 percent of the total value of the other corporation. In addition, a United States corporation and another corporation shall be considered to be related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock or more than 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 and the regulations under that section apply. For taxable years beginning before January 1, 2001, this paragraph (g) shall be applied by substituting ''50 percent or more'' for ''more than 50 percent'' each place it appears.

(h) * * *

(4) * * * Similarly, a partnership (first partnership) is considered as owning more than 50 percent of the value of another partnership (second partnership) if the first partnership owns more than 50 percent of the capital and profits interests of the second partnership. For this purpose, value will be determined at the end of the partnership's taxable year. For taxable years beginning before January 1, 2001, the second preceding sentence shall be applied by substituting ''50 percent'' for ''more than 50 percent''.

(i) * * * (1) * * * In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. * * * For taxable years beginning before January 1, 2001, the third sentence of this paragraph (i)(1) shall be applied by substituting ''50 percent or more'' for ''more than 50 percent'' each place it appears.

* * * * *

(3) *Special rule for dividends.* Solely for purposes of dividend payments between controlled foreign corporations in taxable years beginning after December 31, 2000, two controlled foreign corporations shall be considered related look-through entities if the same United States shareholder owns, directly or indirectly, at least 10 percent of the total voting power of all classes of stock of each foreign corporation. Taxpayers may choose to apply this paragraph (i)(3) in taxable years beginning after December 31, 1991, provided that appropriate adjustments are made to eliminate any double benefit arising from the application of this paragraph (i)(3) to taxable years that are not open for assessment.

(4) Examples. * * *

Example 1. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. S owns 40 percent of the stock of T, a Country X corporation that is a controlled foreign corporation. The remaining 60 percent of the stock of T is owned by V, a domestic corporation. The percentages of value and voting power of T owned by S and V correspond to their percentages of stock ownership. T owns 40 percent (by vote and value) of the stock of U, a Country Z corporation that is a controlled foreign corporation. The remaining 60 percent of U is owned by unrelated U.S. persons. U earns exclusively general limitation non-subpart F income. In 2001, U makes an interest payment of $100 to T. Look-through principles do not apply because T and U are not related look-through entities under paragraph (i)(1) of this section (because T does not own more than 50 percent of the voting power or value of U). The interest is passive income to T, and is subpart F income to P and V. Under paragraph (c)(1) of this section, look-through principles determine P and V's characterization of the subpart F inclusion from T. P and V therefore must characterize the inclusion as passive income.

Example 2. The facts are the same as in *Example 1* except that instead of a $100 interest payment, U pays a $50 dividend to T in 2001. P and V each own, directly or indirectly, more than 10 percent of the voting power of all classes of stock of both T and U. Pursuant to paragraph (i)(3) of this section, for purposes of applying this section to the dividend from U to T, U and T are treated as related look-through entities. Therefore, look-through principles apply to characterize the dividend income as general limitation income to T. The dividend is subpart F income of T that is taxable to P and V. The subpart F inclusions of P and V are also subject to look-through principles, under paragraph (c)(1) of this section, and are characterized as general limitation income to P and V because the income is general limitation income of T.

Example 3. The facts are the same as in *Example 1*, except that U pays both a $100 interest payment and a $50 dividend to T, and T owns 80 percent (by vote and value) of U. Under paragraph (i)(1) of this section, T and U are related look-through entities, because T owns more than 50 percent (by vote and value) of U. Therefore, look-through principles apply to both the interest and dividend income paid or accrued by U to T, and T treats both types of income as general limitation income. Under paragraph (c)(1) of this section, P and V apply look-through principles to the resulting subpart F inclusions, which therefore are also general limitation income to P and V.

* * * * *

(m) * * * (1) * * * For purposes of determining the portion of a dividend paid or accrued (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) by a controlled foreign corporation that is treated as from sources within the United States under section 904(g)(4), the rules in paragraph (m)(4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951(a)(1)(A) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904(g)(2), the rules in paragraph (m)(5) of this section apply. * * *

* * * * *

(4) * * * (i) * * * Any dividend or distribution treated as a dividend under this section (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the

controlled foreign corporation in that separate category.

* * * * *

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved: December 13, 2000.

