section 743(b), so that UTP would recognize gain equal to $180,000. The $90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal $100,000. This would conform to B's share of UTP's basis in the LTP interest (($480,000—$180,000 (*i.e.*, A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election)) × ⅓ = $100,000) as well as B's indirect share of the cash held by LTP ((⅓ × ⅓) × $900,000 = $100,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under paragraph (c) of this section, of the $90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is $100,000.

(d) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–104683–00]

RIN 1545–AX88

Application of Section 904 to Income Subject to Separate Limitations and Computation of Deemed-Paid Credit Under Section 902

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed Income Tax Regulations relating to the computation of the section 902 deemed-paid credit, the section 904(d) foreign tax credit limitation, and to an example in the section 954 regulations relating to the exclusion of certain export financing interest from foreign personal holding company income. Changes to the applicable law were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Taxpayer Relief Act of 1997. These regulations would provide guidance needed to comply with these changes and would affect individuals and corporations reporting subpart F income and claiming foreign tax credits. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 3, 2001. Outlines of topics to be discussed at the public hearing scheduled for April 26, 2001, at 10 a.m. must be received by April 5, 2001.

ADDRESSES: Send submissions to: Regulations Unit CC (REG–104683–00), 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.* The public hearing will be held in the IRS Auditorium, 7th floor, Internal Revenue Building, 1111 Constitution Ave., NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bethany A. Ingwalson (202) 622–3850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Treasury and the IRS provided guidance regarding section 904(d) (enacted in 1986) in TD 8214 (1988–2 C.B. 220), TD 8412 (1992–1 C.B. 271), TD 8556 (1994–2 C.B. 165), TD 8805 (1999–1 C.B. 371), and in final regulations (TD 8916) published elsewhere in this issue of the **Federal Register**. Final regulations regarding the computation of the deemed paid credit under section 902 (also enacted in 1986) were published as TD 8708 (1997–1 C.B. 137). The proposed regulations provide further guidance with respect to the application of sections 902 and 904(d).

The proposed regulations also provide guidance regarding the application of section 904(j). The Taxpayer Relief Act of 1997 (Public Law 105–34, 111 Stat. 788) (TRA 1997) added section 904(j) to the Internal Revenue Code (Code). Section 904(j) exempts individuals from the foreign tax credit limitation of section 904(a) in certain limited circumstances, and provides that no foreign taxes may be carried to or from a year for which a taxpayer has elected to apply section 904(j).

TRA 1997 also added to the Code section 904(b)(2)(C), which provides that the Secretary may issue regulations to modify the application of section 904(b)(2) and (3) to properly reflect capital gain rate differentials under sections 1(h) and 1201(a) and the computation of net capital gain. The proposed regulations provide guidance for the application of section 904(b), including the application of that section in years in which section 1(h) provides for more than one capital gains rate.

Explanation of Provisions

I. Effect of Loss of Domestic Corporate Shareholder on Pooling of Earnings and Taxes in Computing Deemed Paid Credits: § 1.902–1

Under section 902(c)(3), the multi-year pools of post-1986 undistributed earnings and post-1986 foreign income taxes of a foreign corporation are determined by taking into account only periods beginning on and after the first day of the foreign corporation's first taxable year in which a domestic corporation (a ''qualifying shareholder'') owns 10 percent or more of its voting stock or, in the case of a lower-tier foreign corporation in a ''qualified group'' described in section 902(b)(2), owns indirectly at least 5 percent of its voting stock.

Under section 902(c)(6)(B), dividends are treated as paid first out of the post-1986 pooled earnings. Pre-1987 accumulated profits (defined in section 902(c)(6)(A) and § 1.902–1(a)(10) to include both earnings accumulated in pre-1987 years and earnings accumulated in post-1986 years preceding the year in which the section 902 ownership requirements are met) are treated as distributed only after the pools are exhausted, and then out of annual layers of earnings and taxes on a last-in, first-out basis. Distributions out of pre-1987 accumulated profits are governed by the section 902 rules in effect under pre-1987 law. Section 902(c)(6)(A).

The rule limiting the multi-year pools of earnings and taxes to post-1986 taxable years beginning with the year in which a foreign corporation first has a qualifying shareholder alleviates the administrative difficulties such shareholders face in reconstructing accumulated earnings and taxes accounts in connection with their acquisition of stock in a pre-existing foreign corporation. While section 902 provides that pooling of earnings and taxes begins only when the foreign corporation first has a qualifying shareholder entitled to compute a credit for deemed-paid taxes, the statute does not provide for any change in a foreign corporation's post-1986 undistributed earnings and taxes pools following a stock disposition or other transaction after which the foreign corporation no longer has a qualifying shareholder. Section 1.902–1(a)(13)(i) currently provides that, once a foreign corporation begins to maintain pools of earnings and taxes, the pools include periods during which the stock ownership requirements of section 902 are not met. Should such a corporation later again have a qualifying shareholder, such a shareholder would have to reconstruct the post-1986 undistributed earnings and taxes pools to include undistributed earnings and taxes for periods during which there was no qualifying shareholder, in order to compute deemed-paid credits with respect to distributions of earnings and profits accumulated during later periods in which the ownership requirements were met.

Treasury and the IRS believe that the policy concerns underlying the rule deferring the start of pooling until the corporation has a qualifying shareholder also apply to the situation where a foreign corporation once had, but no longer has, such a shareholder. Therefore, Treasury and the IRS believe it is appropriate to stop the multi-year pooling of earnings and taxes at the foreign corporation level when a foreign corporation no longer has a qualifying shareholder.

The proposed regulations would amend § 1.902–1(a)(10) to provide that pre-1987 accumulated profits subject to the annual layering rules of pre-1987 law include not only the actual pre-1987 earnings and profits and pre-pooling earnings and profits described in the current final regulation, but also formerly pooled earnings and profits of a less-than-10%-U.S.-owned foreign corporation attributable to post-1986 years during which the section 902 stock ownership requirements were met, and post-pooling earnings and profits accumulated during subsequent taxable years during which the foreign corporation did not have a qualifying shareholder. The formerly pooled earnings would be considered pre-1987 accumulated profits of the last taxable year of the foreign corporation as of the end of which the ownership requirements were met. Distributions out of formerly pooled earnings would be subject to the same pre-1987 law rules as distributions of other pre-1987 accumulated profits, except that the formerly pooled foreign income taxes related to the formerly pooled earnings would continue to be maintained in U.S. dollars. The proposed regulations would also amend § 1.902–1(a)(13) to provide that pooling of earnings and taxes would resume in the first subsequent taxable year as of the end of which the foreign corporation again has a qualifying shareholder. Formerly pooled earnings would continue to be treated as pre-1987 accumulated profits even if the foreign corporation later began to maintain pools of earnings and taxes again.

Treasury and the IRS believe the proposed rules would be easier for taxpayers to apply than the current regulations, which require pooling to continue through periods when the foreign corporation has no shareholders entitled to compute a deemed-paid credit. These proposed amendments complement the proposed amendments to the section 904 regulations, described below, concerning the effect of intervening noncontrolled status on the look-through pools of post-1986 undistributed earnings and taxes maintained by a controlled foreign corporation. The proposed regulations also would be consistent with the approach taken in recently proposed amendments to the regulations under section 367(b) relating to the carryover of earnings and taxes accounts in reorganizations involving foreign corporations (REG–116050–99, published in the **Federal Register** (65 FR 69138) on November 15, 2000).

II. Separate Categories: § 1.904–4

A. The Active Rents and Royalties Exception

Section 1.904–4(b)(2) sets forth the active rents and royalties exception to the separate limitation for passive income. This exception currently applies only to payments from unrelated payors. Several commentators have requested that Treasury and the IRS amend the regulations to provide that royalties received from a member of the recipient's affiliated group (including foreign affiliates) may qualify for the exception if the royalties are derived in the conduct of an active trade or business and the payor uses the underlying property in an active trade or business. As explained below, Treasury and the IRS propose to adopt a modified version of the suggested change.

Section 904(d)(2)(A)(i) defines passive income as foreign personal holding company income, as defined in section 954(c). The section 904(d) active rents and royalties exception derives from section 954(c)(2)(A), which excludes from foreign personal holding company income, and thus from passive income, any rents or royalties derived in the active conduct of a trade or business and received from an unrelated person. The current final regulations at § 1.904–4(b)(2)(ii) modify this exception to take into account activities of members of the recipient's affiliated group in determining whether the recipient meets the active trade or business prong of the test for section 904(d) purposes.

Treasury and the IRS have consistently declined to extend look-through treatment to payments from foreign non-controlled payors. See TD 8412 (1992–1 C.B. 271, 273). Treasury and the IRS continue to believe that the nature of the income earned by a foreign non-controlled payor from the use of the licensed property should not determine whether a rent or royalty payment constitutes income from the active conduct of a trade or business of the recipient.

However, Treasury and the IRS have decided that it is appropriate to eliminate the distinction between royalties received from related and unrelated payors in applying the active rents and royalties exception for purposes of section 904(d). Therefore, these regulations propose to amend prospectively § 1.904–4(b)(2) to provide that for purposes of section 904 (but not for purposes of section 954), the active rents and royalties exception will not require that the rents and royalties be received from an unrelated payor. This change is proposed to apply to rents and royalties paid or accrued more than 60 days after the date that these regulations are published in final form.

B. Restriction of Affiliated Group Special Rule for Active Rents and Royalties Exception

As noted, § 1.904–4(b)(2)(ii) provides that, for purposes of the active rents and royalties exception from passive income under section 904, rents or royalties will be treated as derived in the active conduct of a trade or business by a United States person or controlled foreign corporation if any member of the recipient's affiliated group (defined to include foreign corporations) meets the requirements of section 954(c)(2)(A) with respect to the licensed property. The proposed regulations would amend the definition of affiliated group for purposes of § 1.904–4(b)(2)(ii) to include only U.S. corporations and controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the stock (by vote and value). This requirement is consistent with the affiliated group rules of § 1.904–4(e)(3)(ii), which consider the activities of other members of the affiliated group for purposes of determining whether an entity is a financial services entity. The proposed regulations revise the affiliated group rule in the active rents and royalties exception due to administrative concerns regarding the difficulty of determining whether related, but non-controlled, foreign corporations engage in the active conduct of a trade or business with respect to licensed property.

C. Effect of Intervening Noncontrolled or Less-Than-10%-U.S.-Owned Status on Distributions From a Controlled Foreign Corporation or Other Look-Through Corporation

Under section 904(d)(2)(E)(i) and § 1.904–4(g)(3)(i), dividends from a controlled foreign corporation (CFC) are treated as dividends from a noncontrolled section 902 corporation to the extent that the distribution is out of earnings and profits accumulated during periods in which the distributing corporation was not a CFC. Proposed § 1.904–4(g)(3)(i)(C)(*1*) provides rules to address the effect of intervening noncontrolled status on the eligibility for look-through treatment of distributions of pre-2003 accumulations of pooled earnings and profits from a CFC. Consistent with the proposed amendments to § 1.902–1(a) previously discussed, proposed § 1.904–4(g)(3)(i)(C)(*2*) provides rules to address the effect of intervening less-than-10%-U.S.-owned status on the post-1986 undistributed earnings and taxes pools and pre-1987 accumulated profits of a foreign corporation and the application of the look-through rules to distributions from such a foreign corporation. The proposed regulations anticipate to some extent, but do not provide comprehensive guidance, regarding the changes to the statutory look-through rules for 10/50 companies that become effective for post-2002 taxable years. Additional conforming changes to the provisions of §§ 1.904–4 and 1.904–5 will be required to reflect the changes in terminology reflected in the proposed regulations that are necessitated by these statutory changes.

The proposed regulations provide that, when a CFC becomes a non-look-through 10/50 corporation (because it ceases to be controlled by United States shareholders, but has at least one qualifying shareholder, in a taxable year beginning before January 1, 2003), post-1986 undistributed earnings that were accumulated through the end of the taxable year preceding the taxable year in which the decontrolling event occurred and that were previously eligible for look-through treatment will be consolidated in, and constitute the opening balance of, a single non-look-through pool at the foreign corporation level. The regulations provide that distributions of the prior look-through earnings will continue to be treated as dividends from a non-look-through 10/50 corporation, and will not be eligible for look-through treatment, even if the foreign corporation later becomes a CFC again or becomes eligible for look-through treatment with respect to earnings accumulated in post-2002 taxable years.

Distributions of post-1986 undistributed earnings in the non-look-through pool will be treated as dividends from a non-look-through 10/50 corporation (10/50 dividend income) when distributed to a qualifying shareholder, or as passive income when distributed to any other shareholder. Pre-1987 accumulated profits distributed after a decontrolling event will similarly be treated as 10/50 dividend income or as passive income when distributed, depending on the status of, and the amount of stock owned by, the shareholder at the time of distribution. Because the separate limitation treatment of distributions during the taxable year is computed with reference to year-end pools of post-1986 undistributed earnings under section 902, the proposed regulations provide that distributions to a qualifying shareholder that are made in the taxable year in which a decontrolling event occurs are treated as 10/50 dividend income to qualifying shareholders, or passive income to other shareholders, whether made before or after the decontrolling event. Similarly, under § 1.904–4(g)(3)(iii), earnings and profits accumulated in the year in which a foreign corporation becomes a CFC are treated as accumulated after the corporation became a CFC. Such earnings will be eligible for look-through treatment when distributed to a United States shareholder during the taxable year in which the distributing corporation becomes a CFC or during any subsequent taxable year until the distributing corporation ceases to be a CFC or other look-through corporation.

As noted, the proposed regulations do not permit look-through treatment for earnings and profits accumulated in pre-2003 taxable years while the distributing corporation was a CFC if the earnings are distributed after an intervening period ending before 2003 during which the corporation was not a CFC, even if the corporation is a CFC or other look-through corporation at the time of distribution. Earnings and profits previously eligible for look-through treatment will be placed in a single non-look-through pool with new earnings accumulated in taxable years beginning before January 1, 2003, while the corporation is not a CFC. The proposed rule would eliminate the need to determine whether distributions made while the corporation is a non-look-through 10/50 corporation (or, after 2002, a 10/50 look-through corporation) are made out of look-through earnings accumulated in pre-2003 years prior to the decontrolling event or pre-2003 non-look-through earnings accumulated afterwards. Treasury and the IRS believe this rule would be simpler to apply with respect to pre-2003 periods during which the records necessary to establish look-through treatment are less likely to be maintained by a foreign corporation that is not controlled by United States shareholders.

This intervening noncontrolled status situation differs from the special situation described in § 1.904–4(g)(3)(ii), which allows look-through treatment on distributions to a more-than-90-percent United States shareholder after August 6, 1997, of earnings and profits that were accumulated while the distributing corporation was a CFC. In the latter case, pre-acquisition post-1986 undistributed earnings of a CFC with a more-than-90-percent United States shareholder were required to be maintained in a non-look-through pool prior to the effective date of the amendment to section 904(d)(2)(E)(i) by TRA 1997. During the entire period the non-look-through pool was required to be maintained, the corporation was a CFC that was more-than-90-percent-owned by a single domestic corporation. Accordingly, the rules governing the effect of the 1997 repeal of the rule limiting look-through treatment to earnings accumulated while the more-than-90-percent United States shareholder was a United States shareholder of the distributing corporation do not provide an appropriate model for resolving the ongoing issue addressed by the proposed regulations.

Section 904(d)(4) as amended by section 1105(b) of TRA 1997 effective for taxable years beginning after December 31, 2002, will generally extend the look-through rules to distributions of earnings accumulated by a 10/50 company in post-2002 taxable years. Accordingly, non-look-through 10/50 corporations will not exist after 2002, although 10/50 look-through corporations will continue to maintain non-look-through pools of earnings and taxes accumulated in pre-2003 taxable years. Therefore, if the regulations are finalized prospectively, the effect of proposed § 1.904–

4(g)(3)(i)(C)(*1*) generally would be limited to situations involving a CFC that is decontrolled after the regulations become final but before January 1, 2003, and to earnings that are accumulated in taxable years beginning before January 1, 2003, and that are not treated as distributed to the CFC's U.S. shareholders under section 1248 in connection with the decontrolling event. Comments are requested as to whether the simplification objectives of the regulation could best be met by extending the effective date to cover decontrolling events that occurred in prior periods.

Consistent with the proposed amendments to § 1.902–1(a) and with the approach taken with respect to the pre-2003 decontrol situation, § 1.904–4(g)(3)(i)(C)(*2*) of the proposed regulations provides that distributions out of formerly pooled earnings that are converted to an annual layer of pre-1987 accumulated profits when a foreign corporation no longer has a qualifying shareholder will be treated as distributions from a non-look-through 10/50 corporation, even if the foreign corporation later becomes a look-through corporation again.

The proposed regulations reserve on the treatment of distributions from a 10/50 look-through corporation, including the treatment of distributions out of earnings and profits accumulated in periods before the taxpayer acquired its stock. Comments are requested on whether additional guidance is needed to clarify the rules governing distributions from CFCs, and on how the regulations should be modified to reflect the rules of section 1105(b) of TRA 1997, extending look-through treatment to distributions from 10/50 corporations out of earnings and profits accumulated in post-2002 taxable years.

D. Additional Separate Categories

Treasury and the IRS propose to add a new paragraph (m) to § 1.904–4, to provide that if section 904(a), (b), and (c) are applied separately to any category of income under the Code (for example, under section 901(j), 865(h), or 904(g)(10)), that category of income (additional category) will be treated for purposes of the Code and regulations (including, for example, section 904(f)) as if it were a separate category listed in sections 904(d)(1) and 904(d)(3)(F)(i). This amendment is intended to clarify the treatment of such additional separate categories without the need for specific cross-references to such categories each time a provision refers to the separate categories listed in section 904(d). Sections 1.904–4(a) and 1.904–5(a)(1) are amended to include a reference to such additional separate categories.

III. Allocation and Apportionment of Taxes to Separate Categories: § 1.904–6

Treasury and the IRS propose to amend § 1.904–6(a)(1) to clarify the rules for determining the amount of income (in each U.S. separate category) taxed by a foreign country, in situations in which foreign law does not provide expense allocation rules. In such cases, for purposes of determining the amount of income taxed by the foreign country in order to allocate and apportion foreign taxes to separate categories, a taxpayer must allocate the expenses that are deductible under foreign law using the same methods that the taxpayer uses to allocate expenses that are deductible under U.S. law for purposes of determining the amount of taxable income.

IV. Capital Gain and Loss Adjustments: § 1.904(b)–1

A. Section 904(b) Capital Gain and Loss Adjustments

The proposed regulations provide guidance regarding the rule of section 904(b)(2)(A) that foreign source capital gain may not exceed the lesser of capital gain net income from sources outside the United States or worldwide capital gain net income. A similar rule applies with respect to net capital gain. The regulations also provide guidance regarding the rule of section 904(b)(2)(B) that capital gains from foreign and U.S. sources, and capital losses from foreign sources, must be adjusted based on capital gain rate differential amounts. The proposed regulations exercise the regulatory authority granted under section 904(b)(2)(C) (authorizing regulations to modify the application of section 904(b)(2) and (3) to properly reflect capital gain rate differentials and the computation of net capital gain) and section 904(d)(6) (authorizing such regulations as may be necessary and appropriate for the purposes of section 904(d)).

The proposed regulations first provide guidance concerning the adjustments required when foreign source capital gains exceed the lesser of capital gain net income (or net capital gain) from sources outside the United States or capital gain net income (or net capital gain) from all sources. Section 904(b)(2)(A) and section 904(b)(2)(B)(i) provide that, for purposes of section 904, foreign source capital gains that are included in foreign source taxable income may not exceed the lesser of capital gain net income from sources outside the United States or capital gain net income from all sources. Section 904(b)(2)(A), (3)(A). Similar rules apply for purposes of determining foreign source net capital gain. Section 904(b)(3)(B). After the 1986 enactment of separate limitation categories in section 904(d), the issue arises as to the extent to which foreign source capital gains should be adjusted if the taxpayer has foreign source capital gains and losses in more than one separate category.

The proposed regulations provide that foreign source capital gains included in foreign source taxable income in any separate category are reduced by reason of section 904(b)(2)(A) and section 904(b)(2)(B)(i) only by foreign source capital losses in the same separate category and by a ratable portion of the excess of capital gain net income from foreign sources (in the aggregate, considering all of the taxpayer's separate categories) over capital gain net income from all sources (considering capital gains and losses from sources within and outside the United States, from all of the taxpayer's separate categories). Thus, the proposed rule would reduce capital gain net income from foreign sources in any separate category only if the taxpayer has a net U.S.-source capital loss, and not in instances where foreign-source capital gains in one separate category are offset only by foreign-source capital losses from another separate category. This rule implements Congress's intent that section 904(b)(2)(A) and section 904(b)(2)(B)(i) should prevent foreign-source capital gains from inappropriately increasing the numerator of the foreign tax credit limitation fraction under section 904(a) if those capital gains were offset by U.S.-source capital losses, while avoiding the potential for double counting of foreign-source losses that might result if foreign-source gains in one separate category were reduced by reason of foreign-source losses that reduce ordinary income in another separate category.

The regulations further provide that if the taxpayer's capital gain net income from sources outside the United States exceeds the taxpayer's capital gain net income from all sources (*i.e.,* where there is a net U.S. capital loss), a pro rata portion of such excess reduces the capital gain net income from sources outside the United States in each of the taxpayer's separate limitation categories and, within each separate category, in each rate group. The pro rata portion is determined based on the relative amounts of net capital gain from sources outside the United States in each separate category or rate group.

In addition, the proposed regulations provide guidance on adjusting capital gains and foreign capital losses to reflect capital gain rate differentials. Section 904(a) limits the foreign tax credit to the lesser of (1) foreign tax paid or accrued; or (2) pre-credit U.S. tax multiplied by a fraction equal to foreign source taxable income over worldwide taxable income (the limitation fraction). Multiplying the pre-credit U.S. tax by the limitation fraction is meant to determine the portion of U.S. taxes that are attributable to foreign source income. Section 904(b)(2)(B) adjusts capital gains in the numerator and denominator, and foreign source capital losses in the numerator, of the limitation fraction if capital gains are taxed at lower rates than ordinary income, as is often the case under current law for individuals. Unless capital gains and foreign capital losses are adjusted to account for this difference, the limitation fraction will not accurately reflect the portion of the total pre-credit U.S. tax that is properly attributable to foreign source income.

The rate differential adjustments to capital gains and foreign source capital losses, under section 904(b) and the proposed regulations, apply only if the specific taxpayer has net capital gain that is subject to reduced tax rates for the taxable year. Treasury and the IRS request comments with respect to applying on an elective basis adjustments based on rate differentials for taxable years in which the Code applies reduced tax rates to capital gains generally, but the specific taxpayer has capital losses that equal or exceed capital gains. Any such elective rule would need to include ordering rules for determining the source, the separate category, and the rate group of the capital losses that are taken into account for the current taxable year, including those capital losses that are currently deductible to the extent of $3,000 under section 1211(b) against ordinary income, and those losses that are subject to the capital loss carryover rules.

As noted, section 904(b)(2)(C) grants regulatory authority to modify the application of section 904(b)(2) and (3) ''to the extent necessary to properly reflect any capital gain rate differential under section 1(h) or 1201(a) and the computation of net capital gain.'' The proposed regulations exercise this authority and adjust the section 904(b)(2)(B) calculations to reflect the fact that, for taxable years ending after May 6, 1997, section 1(h) contains multiple capital gains rates. The proposed regulations thus require that capital gain net income, from sources outside the United States and from all sources, must be adjusted pursuant to section 904(b)(2)(B)(i) and (ii) by the rate differential portion of each rate group of the taxpayer's net capital gain from sources outside the United States and from all sources, respectively.

The proposed regulations also provide guidance on adjusting foreign source capital losses under section 904(b)(2)(B)(iii). The regulations clarify that such capital losses (after netting against foreign source capital gains in the same rate group, as defined in the regulations) should be reduced based on the tax rate applicable under section 1(h) to the net capital gains that are offset by such net capital losses in the determination of the taxpayer's taxable income. Although section 904(b)(2)(B)(iii) provides for such adjustment in instances when net foreign losses have offset U.S. source capital gains, the existence of multiple separate categories after 1986 may result in foreign source capital gains and losses in separate categories offsetting one another. Therefore, the regulations require adjustment of foreign capital losses that offset foreign source capital gains associated with different capital gains rates, in addition to foreign capital losses that offset U.S. source capital gains.

In determining which capital gains are offset by capital losses from sources outside the United States in different rate groups, the proposed regulations provide that net capital losses from sources within the United States will not be taken into account, in order to simplify this determination. Treasury and the IRS request comments regarding whether the regulations should take net capital losses from sources within the United States into account for such purposes, and, if so, what type of ordering rules should be applied.

The IRS is considering providing a simplified worksheet for performing the section 904(b)(2)(B) adjustments in the Form 1116 instructions, for taxpayers whose capital gains are subject only to 10 or 20 percent tax rates under section 1(h) (similar to the simplified worksheet provided in the 1999 Form 1040 instructions as an alternative to Schedule D for taxpayers whose capital gains are subject only to 10 and 20 percent tax rates under section 1(h)). Treasury and the IRS request comments on this approach.

B. Appropriate tax rates for AMT foreign tax credit calculation

The proposed regulations provide that the alternative minimum tax (AMT) rates, rather than the regular tax rates, apply for purposes of carrying out the section 904(b) capital gains rates adjustments for the AMT foreign tax credit. Section 904(b) generally adjusts capital gains and foreign source capital losses based on the difference between the maximum U.S. tax rate and the tax applicable to capital gains under section 1(h). This adjustment is necessary to calculate more accurately the amount of U.S. tax that is attributable to foreign source income (as determined by application of the section 904(a) fraction). Section 59(a)(1)(B) provides that the AMT foreign tax credit must be determined as if ''section 904 were applied on the basis of alternative minimum taxable income,'' and therefore requires the application of section 904(b) in determining the AMT foreign tax credit. In order to reflect more accurately the amount of pre-credit tentative minimum tax attributable to foreign source AMT income, these regulations provide that, for purposes of applying section 904(b) in determining the AMT foreign tax credit, the maximum AMT rates should be used rather than the rates specified in section 1.

In addition, the regulations clarify that section 904(b)(2)(B)(ii) (relating to capital gains from all sources), as well as section 904(b)(2)(B)(i) and (iii) (relating to foreign source capital gains and losses, respectively) apply (in modified form, as provided in section 59) to the determination of the AMT foreign tax credit. The regulations also clarify that section 904(b) applies to taxpayers electing to apply the simplified foreign tax credit limitation rules under section 59(a)(4).

V. Coordination of Section 904(j) with Carryforward and Carryback Rules: § 1.904(j)

Section 904(j) allows a taxpayer to elect not to apply section 904(a) (the foreign tax credit limitation fraction) if the taxpayer's creditable foreign taxes paid or accrued for the year are $300 or less ($600 or less for joint filers), the taxpayer's foreign source gross income consists entirely of passive income, and such income and taxes are reported to the taxpayer on a payee statement. If a taxpayer elects to apply section 904(j) for any taxable year, no foreign taxes paid or accrued in such year may be carried over to any other year, and no foreign taxes paid or accrued in any other year may be carried over to the section 904(j) election year.

The proposed regulations clarify that a taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes paid or accrued for the taxable year and for which a credit is allowable to the taxpayer under section 901 for the taxable year are creditable foreign taxes (as defined in section 904(j)(3)(B). For example, suppose that in year 2, the taxpayer accrues and pays foreign tax that was not shown on a payee statement furnished to the taxpayer and that is related to general limitation income that was recognized and included in income for U.S. tax purposes in year 1. If the foreign taxes in the general limitation category are creditable under section 901 for year 2, the taxpayer may not elect to apply section 904(j) for year 2, even if all of the taxpayer's income in year 2 is qualified passive income.

In addition, taxpayers requested clarification on the application of the carryover provisions in taxable years following section 904(j) election years. Because high-taxed income, as defined in section 904(d)(2)(F), is calculated by reference to the highest rate of tax specified in section 1 or 11 (whichever is applicable), Treasury and the IRS expect that some individual taxpayers who are eligible to elect the application of section 904(j) may have foreign tax credit carryovers in the passive income category.

The proposed regulations clarify that the amount of a foreign tax credit carryover to or from a non-section-904(j)-election year is not reduced to account for the part of the carryover that (but for section 904(j)) could have been used in intervening section 904(j)-election years. Section 904(j) was intended to allow taxpayers to avoid computing the section 904(a) limitation fraction. See Committee on the Budget, U.S. House of Representatives, Report on Revenue Reconciliation Act of 1997, June 24, 1997, at 520–21. Requiring taxpayers to compute the amount of carryover that could have been used in the election year would be inconsistent with the statutory purpose of making the credit provisions less complex and less burdensome for taxpayers with small amounts of solely passive foreign-source income reported on payee statements. (Taxpayers may, of course, choose to perform the calculations to determine whether electing the application of section 904(j) would be more advantageous for them, particularly for years in which a foreign tax credit carryover will expire.)

However, the section 904(j) election does not extend the carryforward and carryback periods under section 904(c). For example, if a carryforward expires in 2000, and the taxpayer elects the application of section 904(j) for the 2000 taxable year, the carryforward cannot be used in 2000 (pursuant to section 904(j)(1)(C)) or in any later year (pursuant to the expiration of the carryforward period).

Similarly, the determination of whether the taxpayer paid or accrued more than $300 (or $600) of creditable foreign taxes is made without regard to carryovers. For example, a single taxpayer who pays $300 of creditable foreign taxes in 2001, and has a $500 carryover to 2001 from a previous year, is eligible to elect the application of section 904(j) for the 2001 year.

However, if the election is made, the taxpayer cannot claim a credit in 2001 for the $500 otherwise treated as a carryover.

VI. Removal of Example in § 1.954–2

The proposed regulations remove *Example 2* under § 1.954–2(b)(2)(iv), which was intended to illustrate the application of the rules under § 1.954–2(b)(2) for the exception from foreign personal holding company for certain export financing interest. Treasury and the IRS are concerned that the example may be unintentionally confusing. For this reason, it is being removed. Comments are invited concerning whether a replacement example is necessary.

Special Analyses

It has been determined that this notice of proposed rulemaking 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 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 26, 2001, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 5, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Rebecca I. Rosenberg of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the entry for ''Section 1.902–1 and 902–2'' and ''1.094–4 through 1.904–7'', and adding entries in numerical order to read in part as follows:

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

Section 1.902–1 also issued under 26 U.S.C. 902(c)(7). * * *

Section 1.904–4 also issued under 26 U.S.C. 904(b)(2)(C) and 904(d)(5).

Section 1.904–5 also issued under 26 U.S.C. 902(d)(5).

Section 1.904–6 also issued under 26 U.S.C. 904(d)(5).

Section 1.904–7 also issued under 26 U.S.C. 902(d)(5). * * *

Par. 2. Section 1.902–0 is amended by:

1. Revising the entry for § 1.902–1(a)(13)(ii).
2. Adding an entry for § 1.902–1(a)(13)(iii).

The revisions and additions read as follows:

§ 1.902–0 Outline for regulations provisions for section 902.

* * * * *

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

(a) * * *

(13) * * *

(ii) Resumption of pooling.

(iii) Examples.

* * * * *

Par 3. Section 1.902–1 is amended as follows:

1. Paragraph (a)(8)(ii) is amended by revising the second sentence.
2. Paragraph (a)(10)(i) is revised.
3. Paragraph (a)(10)(iii) is amended by revising the last sentence and adding one sentence.
4. Paragraphs (a)(13)(i)(A) and (a)(13)(i)(B) are revised.
5. Paragraphs (a)(13)(i)(C) and (a)(13)(i)(D) are added.
6. Paragraph (a)(13)(ii) is revised.
7. Paragraph (a)(13)(iii) is added.

The revisions and additions read as follows:

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

(a) * * *

(8) * * *

(ii) * * * Foreign income taxes (other than taxes attributable to formerly pooled earnings that are maintained in United States dollars) that are deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. * * *

* * * * *

(10) * * * (i) The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987 (pre-1987 earnings). If the special effective date of paragraph (a)(13)(i) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with section 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to that corporation (pre-pooling earnings). Pre-1987 accumulated profits also includes any post-1986 undistributed earnings formerly maintained by a less-than-10%-U.S.-owned foreign corporation (as defined in § 1.904–4(g)(1)) that are attributable to the foreign corporation's taxable years beginning after December 31, 1986, as of the end of which such ownership requirements were met (formerly pooled earnings). Such formerly pooled earnings shall be considered pre-1987 accumulated profits of the last taxable year of the foreign corporation in which such ownership requirements were met as of the end of the taxable year. Pre-1987 accumulated profits also includes earnings and profits accumulated during subsequent taxable years of such a less-than-10%-U.S.-owned foreign corporation as of the end of which such ownership requirements were not met (post-pooling earnings). All four types of pre-1987 accumulated profits described in this paragraph (a)(10)(i) are also sometimes referred to as pre-pooling annual layers.

* * * * *

(iii) * * * Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution, except that foreign income taxes attributable to formerly pooled earnings described in the third sentence of paragraph (a)(10)(i) of this section shall be maintained in United States dollars as originally translated in accordance with section 986(a). Post-1986 foreign income taxes attributable to such formerly pooled earnings shall be treated as pre-1987 foreign income taxes.

* * * * *

(13) * * * (i) * * *

(A) The post-1986 undistributed earnings and post-1986 undistributed foreign income taxes of the foreign corporation shall be determined by taking into account only consecutive taxable years beginning on and after the first day of the first taxable year of the foreign corporation as of the end of which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met and ending before the first day of a subsequent taxable year in which such ownership requirements are not met as of the end of the taxable year;

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation as of the end of which such ownership requirements are met shall be considered pre-1987 accumulated profits (which may include both pre-pooling earnings and pre-1987 earnings);

(C) Formerly pooled earnings described in paragraph (a)(10)(i) of this section shall be considered pre-1987 accumulated profits of the taxable year ending immediately before the next taxable year in which such ownership requirements are not met as of the end of the taxable year; and

(D) Earnings and profits accumulated on and after the first day of a taxable year of the foreign corporation as of the end of which such ownership requirements are not met shall be considered pre-1987 accumulated profits (post-pooling earnings).

(ii) *Resumption of pooling.* If the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are again met with respect to a foreign corporation that originally maintained pools of post-1986 undistributed earnings and post-1986 foreign income taxes but converted such pools to pre-1987 accumulated profits (formerly pooled earnings) and associated pre-1987 foreign income taxes because such ownership requirements were not met as of the close of a subsequent post-1986 taxable year, then the post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first such subsequent taxable year of the foreign corporation as of the end of which such ownership requirements are met and ending before the first day of a subsequent taxable year in which such ownership requirements are not met as of the end of the taxable year. The post-pooling earnings, formerly pooled earnings, pre-pooling earnings, and pre-1987 earnings of such a foreign corporation shall continue to be considered pre-1987 accumulated profits. The rules of paragraph (a)(13)(i)(B) through (D) of this section shall apply if such a foreign corporation again becomes a less-than-10%-U.S.-owned foreign corporation.

(iii) *Examples.* The following examples illustrate the special effective date rules of this paragraph (a)(13):

Example 1. As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals $1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to $100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all subsequent taxable years beginning before the date these regulations are published as final regulations in the **Federal Register**, as well as later taxable years as of the end of which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u—200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has $60 ($100 − [$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

Example 2. The facts are the same as in *Example 1,* except that Corporation M sells five percent of the Corporation B stock to an unrelated buyer on July 1, 2003, so that Corporation B no longer meets the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section as of that date. Thus, as of December 31, 2003, Corporation B's earnings and profits all consist of pre-1987 accumulated profits, comprising pre-1987 earnings for years beginning prior to January 1, 1987, pre-pooling earnings for taxable years 1987 through 1991, no earnings for 1992 through 2001, formerly pooled earnings for 2002 (comprising Corporation B's post-1986 undistributed earnings for 1992 through 2002), and post-pooling earnings for 2003. Dividends paid by Corporation B to Corporation M at any time during 2003 will be considered paid out of pre-1987 accumulated profits. See paragraphs (a)(10) and (a)(13)(i) of this section. However, Corporation M will be eligible to claim a deemed-paid credit only with respect to dividends received on or before July 1, 2003. See paragraphs (a)(1) and (12) of this section and § 1.902–3(a)(1) and (7).

Example 3. The facts are the same as in *Example 2,* except that Corporation M purchases an additional five percent of the stock of Corporation B on July 1, 2004, so that Corporation B again meets the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section on December 31, 2004. As of the end of 2004, assume Corporation B has 500u of post-1986 undistributed earnings (after foreign taxes but before taking into account distributions during 2004) and $100 of post-1986 foreign income taxes attributable to 2004, 500u of post-pooling earnings and 100u of pre-1987 foreign income taxes attributable to 2003, and 1500u of formerly pooled earnings and $250 of pre-1987 foreign income taxes attributable to 2002 (comprising Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes for 1992 through 2002). Corporation B pays dividends to its shareholders of 500u on March 1, 2004, and 500u on September 1, 2004. The March 1, 2004, dividend is out of Corporation B's post-1986 undistributed earnings in its entirety, and reduces Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes to zero, even though no shareholder is eligible to claim a credit for deemed-paid taxes. See paragraphs (a)(8)(i) and (b)(1) of this section. The September 1, 2004, dividend is out of 2003 post-pooling earnings, and reduces 2003 post-pooling earnings and foreign income taxes to zero. Corporation M, which is a 10% domestic shareholder of Corporation B on that date and receives a dividend of 50u, is deemed to have paid 10u of foreign income taxes (50u/500u × 100u) with respect to the dividend. Both the dividend and the deemed-paid taxes are translated into dollars at the spot exchange rate on the dividend date, under the law in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10)(i) and (ii) of this section.

Par. 4. Section 1.904–0 is amended as follows:

1. The entries for § 1.904–4 are amended by:

a. Revising the entry for paragraph (b)(2)(iii).

b. Removing the entry for paragraph (b)(2)(iv).

c. Revising the entries for paragraphs (g) and (g)(1), adding entries for paragraphs (g)(1)(i)–(iii), and revising the entry for paragraph (g)(3)(i)(C).

d. Adding entries for paragraphs (g)(3)(i)(C)(*1*), (g)(3)(i)(C)(*2*), and (g)(4).

e. Adding an entry for paragraph (m).

2. The entries for § 1.904(b)–1 are amended by:

a. Revising section heading and the entries for all of paragraphs (a), (b), and (c).

b. Adding entries for paragraphs (d), (e), (f), (g), and (h).

3. Revising the entries for all of § 1.904(b)–2.

4. Removing all the entries for §§ 1.904(b)–3 and 1.904(b)–4.

5. Adding entries for § 1.904(j)–1.

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.

* * * * *

(b) * * *

(2) * * *

(iii) Example.

* * * * *

(g) Noncontrolled section 902 corporation and non-look-through 10/50 corporation.

(1) Corporate-level accounts and treatment of distributions to shareholders.

(i) Definitions.

(ii) Accounts at foreign corporation level.

(iii) Inclusion at shareholder level.

* * * * *

(3) * * *

(i) * * *

(C) Effect of intervening noncontrolled or less-than-10%-U.S.-owned status.

(*1*) Pre-2003 decontrolling event.

(*2*) Pool-terminating event.

* * * * *

(4) Special rule for dividends paid by a 10/50 look-through corporation.

* * * * *

(m) Income treated as allocable to an additional separate category.

* * * * *

§ 1.904(b)–1 Special rules for capital gains and losses.

(a) Capital amounts included in taxable income from sources outside the United States.

(1) Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States.

(i) In general.

(ii) Allocation of reduction among multiple separate categories or rate groups.

(2) Capital losses from sources outside the United States in the same separate category.

(3) Exclusivity of rules; no reduction by reason of net capital loss from sources outside the United States in a different separate category.

(4) Examples.

(b) Capital gain rate differential.

(1) Application of adjustments only if capital gain rate differential exists.

(2) Determination of whether capital gain rate differential adjustment exists.
(c) Rate differential adjustment of capital gains.
(1) Rate differential adjustment of capital gains in foreign source taxable income.
(2) Rate differential adjustment of capital gains in entire taxable income.
(d) Rate differential adjustment of capital losses from sources outside the United States.
(1) In general.
(2) Determination of which net capital gains are offset by net capital losses from sources outside the United States.
(e) Definitions.
(1) Alternative tax rate.
(2) Capital gain net income.
(3) Net capital gain.
(4) Rate group.
(i) Capital gains.
(ii) Capital losses.
(5) Terms used in sections 1(h), 904(b) or 1222.
(f) Examples.
(g) Coordination with overall foreign loss recapture rules.
(h) Effective date.

§ 1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) Application of section 904(b)(2)(B) adjustments.
(b) Use of alternative minimum tax rates.
(1) Taxpayers other than corporations.
(2) Corporate taxpayers.
(c) Effective date.

* * * * *

§ 1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) Election available only if all foreign taxes are creditable foreign taxes.
(b) Coordination with carryover rules.
(1) No carryovers to or from election year.
(2) Carryovers to and from other years determined without regard to election years.
(3) Determination of amount of creditable foreign taxes.
(c) Examples.

Par. 5. Section 1.904–4 is amended as follows:

1. Paragraph (a) is amended by removing the period at the end and adding the language '', or in § 1.904–4(m) (additional separate categories).''
2. The first sentence of paragraph (b)(2)(i) is revised.
3. Paragraph (b)(2)(ii) is revised.
4. Paragraph (b)(2)(iii) is removed.
5. Paragraph (b)(2)(iv) is redesignated as paragraph (b)(2)(iii).
6. The last three sentences of the *Example* in newly designated paragraph (b)(2)(iii) are revised and three new sentences are added at the end.
7. The paragraph heading for paragraph (g) is revised.
8. Paragraph (g)(1) is redesignated as paragraph (g)(1)(i) and a new heading is added for paragraph (g)(1).
9. Five sentences are added at the end of newly designated paragraph (g)(1)(i).
10. Paragraphs (g)(1)(ii) and (iii) are added.
11. The heading of paragraph (g)(3)(i)(C) is revised and the text to paragraph (g)(3)(i)(C) is added.
12. The text of *Example 2* through *Example 4* is added to paragraph (g)(3)(i)(D).
13. Paragraph (g)(4) is added.
14. The language ''and'' at the end of paragraph (l)(1)(v) is removed.
15. The period at the end of paragraph (l)(1)(vi) is removed and ''; and'' is added in its place.
16. Paragraph (l)(1)(vii) is added.
17. Paragraph (m) is added.

The revisions and additions read as follows:

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

* * * * *

(b) * * *

(2) * * * (i) * * * For rents and royalties paid or accrued more than 60 days after the date these regulations are published as final regulations in the **Federal Register**, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. * * *

(ii) **Exception for certain rents and royalties.** Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(ii), an affiliated group includes only United States corporations and 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. For purposes of this paragraph (b)(2)(ii), indirect ownership shall be determined under section 318 and the regulations under that section.

(iii) * * *

Example. * * * Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations thereunder. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general limitation income to S under § 1.904–4(b)(2)(ii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general limitation income to P under the look-through rules of § 1.904–5(c)(1)(i) and (c)(3), respectively.

* * * * *

(g) *Noncontrolled section 902 corporation and non-look-through 10/50 corporation*—(1) *Corporate-level accounts and treatment of distributions to shareholders*—(i) *Definitions.* * * * Except as otherwise provided, the term ''look-through corporation'' means a foreign corporation that is subject to the look-through rules of section 904(d)(3) or section 904(d)(4) (as in effect for taxable years beginning after December 31, 2002). The term ''non-look-through 10/50 corporation'' means any foreign corporation that is not a look-through corporation and with respect to which a domestic corporation meets the stock ownership requirements of section 902(a), or, for purposes of applying the look-through rules described in section 904(d)(3) and § 1.904–5, a domestic corporation meets the requirements of section 902(b). The term ''less-than-10%-U.S.-owned foreign corporation'' means a foreign corporation that is neither a look-through corporation nor a non-look-through 10/50 corporation. The term ''look-through pool'' means the post-1986 undistributed earnings of a foreign corporation that are subject to the look-through provisions of section 904(d)(3) or section 904(d)(4) as in effect for taxable years beginning after December 31, 2002. The term ''non-look-through pool'' means the post-1986 undistributed earnings of a foreign corporation that were accumulated (or treated as accumulated) while the foreign corporation was a non-look-through 10/50 corporation.

(ii) *Accounts at foreign corporation level.* The post-1986 undistributed earnings of a controlled foreign corporation or other look-through corporation may consist of look-through pools (comprising post-1986 undistributed earnings accumulated during periods when the foreign corporation was, or was treated as, a look-through corporation, which may include post-1986 undistributed earnings in one or more non-look-through pools attributable to dividends paid to the look-through corporation by each separate non-look-through 10/50 corporation), as well as one or more non-look-through pools (including post-1986 undistributed earnings accumulated during periods when the foreign corporation was, or was treated as, a non-look-through 10/50 corporation). Similarly, a look-through corporation's pre-pooling annual layers, as defined in § 1.902–1(a)(10)(i), may or may not be subject to the look-through rules, depending on whether the corporation was, or was treated as, a look-through corporation at the time the earnings were accumulated.

(iii) *Inclusion at shareholder level.* A particular dividend recipient will be entitled to look-through treatment with respect to a particular distribution from a controlled foreign corporation only if the recipient is a United States shareholder, as defined in section 951(b) taking into account section 953(c), of the controlled foreign corporation at the time it receives the dividend. Therefore, a dividend distribution from a controlled foreign corporation to a United States shareholder will be characterized under the look-through rules, whereas a dividend distribution to a less-than-10% shareholder of the controlled foreign corporation will be treated as passive income. Similarly, under section 904(d)(1)(E), only a corporate shareholder calculates a separate foreign tax credit limitation for dividends from each noncontrolled section 902 corporation, and the look-through rules of section 904(d)(4) as in effect for taxable years beginning after December 31, 2002, apply only to applicable dividends out of post-2002 earnings of a corporation that is a noncontrolled section 902 corporation with respect to the taxpayer. Therefore, dividends paid to an individual shareholder by a non-look-through 10/50 corporation, or by a controlled foreign corporation out of a non-look-through pool, will be treated as passive income. Similarly, dividends paid to an individual shareholder by a look-through corporation that is not a controlled foreign corporation will be treated as passive income to such individual, even if the individual owns 10 percent or more of the distributing corporation's stock.

* * * * *

(3) * * *

(i) * * *

(C) *Effect of intervening noncontrolled or less-than-10%-U.S.-owned status*—(*1*) *Pre-2003 decontrolling event.* If a controlled foreign corporation becomes a non-look-through 10/50 corporation, for example, by reason of the corporation's issuance of additional stock or the disposition of stock by the corporation's controlling United States shareholders to foreign persons in a taxable year of the controlled foreign corporation beginning before January 1, 2003, (a decontrolling event), and retains that status as of the end of the foreign corporation's taxable year, then earnings and profits that were accumulated before the decontrolling event during periods when the corporation was a controlled foreign corporation will at all times thereafter be treated as earnings and profits accumulated by a non-look-through 10/50 corporation. The corporation's post-1986 undistributed earnings (or deficits in post-1986 undistributed earnings) in each separate category shall be combined into, and constitute the opening balance of, a single non-look-through pool of post-1986 undistributed earnings accumulated in taxable years beginning before January 1, 2003. The corporation's post-1986 foreign income taxes in each separate category shall similarly be combined into a single category of post-1986 foreign income taxes attributable to the non-look-through pool. Distributions of such earnings and profits after the decontrolling event will not be subject to the look-through rules of § 1.904–5, even if the corporation subsequently becomes a controlled foreign corporation or other look-through corporation again. The corporation's pre-1987 accumulated profits will also be ineligible for look-through treatment if accumulated prior to, and distributed after, the decontrolling event. In determining whether the look-through rules apply to earnings and profits maintained at the distributing corporation level, earnings and profits accumulated or distributed in the taxable year in which a decontrolling event occurs shall be considered accumulated or distributed after the decontrolling event, respectively. However, in determining whether a dividend recipient is entitled to look-through treatment with respect to a particular distribution, only the shareholder's status and ownership of stock at the time it receives the dividend is relevant. See § 1.902–1(a)(1) and paragraph (g)(1)(iii) of this section.

(*2*) *Pool-terminating event.* If a look-through corporation or a non-look-through 10/50 corporation becomes a less-than-10%-U.S.-owned foreign corporation, for example, by reason of the corporation's issuance of additional stock or the disposition of stock by the corporation's United States shareholders (a pool-terminating event), and retains that status as of the end of the foreign corporation's taxable year, then earnings and profits that were accumulated before the pool-terminating event will at all times thereafter be treated as pre-1987 accumulated profits accumulated by a non-look-through 10/50 corporation in accordance with § 1.902–1(a)(10) and (13). Distributions of such earnings and profits after the pool-terminating event will not be subject to the look-through rules of § 1.904–5, even if the corporation subsequently becomes a look-through corporation again. Earnings and profits accumulated or distributed in the taxable year in which a pool-terminating event occurs shall be considered accumulated or distributed after the pool-terminating event, respectively. However, in determining whether a dividend recipient is entitled to look-through treatment with respect to a particular distribution, only the shareholder's status and ownership of stock at the time it receives the dividend is relevant. See § 1.902–1(a)(1) and paragraph (g)(1)(iii) of this section.

* * * * *

(D) * * *

Example 2. (i) *Facts.* X, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. On March 1, 2002, S pays a dividend to X. On July 1, 2002, S issues additional shares of stock to Z, a foreign person, in exchange for a capital contribution. The new stock issuance dilutes X's interest in S to 40 percent. Thus, S is a non-look-through 10/50 corporation beginning on July 1, 2002.

(ii) *Result.* The March 1, 2002, dividend to X is treated as a dividend from a non-look-through 10/50 corporation. X is not entitled to look-through treatment on the dividend under paragraph (g)(3)(i)(C) of this section.

Example 3. (i) *Facts.* X, a domestic corporation, has owned all of the stock of S, a controlled foreign corporation, since S was organized in 1980. Both X and S use the calendar year as the taxable year. On July 1, 2002, X sells 60 percent of the stock of S to Z, a foreign person. On July 1, 2003, X repurchases all of the S stock that it sold to Z in 2002. Thus, S is a controlled foreign corporation for 1980 through June 30, 2002, a non-look-through 10/50 corporation from July 1, 2002, through December 31, 2002, and a look-through corporation from January 1, 2003, forward, as well as a controlled foreign corporation from July 1, 2003, forward.

(ii) *Result.* Pursuant to paragraph (g)(3)(i)(C) of this section, X is entitled to look-through treatment with respect to distributions before January 1, 2002, of S's post-1986 undistributed earnings accumulated through December 31, 2001, and of S's pre-1987 accumulated profits. Distributions after December 31, 2001, of earnings and profits accumulated before January 1, 2003, will be treated as dividends from a non-look-through 10/50 corporation. X is entitled to look-through treatment on distributions of earnings and profits accumulated and distributed after December 31, 2002.

Example 4. (i) *Facts.* The facts are the same as in *Example 3,* except that X sells 95 percent, rather than 60 percent, of the stock of S to Z. Thus, S is a controlled foreign corporation for 1980 through June 30, 2002, a less-than-10%-U.S.-owned foreign corporation from July 1, 2002, through June 30, 2003, and a controlled foreign corporation beginning on July 1, 2003.

(ii) *Result.* The result is the same as in *Example 3,* except that distributions from S made between July 1, 2002, and June 30, 2003, will be treated as passive income to X because X owns less than 10 percent of the stock of S during that period. Distributions from S to X made between January 1, 2002, and June 30, 2002, will be treated as dividends from a non-look-through 10/50 corporation. Distributions from S to X made after June 30, 2003, out of earnings and profits accumulated prior to January 1, 2003, will be treated as dividends from a non-look-through 10/50 corporation. X is entitled to look-through treatment of distributions after June 30, 2003, out of earnings and profits accumulated after December 31, 2002.

* * * * *

(4) *Special rule for dividends paid by a 10/50 look-through corporation.* [Reserved]

* * * * *

(l) * * * (1) * * *

(vii) Income that meets the definitions of a separate category described in paragraph (m) of this section and of any other category of separate limitation income described in section 904(d)(1)(A) through (H) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general limitation income described in section 904(d)(1)(I).

* * * * *

(m) *Income treated as allocable to an additional separate category.* If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(g)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1) and section 904(d)(3)(F)(i).

Par. 6. In § 1.904–5, paragraph (a)(1) is revised to read as follows:

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

(a) * * *

(1) The term ''separate category'' means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (E), (F), (G), (H), or (I) and in § 1.904–4(b), (d), (e), (f), and (g), any category of income described in § 1.904–4(m), or any category of earnings and profits to which income described in such provisions is attributable.

* * * * *

Par. 7. In § 1.904–6, paragraph (a)(1)(ii) is amended by adding two sentences at the end to read as follows:

§ 1.904–6 Allocation and apportionment of taxes.

(a) * * * (1) * * *

(ii) * * * If the taxpayer applies the principles of §§ 1.861–8 through 1.861–14T for purposes of allocating expenses at the level of the taxpayer (or at the level of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes) under this paragraph (a)(1)(ii), such principles shall be applied (for such purposes) in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for United States tax purposes of the taxpayer (or of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes, as the case may be). For example, a taxpayer must use the modified gross income method under § 1.861–9T when applying the principles of that section for purposes of this paragraph (a)(1)(ii) to determine the amount of a controlled foreign corporation's income, in each separate category, that is taxed by a foreign country, if the taxpayer applies the modified gross income method under § 1.861–9T(f)(3) when applying § 1.861–9T to determine the income and earnings and profits of the controlled foreign corporation for United States tax purposes.

* * * * *

Par. 8. Section 1.904(b)–1 is revised to read as follows:

§ 1.904(b)–1 Special rules for capital gains and losses.

(a) *Capital amounts included in taxable income from sources outside the United States*—(1) *Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States*—(i) *In general.* Except as otherwise provided in this section, for purposes of section 904 and this section, taxable income from sources outside the United States (in all of the taxpayer's separate categories in the aggregate) shall include capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) only to the extent of capital gain net income from all sources. Similarly, except as otherwise provided in this section, for purposes of section 904 and this section, net capital gain from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) shall not exceed net capital gain from all sources.

(ii) *Allocation of reduction among multiple separate categories or rate groups.* If capital gain net income (or net capital gain) from sources outside the United States exceeds capital gain net income (or net capital gain), and the taxpayer has capital gain net income (or net capital gain) from sources outside the United States in two or more separate categories or in two or more rate groups, such excess must be apportioned on a pro rata basis as a reduction to each such separate category, and then within each separate category, on a pro rata basis among rate groups. For purposes of the preceding sentence, pro rata means based on the relative amounts of the capital gain net income (or net capital gain) from sources outside the United States in each separate category, or in each rate group within a separate category.

(2) *Capital losses from sources outside the United States in the same separate category.* Except as otherwise provided in paragraph (d) of this section, taxable income from sources outside the United States in each separate category shall be reduced by any capital loss that is allocable or apportionable to sources outside the United States in such separate category to the extent such loss is allowable in determining taxable income for the taxable year (taking into account losses allowable under section 1211(b)).

(3) *Exclusivity of rules; no reduction by reason of net capital losses from sources outside the United States in a different separate category.* Capital gains from sources outside the United States in any separate category shall be limited by reason of section 904(b)(2)(A) and the comparable limitation of section 904(b)(2)(B)(i) only to the extent provided in paragraph (a)(1) of this section (relating to limitation on capital gain from sources outside the United

States when taxpayer has net capital losses from sources within the United States) and paragraph (a)(2) of this section (relating to capital losses from sources outside the United States in the same separate category).

(4) *Examples.* The following examples illustrate the application of this paragraph (a). The examples are as follows:

Example 1. Taxpayer A, a corporation, has a general limitation category capital loss of $3,000 from sources outside the United States, a passive category capital gain of $3,000 from sources outside the United States, and a capital loss of $2,000 from sources within the United States. A has no capital gain net income from sources outside the United States (in the aggregate, from all separate categories), because the $3,000 passive capital gain less the $3,000 general limitation capital loss yields a net of zero. From all sources, A also has no capital gain net income. (The resulting $2,000 net capital loss is not currently allowable under section 1211(a) because A is a corporation.) Because A's capital gain net income from sources outside the United States does not exceed A's capital gain net income from all sources, paragraph (a)(1) of this section does not require any reduction of A's passive category capital gain.

Example 2. Taxpayer B, a corporation, has $500 of capital gain net income from sources outside the United States, of which $300 is in the general limitation category and $200 is in the passive category. B's capital gain net income from sources outside the United States is $500 ($300 + $200). Because B also incurs a capital loss of $100 from sources within the United States, B's capital gain net income (from all sources) is $400 ($300 + $200—$100). Pursuant to paragraph (a)(1)(B) of this section, the $100 excess of capital gain net income from sources outside the United States over capital gain net income from all sources ($500—$400) must be apportioned, as a reduction, three-fifths ($300/$500 of $100, or $60) to the general limitation category and two-fifths ($200/$500 of $100, or $40) to the passive category. Therefore, for purposes of section 904, the general limitation category includes $240 ($300—$60) of capital gain net income from sources outside the United States and the passive category includes $160 ($200—$40) of capital gain net income from sources outside the United States.

Example 3. Taxpayer C, a corporation, has a $10,000 capital loss from sources outside the United States in the general limitation category, a $4,000 capital gain from sources outside the United States in the passive category, and a $2,000 capital gain from sources within the United States. C's capital gain net income from sources outside the United States is zero, since losses exceed gains. C's capital gain net income from all sources is also zero. C's capital gain net income from sources outside the United States does not exceed its capital gain net income from all sources, and therefore paragraph (a)(1) of this section does not require any reduction of C's passive category capital gain. For purposes of section 904, C's passive category includes $4,000 of capital gain net income. C's general limitation category includes a capital loss of $6,000 because only $6,000 of capital loss is allowable as a deduction in the current year. The entire $4,000 of capital loss in excess of the $6,000 of capital loss that offsets capital gain in the taxable year is carried back or forward under section 1212(a), and none of such $4,000 is taken into account under section 904(a) or (b) for the current taxable year.

(b) *Capital gain rate differential*—(1) *Application of adjustments only if capital gain rate differential exists.* Section 904(b)(2)(B) and paragraphs (c) and (d) of this section apply only for taxable years in which the taxpayer has a capital gain rate differential.

(2) *Determination of whether capital gain rate differential exists.* For purposes of section 904(b) and this section, a capital gain rate differential is considered to exist for the taxable year only if the taxpayer has a net capital gain for the taxable year and—

(i) In the case of a taxpayer other than a corporation, tax is imposed at a reduced rate under section 1(h) for the taxable year; or

(ii) In the case of a corporation, tax is imposed under section 1201(a) on the taxpayer at a rate less than any rate of tax imposed on the taxpayer by section 11, 511, or 831(a) or (b), whichever applies (determined without regard to the last sentence of section 11(b)(1)), for the taxable year.

(c) *Rate differential adjustment of capital gains*—(1) *Rate differential adjustment of capital gains in foreign source taxable income.* In determining taxable income from sources outside the United States for purposes of section 904 and this section, capital gain net income from sources outside the United States in each separate category, after any reduction pursuant to paragraph (a) of this section, shall be reduced by the sum of the rate differential portions (as defined in section 904(b)(3)(E)) of each rate group of net capital gain from sources outside the United States in such separate category.

(2) *Rate differential adjustment of capital gains in entire taxable income.* For purposes of section 904 and this section, the entire taxable income shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income reduced by the sum of the rate differential portions (as defined in section 904(b)(3)(E)) of each rate group of net capital gain.

(d) *Rate differential adjustment of capital losses from sources outside the United States*—(1) *In general.* In determining taxable income from sources outside the United States for purposes of section 904 and this section, any net capital loss from sources outside the United States included in a separate category pursuant to paragraph (a) of this section shall be reduced by the sum of the rate differential portion of the net capital gains (from the same rate group in other separate categories, from other rate groups in the same or other separate categories, or from sources within the United States) that are offset by such net capital loss in determining the taxpayer's entire taxable income.

(2) *Determination of which net capital gains are offset by net capital losses from sources outside the United States.* For purposes of paragraph (d)(1) of this section, in order to determine which net capital gains (from any rate group) are offset by net capital losses from sources outside the United States, the following rules shall apply in the following order:

(i) Capital losses from sources outside the United States shall first be netted against capital gains from sources outside the United States in the same rate group and the same separate category as the foreign source capital losses.

(ii) Net capital losses from each rate group from sources outside the United States shall be netted against net capital gains from sources outside the United States from the same rate group in other separate categories, ratably to the extent that net capital gains and losses in a particular rate group occur in two or more separate categories.

(iii) Capital losses from sources within the United States shall be netted against capital gains from sources within the United States in the same rate group.

(iv) The net foreign capital losses from each rate group, as determined under paragraph (d)(2)(ii) of this section, shall be netted against the taxpayer's remaining net capital gains from sources within and outside the United States in the following order, and without regard to any net capital losses, from any rate group, from sources within the United States—

(A) First against net capital gains from sources within the United States in the same rate group;

(B) Next, against net capital gains in other rate groups, in the order in which capital losses offset capital gains for purposes of determining the taxpayer's taxable income and without regard to whether such net capital gains derive from sources within or outside the United States, as follows:

(*1*) A short-term capital loss (including any short-term capital loss carryover) is used first to offset short-term capital gain otherwise taxable at ordinary income rates. Any remaining net short-term capital loss is used first to offset any net long-term gain in the 28 percent rate group, then to offset net long-term gain in the 25 percent rate group, and finally to offset net long-term gain in the 20 percent rate group.

(*2*) A net capital loss in the 28 percent rate group is used first to offset net capital gain in the 25 percent rate group, and then to offset net capital gain in the 20 percent rate group.

(*3*) A net capital loss in the 20 percent rate group is used first to offset net capital gain in the 28 percent rate group, and then to offset net capital gain in the 25 percent rate group.

(v) The net capital losses from sources outside the United States in any rate group, to the extent netted against net capital gains in any other separate category under paragraph (d)(2)(ii) of this section or against net capital gains in any other rate group under paragraph (d)(2)(iv) of this section, shall be treated as coming pro rata from each separate category that contains net capital losses from sources outside the United States in that rate group. For example, assume that the taxpayer has $20 of net capital losses in the 20 percent rate group in the passive category and $40 of net capital losses in the 20 percent rate group in the general limitation category, both from sources outside the United States. Further assume that $50 of the total $60 net capital losses from sources outside the United States are netted against net capital gains in the 28 percent rate group (from other separate categories or from sources within the United States). One-third of the $50 of such capital losses would be treated as coming from the passive category, and two-thirds of such $50 would be treated as coming from the general limitation category.

(vi) The determination of which capital gains are offset by capital losses from sources outside the United States under this paragraph is made solely in order to determine the appropriate rate-differential-based adjustments to such capital losses under this section and section 904(b), and does not change the source, allocation, or separate category of any such capital gain or loss for purposes of computing taxable income from sources within or outside the United States or for any other purpose.

(e) *Definitions.* For purposes of section 904(b) and this section, the following definitions apply:

(1) *Alternative tax rate.* The term *alternative tax rate* means, with respect to any rate group, the rate applicable to that rate group under section 1(h) (for taxpayers other than corporations) or 1201(a) (for corporations). For example, the alternative tax rate for unrecaptured section 1250 gain is 25 percent.

(2) *Capital gain net income.* The term *capital gain net income* means the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges. Such term shall include net section 1231 gain, but shall not include gains or losses from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining capital gain net income, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(3) *Net capital gain.* The term *net capital gain* means the excess of the net long-term capital gain (including net section 1231 gain) for the taxable year over the net short-term capital loss for such year, but shall not include gains or losses from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining net capital gain, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(4) *Rate group.* For purposes of this section—

(i) *Capital gains.* With respect to capital gains, the term *rate group* means the amounts subject to a particular rate of tax under section 1(h). For example, the 20 percent rate group of capital gain net income from sources outside the United States consists of the capital gain net income from sources outside the United States that is subject to tax at a rate of 20 percent under section 1(h).

(ii) *Capital losses.* With respect to capital losses, the rate group shall be determined as if the sale or exchange that produced the capital loss had instead produced a capital gain. For example, if the sale of an asset held for more than one year yields a capital loss, but any gain generated by the sale would have been subject to tax at a rate of 20 percent under section 1(h), the capital loss is allocated to the 20 percent rate group for purposes of this section.

(5) *Terms used in sections 1(h), 904(b) or 1222.* For purposes of this section, any term used in this section and also used in section 1(h), section 904(b) or section 1222 shall have the same meaning given such term by section 1(h), 904(b) or 1222, respectively, except as otherwise provided in this section.

(f) *Examples.* The following examples illustrate the provisions of this section. In these examples, the adjustment for the rate differential portion is shown as a fraction, the numerator of which is the alternative tax rate percentage and the denominator of which is 39.6 percent (the current highest applicable tax rate for individuals under section 1). All of the examples assume that all capital gains and losses are long-term capital gains and losses. (Therefore, in these examples, capital gain net income equals net capital gain, and for convenience both are referred to in the examples as net capital gain in calculating the rate differential adjustments). In addition, all dollar amounts in the examples are abbreviated from amounts in the thousands (*e.g.,* $50 represents $50,000). The examples are as follows:

Example 1. (i) A, an individual, has foreign source items only in the passive category for the taxable year. A has $1,000 of capital gains from sources outside the United States, which would be taxed at a rate of 20 percent under section 1(h). A has $700 of capital losses from sources outside the United States, which resulted from the sale of capital assets held for more than one year. If the sale had resulted in gain rather than loss, the gain would have been taxed at a rate of 20 percent under section 1(h). For the same taxable year, A has $800 of capital gains from sources within the United States that are taxed at a rate of 28 percent under section 1(h). A also has $100 of capital losses from sources within the United States. If the sale or exchange generating such capital losses had instead yielded a capital gain, such gain would have been subject to tax a rate of 20 percent under section 1(h). A also has $500 of ordinary income from sources within the United States.

(ii) A's items of ordinary income, capital gain and capital loss for the taxable year are summarized in the following table: foreign source:

	U.S. source	Foreign source: passive
20% rate group	($100)	$1,000 ($700)
25% rate group.		
28% rate group	800	
Ordinary income	500	

(iii) A's capital gain net income from sources outside the United States ($300) does not exceed A's capital gain net income from all sources ($1,000). Therefore, paragraph (a)(1) of this section does not require any reduction of A's capital gain net income in the passive category.

(iv) In computing A's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, capital gains and losses from sources outside the United States are netted within rate groups and within separate categories. See paragraphs (a)(2), (c)(1), and (d)(1) of this section. The $1,000 of capital gain less the $700 of capital loss yields $300 of net capital gain in the 20 percent rate group in the passive category. A must adjust the resulting net capital gain in the passive category as required under section 904(b)(2)(B)(i) and paragraph (c)(1) of this section, using 20 percent as the alternative tax rate, as follows: $300 (20%/39.6%).

(v) In computing A's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, A must combine the $300 net capital gain from sources outside the United States and the $100 net capital loss from sources within the United States in the same rate group (20 percent). A must adjust the resulting $200 ($300 − $100) of net capital gain in the 20 percent rate group as required under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section, using 20 percent as the alternative tax rate, as follows: $200 (20%/39.6%). A must also adjust the $800 of net capital gain in the 28 percent rate group, using 28 percent as the alternative tax rate, as follows: $800 (28%/39.6%).

(vi) A's passive category foreign tax credit limitation is computed as follows:

$$\frac{\$300\ (20\%/39.6\%)}{\$500 + \$200\ (20\%/39.6\%) + \$800\ (28\%/39.6\%)}$$

Example 2. (i) X, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	Foreign source: General	Foreign source: Passive
20% rate group	$300	($500)	$100
25% rate group	200		
28% rate group	500	(300)	
Ordinary income	1,000	500	500

(ii) X's capital gain net income from sources outside the United States in the aggregate (zero, since losses exceed gains) does not exceed X's capital gain net income from all sources ($300). Therefore, paragraph (a)(1) of this section does not require any reduction of X's capital gain net income in the passive category.

(iii) In computing X's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, X must adjust capital gain net income and net capital losses as provided in section 904(b)(2)(B)(i) and (iii) and paragraphs (c)(1) and (d)(1) of this section.

(A) First, capital gains and losses from sources outside the United States are netted within rate groups and within separate categories. There are no such amounts to be netted in this case.

(B) Because X has net capital losses in the general limitation category, under paragraph (d)(2)(ii) of this section X's net capital losses from sources outside the United States in each rate group are netted against net capital gains from sources outside the United States in other separate categories in the same rate group. Thus, $100 of the $500 net capital loss in the 20 percent rate group in the general limitation category offsets $100 of net capital gain in the 20 percent rate group in the passive category. The $100 net capital gain remains in the passive category and is adjusted under paragraph (c)(1) of this section as follows: $100(20%/39.6%). The $100 net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: $100(20%/39.6%).

(C) Next, under paragraph (d)(2)(iv)(A) of this section, X's net capital losses from sources outside the United States in any rate group and in any separate category are netted against net capital gains in the same rate group from sources within the United States. Thus, $300 of the $500 net capital loss in the 20 percent rate group in the general limitation category offsets $300 of net capital gain in the 20 percent rate group from sources within the United States. The $300 of net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: $300(20%/39.6%). Similarly, the $300 of net capital loss in the 28 percent rate group in the general limitation category offsets $300 of net capital gain in the 28 percent rate group from sources within the United States. The $300 net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: $300(28%/39.6%).

(D) Next, under paragraph (d)(2)(iv)(B) of this section, the remaining net capital losses in a rate group are netted against net capital gains from other rate groups from sources within and outside the United States. The remaining $100 of the $500 net capital loss in the 20 percent rate group in the general limitation category offsets $100 of the remaining net capital gain in the 28 percent rate group from sources within the United States. The $100 of net capital loss remains in the general limitation category and is adjusted under paragraph (d)(1) of this section as follows: $100(28%/39.6%).

(iv) In computing X's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, X must adjust capital gain net income by netting all of X's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate category, under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section. X must also include foreign source ordinary income in the numerators, and worldwide ordinary income in the denominator, of the foreign tax credit limitation fractions. The denominator of X's foreign tax credit limitation fractions reflects $2,000 of worldwide ordinary income, $100 of U.S.-source net capital gain taxed at the 28% rate and adjusted as follows: $100(28%/39.6%), and $200 of U.S.-source net capital gain taxed at the 25% rate and adjusted as follows: $200(25%/39.6%).

(v) X's general limitation foreign tax credit limitation is computed as follows:

$$\frac{\$500 - \$100\ (20\%/39.6\%) - \$300\ (20\%/39.6\%) - \$300\ (28\%/39.6\%) - \$100\ (28\%/39.6\%)}{\$1{,}000 + \$500 + \$500 + \$100\ (28\%/39.6\%) + \$200\ (25\%/39.6\%)}$$

(vi) X's passive category foreign tax credit limitation is computed as follows:

$$\frac{\$500 + \$100\ (20\%/39.6\%)}{\$1{,}000 + \$500 + \$500 + \$100\ (28\%/39.6\%) + \$200\ (25\%/39.6\%)}$$

Example 3. (i) Y, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	Foreign source	
		General	Passive
20% rate group	$300	($720)	($80)
25% rate group	200		
28% rate group	500	(150)	50
Ordinary income	1,000	1,000	500

(ii) Y's capital gain net income from sources outside the United States (zero, since losses exceed gains) does not exceed Y's capital gain net income from all sources ($100). Therefore, paragraph (a)(1) of this section does not require any adjustment.

(iii) In computing Y's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, Y must adjust capital gain net income and net capital losses as provided in section 904(b)(2)(B)(i) and (iii) and paragraphs (c)(1) and (d)(1) of this section. Since Y has no capital gain net income in any separate category, the only adjustments are those required under section 904(b)(2)(B)(iii) and paragraph (d)(1) of this section.

(A) Under paragraph (d)(2)(ii) of this section, $50 of Y's $150 net capital loss in the 28 percent rate group in the general limitation category offsets $50 of net capital gain in the 28 percent rate group in the passive category. The $50 of net capital loss remains in the general limitation category and is adjusted as follows: $50(28%/39.6%). The $50 of net capital gain remains in the passive category and is adjusted as follows: $50(28%/39.6%).

(B) Under paragraph (d)(2)(iv)(A) of this section, the remaining $100 of net capital loss in the 28 percent rate group in the general limitation category offsets $100 of net capital gain in the 28 percent rate group from sources within the United States. The $100 of net capital loss remains in the general limitation category and is adjusted as follows: $100(28%/39.6%).

(C) Under paragraph (d)(2)(iv)(A) of this section, the $300 of net capital gain in the 20 percent rate group from sources within the United States is reduced proportionately by the net capital losses in the 20 percent rate group in the passive and general limitation categories. The proportionate amount of the $720 net capital loss remains in the general limitation category, adjusted as follows: $300($720/$800)(20%/39.6%). The proportionate amount of the $80 net capital loss remains in the passive category, adjusted as follows: $300($80/$800)(20%/39.6%).

(D) Of the remaining $500 of net capital loss in the 20 percent rate group (in the general limitation and passive categories), $400 offsets the remaining $400 of net capital gain in the 28 percent rate group from sources within the United States under paragraph (d)(2)(iv)(B)(*3*) of this section. The proportionate amount of the $720 net capital loss remains in the general limitation category, adjusted as follows: $400($720/$800)(28%/39.6%). The proportionate amount of the $80 net capital loss remains in the passive category, adjusted as follows: $400($80/$800)(28%/39.6%).

(E) Under paragraph (d)(2)(iv)(B)(*3*) of this section, the remaining $100 of net capital loss in the 20 percent rate group (in the general limitation and passive limitation categories) offsets $100 of net capital gain in the 25 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss remains in the general limitation category, adjusted as follows: $100($720/$800)(25%/39.6%). The proportionate amount of the $80 net capital loss remains in the passive category, adjusted as follows: $100($80/$800)(25%/39.6%).

(iv) In computing Y's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, Y must adjust capital gain net income by netting all of Y's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate category, under section 904(b)(2)(B)(ii) and paragraph (c)(2) of this section. Y must also include foreign source ordinary income in the numerators, and worldwide ordinary income in the denominator, of the foreign tax credit limitation fractions. The denominator of Y's foreign tax credit limitation fractions reflects $2,500 of worldwide ordinary income and $100 of U.S.-source net capital gain taxed at the 25% rate and adjusted as follows: $100(25%/39.6%).

(v) Y's general limitation foreign tax credit limitation is computed as follows:

$$\frac{\$1{,}000 - \$50\ (28\%/39.6\%) - \$100\ (28\%/39.6\%) - \$300\ (\$720/\$800)\ (20\%/39.6\%) - \$400\ (\$720/\$800)\ (28\%/39.6\%) - \$100\ (\$720/\$800)\ (25\%/39.6\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100\ (25\%/39.6\%)}$$

(vi) Y's passive category foreign tax credit limitation is computed as follows:

$$\frac{\$500 + \$50\ (28\%/39.6\%) - \$300\ (\$80/\$800)\ (20\%/39.6\%) - \$400\ (\$80/\$800)\ (28\%/39.6\%) - \$100\ (\$80/\$800)\ (25\%/39.6\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100\ (25\%/39.6\%)}$$

(g) *Coordination with overall foreign loss recapture rules.* Section 904(b) and this section shall apply before the provisions of section 904(f). Therefore, the amount of a taxpayer's separate limitation income or loss in each separate category, the amount of overall foreign loss, and the amount of any additions to or recapture of separate limitation loss or overall foreign loss accounts pursuant to section 904(f) shall be determined after applying section 904(b) and this section to adjust capital gains and losses in each separate category.

(h) *Effective date.* This section shall apply to taxable years beginning after the date this regulation is published in the **Federal Register** as a final regulation.

Par. 9. Section 1.904(b)–2 is revised to read as follows: § 1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) *Application of section 904(b)(2)(B) adjustments.* Section 904(b)(2)(B) shall apply for purposes of determining the alternative minimum tax foreign tax credit under section 59 (regardless of whether or not the taxpayer has made an election under section 59(a)(4)).

(b) *Use of alternative minimum tax rates*—(1) *Taxpayers other than corporations.* In the case of a taxpayer other than a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59—

(i) Section 904(b)(3)(D)(i) shall be applied by substituting ''section 55(b)(3)'' for ''subsection (h) of section 1'';

(ii) Section 904(b)(3)(E)(ii)(I) shall be applied by substituting ''section 55(b)(1)(A)(i)'' for ''subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies)''; and

(iii) Section 904(b)(3)(E)(iii)(I) shall be applied by substituting ''the alternative rate of tax determined under section 55(b)(3)'' for ''the alternative rate of tax determined under section 1(h)''.

(2) *Corporate taxpayers.* In the case of a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59, section 904(b)(3)(E)(ii)(II) shall be applied by substituting ''section 55(b)(1)(B)'' for ''section 11(b)''.

(c) *Effective date.* This section shall apply to taxable years beginning after the date this section is published as a final regulation in the **Federal Register**.

§§ 1.904(b)–3 and 1.904(b)–4 [Removed]

Par. 10. Sections 1.904(b)–3 and 1.904(b)–4 are removed.

Par. 11. Section 1.904(j)–1 is added to read as follows:

§ 1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) *Election available only if all foreign taxes are creditable foreign taxes.* A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

(b) *Coordination with carryover rules*—(1) *No carryovers to or from election year.* If the taxpayer elects to apply section 904(j) for any taxable year, then no taxes paid or accrued by the taxpayer during such taxable year may be deemed paid or accrued under section 904(c) in any other taxable year, and no taxes paid or accrued in any other taxable year may be deemed paid or accrued under section 904(c) in such taxable year.

(2) *Carryovers to and from other years determined without regard to election years.* The amount of the foreign taxes paid or accrued, and the amount of the foreign source taxable income, in any year for which the taxpayer elects to apply section 904(j) shall not be taken into account in determining the amount of any carryover to or from any other taxable year. However, an election to apply section 904(j) to any year does not extend the number of taxable years to which unused foreign taxes may be carried under section 904(c) and § 1.904–2(b). Therefore, in determining the number of such carryover years, the taxpayer must take into account years to which a section 904(j) election applies.

(3) *Determination of amount of creditable foreign taxes.* Otherwise allowable carryovers of foreign tax credits from other taxable years shall not be taken into account in determining whether the amount of creditable foreign taxes paid or accrued by an individual during a taxable year exceeds $300 ($600 in the case of a joint return) for purposes of section 904(j)(2)(B).

(c) *Examples.* The following examples illustrate the provisions of this section:

Example 1. In 2001, X, a single individual using the cash basis method of accounting for income and foreign tax credits, pays $100 of foreign taxes with respect to general limitation income that was earned and included in income for United States tax purposes in 2000. The foreign taxes would be creditable under section 901 but are not shown on a payee statement furnished to X. X's only income for 2001 from sources outside the United States is qualified passive income, with respect to which X pays $200 of creditable foreign taxes shown on a payee statement. X may not elect to apply section 904(j) for 2001 because some of X's foreign taxes are not creditable foreign taxes within the meaning of section 904(j)(3)(B).

Example 2. (i) In 2002, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of $250 attributable to passive income. Under section 904(c), A may also carry forward to 2002 $100 of unused foreign taxes paid in 1998 with respect to passive income, $300 of unused foreign taxes paid in 1998 with respect to general limitation income, $400 of unused foreign taxes paid in 1999 with respect to passive income, and $200 of unused foreign taxes paid in 1999 with respect to general limitation income. In 2002, A's only foreign source income is passive income described in section 904(j)(3)(A)(i), and this income is reported to A on a payee statement (within the meaning of section 6724(d)(2)). If A elects to apply section 904(j) for the 2002 taxable year, the unused foreign taxes paid in 1998 and 1999 are not deemed paid in 2002, and A therefore cannot claim a foreign tax credit for those taxes in 2002.

(ii) In 2003, A again is eligible for and elects the application of section 904(j). The carryforwards from 1998 expire in 2003. The carryforward period established under section 904(c) is not extended by A's election under section 904(j). In 2004, A does not elect the application of section 904(j). The $600 of unused foreign taxes paid in 1999 on passive and general limitation income are deemed paid in 2004, under section 904(c), without any adjustment for any portion of those taxes that might have been used as a foreign tax credit in 2002 or 2003 if section 904(j) had not prevented A from carrying over taxes to those years.

(d) *Effective date.* Section 1.904(j)–1 applies to taxable years beginning after December 31, 1997.

Par. 12. Section 1.954–2 is amended by:

1. Revising paragraph (b)(2)(iv), *Example 2.*

2. Removing paragraph (b)(2)(iv), *Example 3.*

The revision reads as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

Example 2. (i) DS, a domestic corporation, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of § 1.954–3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 is not manufactured in the United States under § 1.927(a)–1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

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Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

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