Jonathan Talisman,

Acting Assistant Secretary (Tax Policy).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8914]

RIN 1545–AX67

Definition of Hyperinflationary Currency for Purposes of Section 988

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning when a currency will be considered hyperinflationary for purposes of section 988. These final regulations are intended to prevent distortions associated with the computation of income and expense arising from section 988 transactions denominated in hyperinflationary currencies.

DATES: The effective date of this regulation is February 14, 2000.

FOR FURTHER INFORMATION CONTACT: John W. Rogers III of the Office of Associate Chief Counsel (International) at (202) 622–3870.

SUPPLEMENTARY INFORMATION:

Background

This document contains final Income Tax Regulations (26 CFR part 1) under section 988 of the Internal Revenue Code (Code). On March 17, 1992, the IRS and Treasury published final regulations (57 FR 9172) relating to the taxation of section 988 transactions, including, inter alia, transactions denominated in hyperinflationary currencies. Also on March 17, 1992, proposed regulations were published (57 FR 9217) relating to the treatment of certain financial instruments denominated in hyperinflationary currencies. The proposed regulations did not separately define hyperinflationary currency. Rather, they simply made reference to the definition in the final regulations, § 1.988–1(f).

TD 8860 (65 FR 2026) (January 13, 2000) finalized the proposed regulations relating to the treatment of financial instruments denominated in hyperinflationary currencies. Also in that issue of the **Federal Register** was a notice of proposed rulemaking regarding a proposed change in the period of years that are considered in determining whether a currency is hyperinflationary for purposes of section 988 (base period). The notice of proposed rulemaking also provided notice of a public hearing on the proposed regulations. No requests to speak were received, and the public hearing was canceled. This Treasury decision finalizes the proposed regulations relating to the change in base period, with certain minor changes.

Explanation of Provisions

As set out in the notice of proposed rulemaking, the term hyperinflationary currency, as defined in § 1.988–1(f), utilizes the definition in § 1.985–1(b)(2)(ii)(D). This definition was developed in the context of the Dollar Approximate Separate Transactions Method (DASTM) regulations, § 1.985–3, and generally considers the cumulative effects of inflation over the base period in determining whether a currency is hyperinflationary. In § 1.985–1(b)(2)(ii)(D), the base period consists of the thirty-six calendar month period immediately preceding the first day of the current calendar year. Use of this base period is generally appropriate in the context of DASTM because a qualified business unit needs to know in advance if it is subject to § 1.985–3 calculations.

However, failure to take the current year's inflation into account for purposes of computing foreign currency gain or loss under section 988 may lead to distortions in income and expense because inflation may rise dramatically in single year. Accordingly, the IRS and Treasury believe that for purposes of section 988, it is more appropriate to consider the cumulative inflation rate over the thirty-six month period ending on the last day of the taxpayer's (or the qualified business unit's) current taxable year. This change in the base period, however, applies only for the purposes of section 988 and not for the purpose of determining whether a taxpayer (or QBU) is subject to the provisions of § 1.985–3.

Summary of Comments

One comment was received in connection with the proposed change in the measurement of the base period under section 988. This comment relates to the application of the rule to regulated investment companies (RICs). The commenter stated that sections 852(a) and 4982 effectively require a RIC to distribute essentially all of its income during the calendar year in which it is earned. Thus, the commenter concluded that RICs need to know before the end of their tax year whether a particular currency is hyperinflationary. The Treasury and IRS recognize that the revised definition of base period could present an administrative burden for RICs. Accordingly, the final regulation provides that RICs are not subject to the revised base period standard of these final regulations.

A similar exclusion from the revised base period standard has been made for REITs due to their similar distribution requirements. The regulation has also been amended to provide that the Service may by notice provide that the revised base period standard shall not apply to any section 988 transaction of an entity with distribution requirements similar to that of RICs and REITs.

In addition, the regulation was amended to provide that generally accepted accounting principles may not apply to alter the base period outlined in paragraph (f)(1)(ii)(A) of this section. This change is intended to clarify that the last sentence of § 1.985–1(b)(2)(ii)(D) may not be used to alter the base period for purposes of section 988.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these regulations is John W. Rogers III of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department also 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: