Part V

Department of the Treasury

Internal Revenue Service

26 CFR Parts 1 and 602
Application of Separate Limitations to Dividends From Noncontrolled Section 902 Corporations; Final Rule and Proposed Rule
DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9260]

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Application of Separate Limitations to Dividends From Noncontrolled Section 902 Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations regarding the application of separate foreign tax credit limitations to dividends received from noncontrolled section 902 corporations under section 904(d)(4). Section 403 of the American Jobs Creation Act of 2004, Public Law 108–357, 118 Stat. 1418 (October 22, 2004) (AJCA), modified the treatment of such dividends effective for taxable years beginning after December 31, 2002. Section 403(l) of the Gulf Opportunity Zone Act of 2005, Public Law 109–135, 119 Stat. 2577 (December 22, 2005) (GOZA), permits taxpayers to elect to defer the effective date of the AJCA amendments until taxable years beginning after December 31, 2004. The temporary regulations provide guidance needed to comply with these changes and affect corporations claiming foreign tax credits. The text of these temporary regulations also serves as the text of the proposed regulations (REG–144784–02) set forth in the notice of proposed rulemaking published in this issue of the Federal Register.

DATES: Effective Date: These regulations are effective April 25, 2006. For dates of applicability, see §§ 1.861–9T(f)(4)(iv), 1.861–12T(c)(4)(iii), 1.902–1T(g), 1.904–2T(h)(1) and (2), 1.904–4T(c)(2)(i), 1.904–7T(f)(10), 1.904(f)–12T(g)(5), and 1.964–1T(c)(2) and (c)(6).

Applicability Dates: These regulations generally apply to dividends paid in taxable years of noncontrolled section 902 corporations beginning after December 31, 2002.

FOR FURTHER INFORMATION CONTACT: Ginny Chung (202) 622–3850 (not a toll free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–2014. Responses to these collections of information are required to obtain a tax benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. For further information concerning these collections of information, and where to submit comments on the collections of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the Federal Register.

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

Background

This document contains amendments to the regulations under sections 861, 902, 904, and 964 relating to the application of separate limitations to dividends from noncontrolled section 902 corporations (10/50 corporations) under section 904(d)(4), as amended by the AJCA and GOZA. Prior to the Taxpayer Relief Act of 1997, Public Law No. 105–34, 111 Stat. 788, 971 (1997 Act), dividends from each 10/50 corporation were subject to a separate foreign tax credit limitation (a separate category for dividends from each 10/50 corporation). The 1997 Act modified these rules, effective for taxable years beginning after December 31, 2002. In lieu of the separate category treatment, the 1997 Act provided that dividends paid by 10/50 corporations that are not passive foreign investment companies out of earnings and profits accumulated in taxable years beginning on or before December 31, 2002, (10/50 dividends out of pre-2003 earnings) would be included in a single separate category (the single category for dividends from all 10/50 corporations), and dividends from 10/50 corporations out of earnings and profits accumulated in taxable years beginning after December 31, 2002, (10/50 dividends out of post-2002 earnings) would be treated as income in a separate category based on the separate category of the underlying earnings and profits being distributed (look-through treatment). On December 23, 2002, the IRS and the Treasury Department issued Notice 2003–5 (2003–1 C.B. 294), which provided guidance addressing the application of section 904 to dividends paid by 10/50 corporations under the 1997 Act.

The AJCA modified the 10/50 dividend rules in the 1997 Act and provided that dividends from 10/50 corporations would be eligible for look-through treatment effective for taxable years beginning after December 31, 2002, without regard to when the distributed earnings were accumulated. Section 403(l) of the GOZA provided a rule allowing a taxpayer to elect, for taxable years beginning after December 31, 2002, and before January 1, 2005, not to apply the expanded look-through rules enacted in the AJCA to 10/50 dividends out of pre-2003 earnings. Section 403(l) of the GOZA also provided, with respect to carrybacks and carryforwards under section 904(c) of excess foreign taxes allocable to a dividend from a 10/50 corporation, that a taxpayer that elects not to apply the expanded look-through rules enacted in the AJCA to taxable years beginning in 2003 and 2004 must defer the application of the look-through rules for carryovers of excess foreign taxes contained in section 904(d)(4)(C)(iv).

The temporary regulations modify the section 902 and 904 regulations to reflect the look-through treatment of dividends from 10/50 corporations and provide transition rules for the treatment of overall foreign losses and separate limitation losses under section 904(f) and the carryover of excess foreign taxes under section 904(c). The temporary regulations also modify the grouping rules of § 1.904–4(c) that apply for purposes of determining whether an item of income is considered high-taxed income, the rules under § 1.861–9T governing the apportionment of interest expense of a 10/50 corporation, and the rules under § 1.861–12T governing the characterization of stock of a 10/50 corporation for purposes of apportioning the shareholder’s interest expense.

In addition, the temporary regulations modify the regulations under section 964 to add rules permitting majority domestic corporate shareholders of a 10/50 corporation to make tax accounting elections on behalf of the 10/50 corporation. The temporary regulations also expand the section 964 regulations to allow controlling United States shareholders and majority domestic corporate shareholders to adopt or Change the taxable year of a controlled foreign corporation or 10/50 corporation (as the case may be) on behalf of the
foreign corporation. The temporary regulations also revise the regulations’ procedural rules to permit statements evidencing the shareholders’ action to be filed with the shareholders’ tax returns instead of 183 days after the close of the foreign corporation’s taxable year. Finally, the temporary regulations modify the section 964 regulations to eliminate obsolete provisions and reorganize some of the rules contained in §1.964–1T(g).

The IRS and the Treasury Department request comments on additional guidance that may be needed to implement section 403 of the AJCA and section 403(f) of the GOZA.

**Explanation of Provisions**

**I. Interest Expense Apportionment**

A. Interest Expense of a 10/50 Corporation

For purposes of apportioning interest expense of a 10/50 corporation, the same procedures in order to apply the dividend look-through rule, new §1.861–9T(f)(4) generally applies the principles of §1.861–9T(f)(3) (apportionment of interest expense of a controlled foreign corporation). Under this rule, interest expense of a 10/50 corporation may be apportioned using either the asset method or the modified gross income method. Section 1.861–9T(f)(4) also provides that the election to use the asset method or modified gross income method may be made by either the 10/50 corporation itself or by the “majority domestic corporate shareholders” of the 10/50 corporation. The term “majority domestic corporate shareholders” means those domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as the 10/50 corporation) that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all of the voting stock of the 10/50 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or a relevant first-tier 10/50 corporation). Unlike a controlled foreign corporation (CFC), however, a 10/50 corporation will not be required to use the asset method even though the majority domestic corporate shareholders elect the fair market value method of apportionment. Compare §1.861–9T(f)(3)(i) and §1.861–9T(c)(2) (requiring CFC to use fair market value method if controlling United States shareholders as defined in §1.861–9T(f)(3)(ii) elect fair market value method). The IRS and the Treasury Department believe that the conformity rule of §1.861–8T(c)(2) should not apply to foreign corporations that are not controlled by domestic shareholders. Therefore, regardless of the methods used by the majority domestic corporate shareholders of a 10/50 corporation, the 10/50 corporation (or the majority domestic corporate shareholders on behalf of the 10/50 corporation) may elect to use any of the methods described in §1.861–9T or §1.861–9 (e.g., the modified gross income, tax book value, alternative tax book value, or fair market value method) to apportion the 10/50 corporation’s interest expense.

B. Characterization of Stock of a 10/50 Corporation

For purposes of apportioning interest expense to income of a taxpayer in the various separate categories under section 904(d), §1.861–12T(c)(4) currently treats stock of each 10/50 corporation owned by the taxpayer as an asset giving rise to income in a separate category. The temporary regulations are amended to reflect the repeal of separate categories for dividends from 10/50 corporations. Because dividends from 10/50 corporations are eligible for look-through treatment in the same manner as dividends from CFCs, the IRS and the Treasury Department believe that stock of a 10/50 corporation should be treated for interest expense apportionment purposes in the same manner as stock of a CFC, which is characterized based on the income produced in the current year, or expected to be produced in future years, by the assets of the CFC. See §1.861–12T(c)(3)(ii). As amended by this Treasury Decision, the basis adjustment rule of §1.861–12T(c)(2)(i) is revised to clarify that it applies to stock of a 10 percent owned corporation not only where stock in a 10 percent owned corporation is held directly by members of the affiliated group, but also where the stock is held indirectly through a partnership or other pass-through entity. Thus, the basis adjustment is required whenever the stock (rather than the interest in the pass-through entity) is the relevant asset for purposes of interest expense apportionment.

**II. Deemed Paid Credit Under Section 902**

A. Extension of Look-Through Rules and Tier Limitation

The 1997 Act and AJCA amendments expanded the look-through treatment of dividends from 10/50 corporations. The temporary regulations amend §1.902–1(i)(1) to reflect these changes. The temporary regulations also reflect provisions of the 1997 Act amending section 902 to provide for the calculation of deemed-paid taxes with respect to distributions through up to six tiers of foreign corporations in a chain of corporations in a “qualified group” described in section 902(b)(2). Under section 902(b)(2), the term “qualified group” does not include any foreign corporation below the third tier in the chain unless such corporation is a controlled foreign corporation of which the domestic corporation is a United States shareholder. For a member of the qualified group below the third tier, only foreign income taxes paid with respect to periods during which it was a controlled foreign corporation are eligible to be deemed paid. The temporary regulations modify
§ 1.902–1 to reflect these statutory amendments, effective for taxes paid by fourth-, fifth-, and sixth-tier qualified group members with respect to taxable years beginning after August 5, 1997.

B. Amounts Included in Post-1986 Foreign Income Taxes

Under § 1.902–1(a)(7), foreign income taxes do not include amounts not treated as a tax or certain taxes for which credit is disallowed under various provisions of section 901. The temporary regulations update the definition of foreign income taxes in § 1.902–1(a)(7) to exclude taxes for which a credit is disallowed under sections 901(j) (relating to the disallowance of a credit for foreign taxes paid or accrued to certain countries), sections 901(k) and (l) (disallowing credit for certain withholding taxes paid with respect to dividends or other income if the recipient does not meet certain holding period requirements or is under an obligation to make related payments that tend to substantiate similar or related property), or any similar provision. In addition, the temporary regulations modify § 1.902–1(a)(8) to reflect the amendment of section 902(c)(2)(B) in 1997, which clarified the definition of post-1986 foreign income taxes by substituting the phrase “attributable to” for the phrase “deemed paid with respect to.”

Section 1113(c)(2) of the 1997 Act provided that in the case of any chain of foreign corporations described in clauses (i) and (ii) of section 902(b)(2)(B), no liquidation, reorganization, or similar transaction in a taxable year beginning after August 5, 1997, can have the effect of permitting taxes to be taken into account under section 902 which could not have been taken into account under section 902 but for the transaction. This rule was enacted as part of the effective date of the 1997 Act’s extension of the deemed-paid credit rules from three to six tiers as discussed above. Accordingly, § 1.902–1T(c)(6) is added to clarify that foreign taxes paid or accrued by a qualifying shareholder are not eligible to be deemed paid if they were paid or accrued in a taxable year beginning on or before August 5, 1997, if such member was a fourth-, fifth- or sixth-tier corporation with respect to the taxpayer on the first day of its first taxable year beginning after August 5, 1997.

III. Carryovers and Carrybacks of Excess Foreign Taxes Under Section 904(c)

Section 904(d)(4)(C)(i), as amended by the AJCA, provides that look-through treatment applies to the carryover of excess foreign taxes from pre-2003 taxable years to post-2002 taxable years to the extent that they are allocable to dividends from 10/50 corporations. Consistent with this statutory amendment, § 1.904–2T(h)(1) provides that to the extent that a taxpayer has paid, accrued, or deemed paid excess taxes in a separate category for dividends from a 10/50 corporation paid in a pre-2003 taxable year and these excess taxes are carried over to taxable years beginning on or after the first day of the 10/50 corporation’s first post-2002 taxable year, the excess taxes are assigned to the appropriate separate category as if the associated dividends had been eligible for look-through treatment when paid, based on the reconstruction of the 10/50 corporation’s pre-2003 earnings in accordance with § 1.904–7T(f) (discussed below in section V.E., “Treatment of earnings and taxes accumulated during a non-look-through period”). In the case of excess taxes attributable to dividends from a 10/50 corporation with respect to which the taxpayer is no longer a qualifying shareholder as of the first day of its first post-2002 taxable year, § 1.904–2T(h)(1) provides that the excess taxes are assigned pro rata to the separate categories to which the foreign corporation’s pre-2003 earnings would have been assigned had they been distributed in the last year that the taxpayer was a qualifying shareholder.

If the Commissioner determines that the look-through characterization of the excess taxes cannot be reasonably determined under one of the methods described in § 1.904–7T(f)(4), the Commissioner will assign such taxes to the general limitation category. Section 1.904–2T(h)(1) also provides that any excess taxes carried over from pre-2003 taxable years to post-2002 taxable years that would otherwise be assigned to the passive category are assigned to the general limitation category. The IRS and the Treasury Department believe that these rules are appropriate because to the extent the pre-2003 dividend paid by the 10/50 corporation that generated the excess taxes could not have been treated as passive income, such income and associated taxes would have been considered high-taxed income under section 904(d)(2)(A)(iii)(III) and generally would have been recharacterized as general limitation income and taxes.

Section 904(d)(4)(C)(iv), as amended by the AJCA, authorizes the Secretary to issue regulations for allocating carrybacks of excess taxes allocable to a dividend paid by a 10/50 corporation in a post-2002 taxable year to a pre-2003 taxable year for purposes of allocating such dividend among the separate categories in effect for the taxable year to which carried. The IRS and the Treasury Department determined that the regulations should not provide for the carryback of post-2002 excess taxes attributable to look-through dividends paid by a 10/50 corporation to a separate limitation category for dividends from each 10/50 corporation in pre-2003 years. Such a rule would be administratively burdensome because it would require taxpayers to maintain multiple sets of section 904(c) accounts for separate categories for the 2003 and 2004 taxable years and because it would necessitate complex stacking rules to determine the amount of excess taxes in a separate category that were attributable to dividends paid by specific 10/50 corporations. Accordingly, § 1.904–2T(h)(2) provides that excess taxes that are allocable to dividends from 10/50 corporations paid in post-2002 taxable years that are attributable to one or more separate categories are carried back to prior taxable years in the same separate categories to which the dividends were assigned.

IV. High-Taxed Income of a 10/50 Corporation

In general, income received or accrued by a United States person that would otherwise be passive income is treated as general limitation income if the income is determined to be high-taxed income within the meaning of section 904(d)(4)(C)(iv). In determining whether passive income is high-taxed income, the grouping rules of § 1.904–4(c) apply separately to dividends and subpart F inclusions from each controlled foreign corporation, income of a qualified business unit (QBU), and income of a QBU of a controlled foreign corporation and any other look-through entity as defined in § 1.904–5(l). §§ 1.904–4(c)(4) and (c)(5)(iv). The temporary regulations at § 1.904–4T(c)(5) and (c)(4) provide that the grouping rules similarly apply separately to dividends from each 10/50 corporation, which includes dividends that are treated as passive income either on a look-through basis or due to inadequate substantiation. The IRS and the Treasury Department believe that this rule is consistent with the intent of the existing separate grouping rules as well as legislative intent that “the high-tax income rules apply appropriately to dividends treated as passive category income because of inadequate substantiation.” H.R. Conf. Rep. No. 108-755, 108th Cong. 2d Sess. 386 n.222 (2004). Consistent with the changes to the look-through rules enacted in the
AJCA, this rule is effective for dividends paid in post-2002 taxable years of 10/50 corporations.

V. Look-Through Rules as Applied to 10/50 Corporations

A. Treatment of Dividends Paid by a 10/50 Corporation in General

Section 904(d)(4)(A), as amended by the AJCA, provides that look-through treatment applies to any dividend paid by a 10/50 corporation in a post-2002 taxable year, regardless of the year in which the earnings were accumulated. Accordingly, § 1.904–5T(c)(4)(iii) provides that any dividends paid in a post-2002 taxable year to a domestic corporation by a 10/50 corporation with respect to which the domestic corporation meets the stock ownership requirements of section 902(a) are treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the 10/50 corporation. Interest, rents, and royalties paid by a 10/50 corporation to a domestic corporation are not eligible for look-through treatment and are treated as passive income except as otherwise provided in section 904(d)(2)(A) and the regulations thereunder. Any dividend distribution by a 10/50 corporation to a shareholder that is not a corporation meeting the stock ownership requirements of section 902(a) or (b) is also treated as passive income. Finally, as provided in section 904(d)(4)(C)(iii), § 1.904–5T(c)(4)(iii) provides that a dividend from a 10/50 corporation is treated as passive income if the look-through characterization of the dividend is not substantiated to the satisfaction of the Commissioner. These rules are generally applicable to dividends paid by a 10/50 corporation during its first post-2002 taxable year and thereafter, without regard to whether the corresponding taxable year of the dividend recipient is a post-2002 taxable year.

B. Allocation and Apportionment of Expenses of a 10/50 Corporation

In applying look-through to dividends from 10/50 corporations, expenses of the 10/50 corporation (such as payments of interest, rents, and royalties) must be allocated and apportioned to the 10/50 corporation’s pool of post-1986 undistributed earnings. § 1.904–5T(c)(2)(iii) provides that expenses of a 10/50 corporation are allocated and apportioned to the income of the 10/50 corporation in the same manner as expenses of a CFC. See, e.g., section 954(b)(5); § 1.904–5(c)(2)(ii).

The temporary regulations, however, do not extend the special allocation rule for related person interest expense under section 954(b)(5) and § 1.904–5(c)(2)(ii) (providing that interest paid by a CFC to a U.S. shareholder or any related look-through entity is first allocated to reduce foreign personal holding company income which is passive income) to interest paid by 10/50 corporations. The AJCA did not extend look-through treatment to interest paid by a 10/50 corporation to a domestic shareholder or to a related entity, and 10/50 corporations are not subject to subpart F. Accordingly, interest paid by a 10/50 corporation to a domestic shareholder, CFC, or another 10/50 corporation is treated as passive income (or high witholding tax interest, financial services income, or high-taxed general limitation income, as appropriate) and is apportioned to reduce the payor’s pool of post-1986 undistributed earnings under the rules applicable to unrelated person interest expense, even though the generally applicable expense allocation rules of § 1.904–5 apply to determine which earnings are reduced at the payor 10/50 corporation level.

C. Treatment of Dividends Paid Between Lower-Tier Look-Through Entities

To reflect the extension of look-through treatment to dividends paid by 10/50 corporations and the repeal of separate categories for dividends from each 10/50 corporation, the temporary regulations remove the rules of § 1.904–4(g) and amend the relevant provisions of §§ 1.902–1 and 1.904–5. In order for a dividend from a 10/50 corporation to qualify for look-through treatment, the shareholder must be a domestic corporation meeting the stock ownership requirements of section 902(a) with respect to the 10/50 corporation. Sections 904(d)(2)(E) and 904(d)(4).

In determining whether dividends paid by lower-tier corporations are eligible for look-through treatment, the eligibility requirements for dividends from 10/50 corporations and CFCs cannot be precisely conformed, because a taxpayer’s eligibility for look-through treatment of a dividend from a 10/50 corporation is based on whether the taxpayer meets the stock ownership requirements of section 902, whereas a taxpayer’s eligibility for look-through treatment of a dividend from a CFC is based on whether the taxpayer is a United States shareholder with respect to the CFC under section 954(b). See section 904(d)(3)(E), 904(d)(3)(D), and 904(d)(4)(A). However, the IRS and the Treasury Department believe that the eligibility requirements for look-through treatment of dividends from 10/50 corporations and CFCs should be conformed to the greatest extent possible.

Accordingly, § 1.902–1T(d)(1) provides that the amount of foreign taxes deemed paid is computed separately with respect to post-1986 undistributed earnings or pre-1987 accumulated profits in each separate category out of which a look-through dividend is paid in the following situations: (1) A dividend from a CFC to a domestic corporation meeting the stock ownership requirements of section 902(a) that is a United States shareholder (as defined in section 951(b) or section 953(c)) of the CFC; (2) a dividend from a 10/50 corporation to a domestic corporation meeting the stock ownership requirements of section 902(a); (3) a dividend received by an upper-tier CFC from a lower-tier CFC where the CFCs are related look-through entities under § 1.904–5(i)(3); and (4) a dividend from a CFC or 10/50 corporation to a foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1) (i.e., both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2)). Similarly, the temporary regulations at § 1.904–5T(i)(4) apply look-through treatment to any dividend paid by a CFC or 10/50 corporation to another member of the same qualified group (as defined in section 902(b)(2)) that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1), and retain the current rule of § 1.904–5(i)(3) to the extent that it applies look-through treatment to dividends between CFCs that have a common 10 percent U.S. shareholder but do not meet the requirements of section 902(b).

D. Application of Section 904(g) to 10/50 Corporations

Section 904(g) (redesignated under the AJCA as section 904(h) for taxable years beginning after 2006) provides that certain inclusions, including dividends and interest paid or accrued by a United States-owned foreign corporation to a United States shareholder or a related person and which would be treated as foreign source income, are treated as U.S. source income. Section 904(g)(6) defines a United States-owned foreign corporation as any foreign corporation if United States persons (as defined in section 7701(a)(30) hold 50 percent or more of the total combined voting power of all classes of voting stock or the total value of the stock. Section
1.904–5(m) provides rules concerning the resourcing of certain amounts received or accrued (or treated as received or accrued) by a United States shareholder from a CFC. The temporary regulations at § 1.904–5T(m) clarify that the rules for resourcing interest and dividends also apply to a 10/50 corporation that meets the definition of a United States-owned foreign corporation. These temporary regulations apply to amounts paid by a 10/50 corporation in taxable years of such corporation beginning after April 25, 2006.

E. Treatment of Earnings and Taxes Accumulated During a Non-Look-Through Period

Section 1.904–7T(f)(2) provides that earnings accumulated and foreign income taxes paid after a 10/50 corporation had a domestic corporate shareholder that met the stock ownership requirements of section 902(a) but before any such shareholder was eligible for look-through treatment of dividends (non-look-through pool) that exist as of the end of the 10/50 corporation’s last pre-2003 taxable year are treated as if they were accumulated and paid during a period in which the distribution would have been eligible for look-through treatment (look-through period). These earnings and taxes are treated as the opening balance of the post-1986 undistributed earnings and taxes pools in the 10/50 corporation’s other separate categories on the first day of the 10/50 corporation’s first post-2002 taxable year. Dividends that were paid in pre-2003 taxable years out of earnings accumulated in a non-look-through pool are not eligible for look-through treatment.

Section 1.904–7T(f)(4)(i) provides that in order to substantiate the look-through characterization of the earnings and taxes in the non-look-through pools, the taxpayer must reconstruct the non-look-through pools of earnings and taxes for each year in the non-look-through period, beginning with the first year in which earnings were accumulated in the non-look-through pool. Earnings and taxes are treated as if they were accumulated during a look-through period, taking into account earnings distributed and taxes deemed paid in the non-look-through period as if they were distributed and deemed paid pro rata from the amounts that were added to the non-look-through pools during the non-look-through period. As reconstructed, earnings and taxes in the non-look-through pools as of the last day of the 10/50 corporation’s last pre-2003 taxable year are assigned to the look-through pools on the first day of the 10/50 corporation’s first post-2002 taxable year.

The IRS and the Treasury Department recognize that shareholders may face difficulties in reconstructing historical accumulated earnings and taxes accounts of a 10/50 corporation on a look-through basis, because noncontrolling shareholders may have difficulty obtaining detailed records for prior periods from the 10/50 corporation. Therefore, the IRS and the Treasury Department anticipate that a reasonable approximation of the amounts properly included in the look-through pools, based on available records obtained through reasonable, good-faith efforts by the taxpayer, will adequately substantiate the reconstruction required by the statute.

Alternatively, § 1.904–7T(f)(4)(ii) provides a safe harbor in reconstructing the non-look-through pools. Under the safe harbor, a taxpayer may allocate the earnings and taxes in the non-look-through pools ratably to the look-through pools on the first day of the 10/50 corporation’s first post-2002 taxable year in the same percentages as the taxpayer (or the qualified group member that owns the 10/50 corporation) properly characterizes the stock of the 10/50 corporation in the separate categories for purposes of apportioning the taxpayer’s (or qualified group member’s) interest expense in its first taxable year ending after the first day of the 10/50 corporation’s first post-2002 taxable year. Under § 1.861–12T(c)(3) and (4), this characterization generally is based on how the assets or income of the 10/50 corporation are characterized in the separate categories for purposes of apportioning interest expense of the 10/50 corporation in the 10/50 corporation’s first post-2002 taxable year. However, § 1.904–7T(f)(4)(ii) provides that if a taxpayer elects to use the safe harbor rule with respect to a 10/50 corporation that uses the modified gross income method to apportion interest expense for the 10/50 corporation’s first post-2002 taxable year, earnings and taxes in the non-look-through pools are allocated to the look-through pools based on an average of the 10/50 corporation’s modified gross income ratios for its taxable years beginning in 2003 and 2004. The IRS and the Treasury Department believe that the two-year base period rule is necessary to avoid potential distortions associated with allocating earnings and taxes from the non-look-through pool to the look-through pools based on the 10/50 corporation’s modified gross income for just one taxable year.

Section 904(d)(4)(C)(ii), as amended by the AJCA, provides that if the Secretary determines that look-through treatment of a dividend out of earnings formerly accumulated in the non-look-through pool has not been adequately substantiated, the dividend is treated as passive income for purposes of section 904(d). Section 1.904–7T(f)(4)(iii) provides that in the case where a taxpayer does not elect the safe harbor rule of § 1.904–7T(f)(4)(ii) and the Commissioner determines that the look-through characterization of earnings and taxes in the non-look-through pools cannot reasonably be determined based on the available information, the Commissioner will assign the earnings and associated taxes to the passive category for purposes of section 904(d).

As provided in § 1.904–7T(f)(3), rules similar to § 1.904–7T(f)(2) will apply in assigning to separate categories earnings and taxes of a CFC that were accumulated during a non-look-through period. As reconstructed, earnings and taxes in a CFC’s non-look-through pools as of the last day of the CFC’s last pre-2003 taxable year will be added to the opening balance of the CFC’s look-through pools of earnings and taxes on the first day of the CFC’s first post-2002 taxable year. The taxpayer must substantiate the look-through characterization of such earnings and taxes in accordance with § 1.904–7T(f)(4) by either reconstructing the non-look-through pools or electing the safe harbor.

In addition, as provided in § 1.904–7T(f)(6), the rules of § 1.904–7T(f)(2) will apply to assign to separate categories pre-1987 accumulated profits and pre-1987 foreign income taxes of a foreign corporation that were accumulated during a non-look-through period and, prior to the AJCA amendments, would have been assigned to a separate category for dividends from a 10/50 corporation. Accordingly, pre-1987 accumulated profits and pre-1987 foreign income taxes accumulated during a non-look-through period will be treated as if they were accumulated during a look-through period. The taxpayer must substantiate the look-through characterization of such earnings and taxes in accordance with § 1.904–7T(f)(4) by either reconstructing the annual layers of pre-1987 accumulated profits or electing the safe harbor.

F. Treatment of a Deficit Accumulated in a Non-Look-Through Period

Section 1.904–7T(f)(5) provides that if there is an accumulated deficit in the non-look-through pool as of the end of a 10/50 corporation’s last pre-2003...
taxable year, the deficit and associated taxes are treated in the same manner as earnings and taxes in a positive non-look-through pool, i.e., the deficit and taxes are treated as if they had been accumulated and paid during a look-through period. The earnings and deficits in earnings making up the accumulated deficit are assigned to the look-through pools based on where the 10/50 corporation’s income and expenses or losses would have been assigned had they been incurred during a look-through period, or, if the taxpayer elects the safe harbor, the deficit is allocated based on how the stock of the 10/50 corporation is properly characterized for interest expense apportionment purposes. If the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the deficit in the non-look-through pool cannot be reasonably determined based on the available information, the Commissioner will assign the deficit and any associated taxes to the 10/50 corporation’s passive category.

The temporary regulations treat the deficit in the non-look-through pool as the opening balance of the post-1986 undistributed earnings pools in the 10/50 corporation’s other separate categories on the first day of the 10/50 corporation’s first post-2002 taxable year. If the 10/50 corporation makes a distribution in a post-2002 taxable year in which there is a deficit balance in the aggregate of the look-through pools (as increased or reduced by earnings or a deficit in the non-look-through pool), the deficit balance is carried back on a look-through basis, to reduce pre-1987 accumulated profits on a last in-first out basis, and the deficit is removed from post-1986 undistributed earnings. See § 1.902–2(a)(1). If the deficit reduces to zero all of the pre-1987 accumulated profits, no foreign taxes in any of the 1987 annual layers are deemed paid with respect to the dividend. See § 1.902–1(b)(4).

In the case of a CFC that was formerly a 10/50 corporation and has a deficit in the non-look-through pool that was accumulated while it was a 10/50 corporation, any deficit that was not absorbed by earnings in the look-through pools and that remains at the end of the CFC’s last pre-2003 taxable year is assigned to the look-through pools on the first day of the CFC’s first post-2002 taxable year based on the same method. To the extent that the portion of the deficit in the non-look-through pool that is assigned to a separate category exceeds post-1986 undistributed earnings in that category as of the end of the CFC’s last pre-2003 taxable year, the deficit will carry forward into the CFC’s post-1986 undistributed earnings pools for 2003. Under § 1.904–7T(f)(6), similar rules apply to recharacterize a deficit in pre-1987 accumulated profits and any associated pre-1987 foreign income taxes that were accumulated during a non-look-through period.

G. Pre-Acquisition E&P of a 10/50 Corporation

Section 904(d)(4)(Ci)(III), as amended, by the AJCA, provides that the Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits of a 10/50 corporation for periods before the taxpayer’s acquisition of the stock to which the distributions relate (pre-acquisition E&P). Such distributions may be out of post-1986 undistributed earnings accumulated by a 10/50 corporation before the specific shareholder acquired its stock or out of pre-1987 accumulated profits accumulated before the 10/50 corporation had any qualifying shareholder. Prior to the AJCA amendments, such distributions, as well as distributions by a CFC out of earnings and profits for periods during which it was not a CFC, were subject to a separate foreign tax credit limitation for dividends from a 10/50 corporation. See section 904(d)(1)(E), section 904(d)(2)(E), and § 1.904–4(g)(3).

The temporary regulations do not limit look-through treatment for dividends out of earnings and profits accumulated in non-look-through periods during which a 10/50 corporation or CFC had no qualifying shareholder. The IRS and the Treasury Department believe that look-through treatment of pre-acquisition E&P is the more appropriate policy result than passive category treatment, if look-through characterization can be adequately substantiated under the rules of §§ 1.904–5T(c)(4)(iii) and 1.904–7T(f)(4). In addition, the temporary regulations do not limit look-through treatment for dividends out of pre-acquisition E&P accumulated in periods during which the distributing corporation was a 10/50 corporation, because any such restriction would create administrative complexities associated with maintaining multiple sets of look-through categories for earnings and profits from 10/50 corporations and CFCs in post-2002 taxable years are generally eligible for look-through treatment, regardless of whether the distributing corporation was a look-through entity when the earnings were accumulated, and regardless of when the taxpayer acquired its stock.

H. Post-1986 Undistributed Earnings of a CFC Attributable to Dividends From Lower-Tier 10/50 Corporations

Where a CFC has a separate category for dividends from each 10/50 corporation containing earnings attributable to pre-2003 distributions from the lower-tier 10/50 corporation, § 1.904–7T(f)(7) provides that the CFC’s look-through pools of earnings and taxes will be adjusted to account for accumulated earnings and taxes attributable to dividends from the lower-tier 10/50 corporation as if the earnings and taxes were accumulated and deemed paid during a look-through period. Therefore, the earnings and taxes are recharacterized on the same basis used by the taxpayer to reconstruct the non-look-through pools of the lower-tier 10/50 corporation under § 1.904–7T(f)(4). Taxes in each separate category for dividends from a lower-tier 10/50 corporation are assigned to the upper-tier CFC’s look-through pools based on where the associated earnings distributed by the lower-tier foreign corporation (prior to being reduced by, for example, expense apportionment or payment of foreign income taxes at the CFC level) would have been assigned had such earnings been eligible for look-through treatment when received by the CFC.

If a CFC has a deficit in a separate category for dividends from a lower-tier 10/50 corporation (due to, for example, expense apportionment or the payment of foreign income taxes by the CFC with respect to the lower-tier 10/50 corporation), the deficit and any associated taxes are treated as if they had been accumulated and deemed paid during a look-through period. Accordingly, the deficit is assigned to the upper-tier CFC’s look-through pools based on where the upper-tier CFC’s income and expenses or losses would have been assigned had dividends from the lower-tier 10/50 corporation been eligible for look-through treatment in the year such dividends were paid or such expenses and losses were incurred by the CFC.

Similar to § 1.904–7T(f)(4)(ii) (which provides a safe harbor in reconstructing the look-through account for undistributed earnings (or a deficit) and taxes in the non-look-through pool
of a 10/50 corporation or CFC), § 1.904–7T(f)(7)(iii) provides a safe harbor in reconstructing the look-through pools at the CFC level to account for undistributed earnings (or a deficit) and taxes in a CFC-level separate category for dividends from a lower-tier 10/50 corporation. The taxpayer may allocate the earnings (or deficit) and taxes to the look-through pools at the CFC level by applying the safe harbor at the level of the CFC. Thus, if the taxpayer elects the safe harbor, the earnings (or deficit) and taxes are allocated based on how the CFC would properly characterize the stock of the lower-tier 10/50 corporation for purposes of apportioning the CFC’s interest expense, which in turn is based on the apportionment ratios properly used by the 10/50 corporation to apportion its interest expense in its first post-2002 taxable year. In the case of a taxpayer that elects to use the safe harbor rule where the 10/50 corporation uses the modified gross income method to apportion interest expense for its first post-2002 taxable year, undistributed earnings (or a deficit) and taxes in a CFC-level separate category for dividends from a 10/50 corporation are allocated to the look-through pools based on the average of the 10/50 corporation’s modified gross income ratios for its taxable years beginning in 2003 and 2004.

In the case of a CFC that has in its qualified group a chain of 10/50 corporations, the safe harbor applies first to the stock of the third-tier 10/50 corporation and then to the stock of the second-tier 10/50 corporation. In the case of a taxpayer that elects the safe harbor with respect to a lower-tier 10/50 corporation of which the taxpayer was no longer a qualifying shareholder as of the end of the upper-tier CFC’s last pre-2003 taxable year (e.g., because the 10/50 corporation was no longer a member of the CFC’s qualified group), the earnings (or deficit) and taxes in the separate category for dividends from the lower-tier 10/50 corporation are assigned to the CFC’s look-through pools in the same percentages as the stock of the 10/50 corporation would have been characterized had the look-through rules applied in the last year the taxpayer was a qualifying shareholder of the 10/50 corporation.

If the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the undistributed earnings (or deficit) and taxes in a CFC’s separate category for dividends from a lower-tier 10/50 corporation cannot reasonably be determined based on the available information, the Commissioner will assign the earnings (or deficit) and taxes to the CFC’s passive category.

I. Treatment of Distributions Received by a 10/50 Corporation From a Lower-Tier 10/50 Corporation When the Corporations Do Not Have The Same Taxable Years

Section 1.904–7T(f)(6) provides guidance concerning when a dividend paid by a lower-tier corporation to an upper-tier corporation that is a member of the same qualified group is eligible for look-through treatment when the corporations’ first post-2002 taxable years begin on different dates. In the case of a dividend paid during the upper-tier corporation’s first post-2002 taxable year but during the lower-tier corporation’s post-2002 taxable year, the dividend will be included in a separate category in the year received. However, any earnings of the upper-tier corporation attributable to such dividends are treated, beginning on the first day of the upper-tier corporation’s next taxable year, as if they were accumulated during a look-through period. Dividends paid during the upper-tier corporation’s first post-2003 taxable year but during the lower-tier corporation’s post-2002 taxable year are eligible for look-through treatment in the year received.

VI. Separate Limitation Losses and Overall Foreign Losses

Because the 1997 Act and the AJCA eliminated separate categories for dividends from 10/50 corporations for post-2002 taxable years, the temporary regulations provide transition rules for recapture in a post-2002 taxable year of (1) an overall foreign loss (OFL) or separate limitation loss (SLL) in a separate category for dividends from each 10/50 corporation that offset U.S. source income or income in other separate categories, respectively, in a pre-2003 taxable year; and (2) an SLL in another separate category (e.g., the general limitation passive category) that offset income in a separate category for dividends from each 10/50 corporation in a pre-2003 taxable year.

A. Recapture of an OFL or SLL Incurred in a Separate Category for Dividends From a 10/50 Corporation

Section 1.904(i)–12T(g)(1) provides that where a taxpayer had an OFL or SLL in a separate category for dividends from a 10/50 corporation (i.e., an OFL, or SLL, in the separate category that offset U.S. source income, or income in other separate categories, in a pre-2003 taxable year) in a later year in which the taxpayer received a dividend in the separate category, and the OFL or SLL would have been recaptured out of income in the separate category for dividends from that 10/50 corporation, the OFL or SLL account is recaptured out of income in the taxpayer’s other separate categories in the same percentages as the income generated by the assets of the 10/50 corporation. Specifically, the loss account will be recaptured in subsequent taxable years out of income in the same separate categories in which the stock of the 10/50 corporation is properly characterized for purposes of apportioning the taxpayer’s interest expense in its first taxable year in which dividends from the 10/50 corporation are eligible for look-through treatment (i.e., its first taxable year ending after the first day of the 10/50 corporation’s first post-2002 taxable year). Any SLL account in a separate category for dividends from a 10/50 corporation with respect to another category that would be assigned to that other category under this rule will be eliminated, since “recapture” to and from the same category would be meaningless. See § 1.904(i)–12T(g)(4) Example 1.

The IRS and the Treasury Department determined that it is appropriate to reallocate OFL and SLL accounts based on how the taxpayer characterizes the stock of the 10/50 corporation for interest expense apportionment purposes in its first taxable year ending after the first day of the 10/50 corporation’s first post-2002 taxable year. The IRS and the Treasury Department believe that recapturing losses from income earned in subsequent years is a forward-looking concept. Reallocation losses that were incurred in a separate category for dividends from each 10/50 corporation to the appropriate separate category based on the interest expense apportionment ratio (as opposed to, for example, reallocating losses based on reconstructed non-look-through pools) is consistent with that concept.

In the case of a taxpayer that has an OFL or SLL account in a separate category for dividends from a 10/50 corporation but no longer is a qualifying shareholder with respect to the foreign corporation, the IRS and the Treasury Department determined that reallocating OFLs and SLLs incurred in separate categories for dividends from 10/50 corporations to the other separate categories may be inappropriate. In pre-2003 taxable years, recapture of the OFL or SLL would not have occurred because the taxpayer would not have received any additional dividends from the corporation that would be treated as income in the separate 10/50 loss category (unless the former shareholder
reacquired a sufficient interest in the corporation to become a qualifying shareholder. Accordingly, § 1.904(f)–12T(g)(3) provides that where a taxpayer was not a qualifying shareholder with respect to a foreign corporation on December 20, 2002 (or was not a qualifying shareholder on the first day of the taxpayer’s first post-2002 taxable year, pursuant to a transaction that was the subject of a binding contract which was in effect on December 20, 2002), any OFL or SLL accounts in the taxpayer’s separate category for dividends from that corporation will not be reallocated. See Notice 2003–5 (announcing regulations would provide that OFL and SLL accounts in a separate category for dividends from each 10/50 corporation where the taxpayer was no longer a qualifying shareholder as of December 20, 2002, will not be consolidated into the OFL and SLL accounts of the single category for dividends from 10/50 corporations).

Section 1.904(f)–12T(g)(3) also provides that where an OFL or SLL account in a separate category for dividends from each 10/50 corporation is not reallocated because the taxpayer is no longer a qualifying shareholder of that foreign corporation, the taxpayer may not carry over any excess foreign taxes in that separate category to another separate category on a look-through basis. However, the temporary regulations allow the taxpayer to elect to carry over all excess taxes in its separate categories for dividends from 10/50 corporations to the other separate categories, that the taxpayer also reallocates the OFL and SLL accounts of such separate categories for dividends from 10/50 corporations into the OFL and SLL accounts of the appropriate separate categories.

B. Recapture of an SLL Incurred in Other Categories

To the extent that an SLL in another separate category (e.g., the general limitation or passive category) offset income in a separate category for dividends from each 10/50 corporation in a pre-2003 taxable year (or later year with or within which the 10/50 corporation’s last pre-2003 taxable year ends), income subsequently earned in the loss category will be recaptured as income in the same separate categories in which the taxpayer properly characterizes the stock of the 10/50 corporation on a look-through basis for purposes of apportioning the taxpayer’s interest expense. See §§ 1.904(f)–12T(g)(2), Section 1.904(f)–12T(g)(4).

Example 2. See how the apportionment rule applies to SLLs in the general limitation and passive categories that previously offset income in a separate category for dividends from a 10/50 corporation, where the taxpayer characterizes the stock of the 10/50 corporation as a multiple category asset.

VII. Tax Elections, Adoptions of Method of Accounting or Taxable Year, and Changes in Method of Accounting or Taxable Year Made on Behalf of a CFC or 10/50 Corporation

Section 1.964–1T(c)(2) and (3) add rules allowing the majority domestic corporate shareholders of a 10/50 corporation to make an election, adopt a method of accounting or taxable year, or change a method of accounting or taxable year on behalf of the 10/50 corporation. Under § 1.964–1T(c)(5), the term majority domestic corporate shareholders is defined as those domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as the 10/50 corporation), that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all the voting stock of the 10/50 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or a relevant first-tier foreign corporation).

Section 1.964–1T(c)(3) of the current final regulations permits controlling United States shareholders of a CFC to make an election, or to adopt or change a method of accounting, on behalf of the CFC. Subject to the rules of section 898, the temporary regulations at § 1.964–1T(c)(3) extend this rule to permit controlling United States shareholders of a CFC to adopt or change the taxable year of a CFC. Finally, the temporary regulations revise the requirement that the controlling shareholders file a written statement executed by each of the controlling shareholders with the IRS within 180 days of the close of the foreign corporation’s taxable year for which the adoption or change in method of accounting is to be effective. In lieu of the written statement, § 1.964–1T(c)(3)(ii)(B) requires that the jointly executed statement evidencing the controlling shareholders’ consent to the adoption or change be retained by one or more of the shareholders, and that each shareholder file a separate statement with its tax return for the taxable year with or within which the foreign corporation’s first post-2005 taxable year ends. This change will facilitate e-filing by eliminating the signature requirement and will facilitate compliance by conforming the dates on which the election statement and the shareholder’s tax return must be filed.

VIII. Election To Defer Effective Date of 10/50 Look-Through Rules

A. Time, Form, and Manner of Election

As discussed in the Background section of this document, section 403(i) of the GOZA provides a rule under which a taxpayer may elect not to apply the extended look-through rules enacted in the AJCA for taxable years of 10/50 corporations beginning after December 31, 2002, and before January 1, 2005 (2003 and 2004 taxable years). In order to make the election, a taxpayer must attach a statement notifying the IRS of such election to its next tax return for which the due date (with extensions) is more than 90 days after April 25, 2006. The electing taxpayer’s tax liability as shown on its original or amended tax returns for its affected taxable years generally must be consistent with the guidance set forth in Notice 2003–5, 2003–1 C.B. 294, and the rules of § 1.861–1T(c)(4) (characterizing the stock of a 10/50 corporation as an asset in the various separate categories). The electing taxpayer must also make appropriate adjustments to eliminate any double benefit arising from the election in years that are not open for assessment. § 1.904–7T(f)(9).

B. Transition Rules

Taxpayers that elect to apply the pre-AJCA look-through rules for the 2003 and 2004 taxable years must assign dividends paid by 10/50 corporations in their 2003 and 2004 taxable years out of the non-look-through pool that existed as of the end of the foreign corporation’s last pre-2005 taxable year are treated as if they were accumulated and paid during a period in which a distribution from that corporation would have been eligible for look-through treatment. These earnings (or deficits) and taxes are added to the foreign corporation’s post-1986 undistributed earnings and taxes pools in the appropriate separate categories on the first day of the foreign corporation’s first post-2004 taxable year. In accordance with the principles of § 1.904–7T(f)(4), the taxpayer must...
reconstruct the non-look-through pools or, if the taxpayer elects the safe harbor, allocate the earnings and taxes in the foreign corporation’s non-look-through pools to the foreign corporation’s look-through pools on the first day of the foreign corporation’s first post-2004 taxable year. Under the safe harbor, this allocation is made in the same percentages as the taxpayer properly characterized the stock of the foreign corporation for purposes of interest expense apportionment in the taxpayer’s first taxable year ending after the first day of the foreign corporation’s first post-2002 taxable year. If the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined, the Commissioner will allocate the earnings (or deficit) and taxes to the passive category.

To the extent that a taxpayer had excess foreign taxes in the single category for dividends from all 10/50 corporations (regardless of whether they were carried forward from separate categories for dividends from each 10/50 corporation in pre-2003 taxable years under Notice 2003–5 or resulted from dividends paid in 2003 and 2004 taxable years), they will be carried forward to the appropriate separate categories in the same manner as excess taxes in the separate categories for dividends from each 10/50 corporation are carried over in the case of a non-electing taxpayer. See § 1.904–2T(h)(1). The taxpayer must determine which 10/50 corporations paid the dividends to which the excess taxes are attributable and then assign the taxes to the appropriate separate categories as if such dividends had been eligible for look-through treatment when paid. Accordingly, § 1.904–7T(f)(9)(iv) provides that excess taxes in the single category for dividends from 10/50 corporations are assigned to the appropriate separate categories by reconstructing the non-look-through pools or, if the taxpayer elects the safe harbor, by allocating the taxes in the same percentages as the taxpayer properly characterized the stock of the foreign corporation for purposes of apportioning the taxpayer’s interest expense for its first taxable year with or within which the 10/50 corporation’s first post-2002 taxable year began. This transition rule applies only to excess taxes attributable to dividends out of pre-2003 earnings, because only these taxes are included in the single category for dividends from all 10/50 corporations.

To the extent that excess taxes carried forward to the single category for dividends from 10/50 corporations under the rules of Notice 2003–5 were absorbed by low-taxed dividends paid by 10/50 corporations in 2003 or 2004 taxable years out of pre-2003 earnings, or expired unused, the amount of excess taxes carried forward to a separate category on a look-through basis will be smaller than the aggregate amount of excess taxes initially carried forward to the single category for dividends from 10/50 corporations. To simplify the process of determining which 10/50 corporations paid the dividends to which the remaining excess taxes are attributable, § 1.904–7T(f)(9)(iv) treats the remaining excess taxes as attributable pro rata to the dividends paid by all 10/50 corporations out of non-look-through pools in a particular taxable year that resulted in excess taxes that were eligible to be carried forward. Such excess taxes are then carried forward to the separate categories based on how the non-look-through pools are recharacterized under the rules of § 1.904–7T(f)(4).

Excess taxes that would otherwise be assigned to the passive category and excess taxes with respect to which neither the IRS nor the taxpayer can substantiate look-through character are assigned to the general limitation category. This rule, previously discussed in section III above, applies regardless of whether a taxpayer elects to apply the pre-AJCA look-through rules to dividends paid in taxable years of its 10/50 corporations beginning in 2003 and 2004.

To the extent that a taxpayer has excess foreign taxes attributable to a look-through dividend paid by a 10/50 corporation in post-2002 taxable years and such taxes are eligible for carryback, the taxes will be carried back within the same separate category and not to the separate categories or single category for dividends from 10/50 corporations. See § 1.904–7T(f)(9)(v).

For taxpayers that maintained OFL and SLL recapture accounts in the single category for dividends from all 10/50 corporations (for example, as the result of consolidating OFL and SLL accounts of separate categories for dividends from each 10/50 corporation into one set of OFL and SLL accounts of the single category for dividends from all 10/50 corporations under Notice 2003–5), the temporary regulations provide a transition rule for recapture in a post-2004 taxable year of an OFL and SLL in the single category for dividends from each 10/50 corporation. Section 1.904–7T(f)(9)(vi) provides that the OFL and SLL accounts are assigned to the appropriate separate categories, on the first day of the taxpayer’s first post-2004 taxable year following the last taxable year in which it received a dividend in this category. The assignment is based on how the stock of each 10/50 corporation giving rise to the OFL or SLL is properly characterized for purposes of apportioning the taxpayer’s interest expense for its first taxable year with or within which the 10/50 corporation’s first post-2002 taxable year began.

For taxpayers that maintained an SLL recapture account in another separate category (e.g., the general or passive category) with respect to the single category for dividends from all 10/50 corporations, § 1.904–7T(f)(9)(vii) provides that the SLL will be recaptured as income in the appropriate separate categories in post-2004 taxable years. Income is recaptured in the separate categories in the same percentages as the taxpayer properly characterized the stock of the 10/50 corporations with respect to which the loss account was established for purposes of apportioning the taxpayer’s interest expense for its first taxable year with or within which the 10/50 corporation’s first post-2002 taxable year began.

Where a CFC or 10/50 corporation had a single category for dividends from all 10/50 corporations containing earnings attributable to dividends paid in 2003 or 2004 taxable years of a lower-tier 10/50 corporation, the undistributed earnings, previously-taxed earnings, and associated taxes are treated in post-2004 taxable years of its 10/50 corporations maintaining 2003 undistributed earnings and taxes in a separate category for dividends from each 10/50 corporation maintained at the CFC or 10/50 corporation level. Accordingly, § 1.904–7T(f)(9)(viii) provides that the undistributed earnings and associated taxes in the single category for dividends from all 10/50 corporations are assigned to the appropriate separate categories based on the taxpayer’s reconstruction of the non-look-through pools of the lower-tier foreign corporation. or, if the taxpayer elects the safe harbor, by allocating the earnings and taxes in the same percentages as the taxpayer properly characterized (or would have characterized) the stock of the lower-tier 10/50 corporation for purposes of apportioning the upper-tier corporation’s interest expense for its first post-2002 taxable year.

Where a CFC or 10/50 corporation had an aggregate deficit in the single category for dividends from all 10/50 corporations of a foreign corporation’s 2004 taxable year, the deficit and associated taxes are treated
in the same manner as a deficit in post-1986 undistributed earnings attributable to dividends from a lower-tier 10/50 corporation. Accordingly, § 1.904–7T(f)(9)(ix) provides that the deficit is assigned to the look-through pools based on where the upper-tier corporation’s income and expenses or losses would have been assigned had they been incurred during a look-through period, or, if the taxpayer elects the safe harbor, the deficit is allocated based on how the taxpayer properly characterized the stock of the lower-tier corporation for purposes of apportioning the upper-tier corporation’s interest expense in its first taxable year with or within which the lower-tier corporation’s first post-2002 taxable year began. Where the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the deficit cannot reasonably be determined based on the available information, the Commissioner will assign the deficit and taxes to the upper-tier corporation’s passive category.

IX. Effective Date

Section 403 of the AJCA provides that the amendments apply to taxable years beginning after December 31, 2002. The statutory language and legislative history of the AJCA do not specifically state whether the effective date refers to the taxable year of the foreign corporation or that of the U.S. shareholder. The temporary regulations clarify that the effective date of the amendments refers to the foreign corporation’s taxable year, thereby eliminating the separate category for dividends from each 10/50 corporation as of the beginning of the foreign corporation’s first post-2002 taxable year. Thus, dividends paid by the foreign corporation on and after that date (including dividends paid in a U.S. shareholder’s pre-2003 taxable year) are eligible for look-through treatment. Basing the effective date on the foreign corporation’s taxable year eliminates the need to create and maintain multiple sets of look-through pools of a single foreign corporation that begin on different dates for different shareholders. Accordingly, the temporary regulations are effective for dividends paid in taxable years of 10/50 corporations beginning after December 31, 2002.

As discussed in the Background section of this document, section 403(l) of the GOZA provides a rule allowing taxpayers to elect not to apply the expanded look-through rules enacted in the AJCA to taxable years beginning in 2003 and 2004. As discussed in section VII above, the temporary regulations provide guidance on the time, form, and manner of the election as well as transition rules applicable to taxpayers that elect to apply the pre-AJCA rules governing 10/50 dividends to 2003 and 2004 taxable years.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble of the cross-referenced notice of proposed rulemaking published in this issue of the Federal Register.

Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is Ginny Chung, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part:

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

Par. 2. Section 1.861–9T is amended as follows:

1. Revise the last sentence of paragraph (f)(3)(iii).

2. Redesignate paragraph (f)(4) as paragraph (f)(5) and add a new paragraph (f)(4).

The revision and addition read as follows:

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

(f) * * * * * (i) The election shall be made by filing a statement described in § 1.964–1T(c)(3)(iii) at the time and in the manner described therein and providing a written notice described in § 1.964–1T(c)(3)(iii), except that no such statement or notice is required to be filed or sent before July 24, 2006. * * * * * (ii) * * * * * (j) of this section. A noncontrolled section 902 corporation that is not a controlled foreign corporation may elect to use a different method of apportionment than that elected by one or more of its shareholders. A noncontrolled section 902 corporation must use the same method of apportionment with respect to all its domestic corporate shareholders.

(ii) Manner of election. The election to use the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section may be made either by the noncontrolled section 902 corporation or by the majority domestic corporate shareholders (as defined in § 1.964–1T(c)(5)(ii)) on behalf of the noncontrolled section 902 corporation. The election shall be made by filing a statement described in § 1.964–1T(c)(3)(ii) at the time and in the manner described therein and providing a written notice described in § 1.964–1T(c)(3)(iii), except that no such statement or notice is required to be filed or sent before July 24, 2006.

(iii) Stock characterization. In general, the stock of a noncontrolled section 902 corporation shall be characterized in the hands of any domestic corporation that meets the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation, or in the hands of any member of the same qualified group as defined in section 902(b)(2), using the same method that the noncontrolled section 902 corporation uses to apportion its interest expense.
noncontrolled section 902 corporation shall be characterized as a passive category asset in the hands of any such shareholder that fails to meet the substantiation requirements of §1.904–5T(c)(4)(iii), or in the hands of any shareholder that is not eligible to compute an amount of foreign taxes deemed paid with respect to a dividend from the noncontrolled section 902 corporation for the taxable year. See §1.861–12T(c)(4).

(iv) Effective date. This paragraph (f)(4) applies for taxable years of shareholders ending after the first day of the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002.

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

1. Remove the language “directly by the taxpayer” from paragraph (c)(2)(i) introductory text and add the language “by the taxpayer either directly or, for taxable years beginning after April 25, 2006, indirectly through a partnership or other pass-through entity” in its place.

2. Revise paragraph (c)(4).

The revision reads as follows:

§1.861–12T Characterization rules and adjustment for certain assets (temporary regulations.)

(c) * * *

(4) Characterization of stock of noncontrolled section 902 corporations—(i) General rule. The principles of paragraph (c)(3) of this section shall apply to stock in a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)). Accordingly, stock in a noncontrolled section 902 corporation shall be characterized as an asset in the various separate limitation categories on the basis of either the asset method described in (c)(3)(ii) of this section or the modified gross income method described in (c)(3)(iii) of this section. Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of assets shall be characterized in the hands of its domestic shareholders (as defined in §1.902–1(a)(1)) under the asset method described in paragraph (c)(3)(ii). Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of gross income shall be characterized in the hands of its domestic shareholders under the gross income method described in paragraph (c)(3)(ii).

(ii) Nonqualifying shareholders. Stock in a noncontrolled section 902 corporation shall be characterized as a passive category asset in the hands of a shareholder that is not eligible to compute an amount of foreign taxes deemed paid with respect to a dividend from the noncontrolled section 902 corporation for the taxable year, and in the hands of any shareholder with respect to whom look-through treatment is not substantiated. See §1.904–5T(c)(4)(iii).

(iii) Effective date. This paragraph (c)(4) applies for taxable years of shareholders ending after the first day of the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002.

Par. 4. Section 1.902–0 is amended as follows:

1. Remove the entry for §1.902–1(a)(4) and add entries for §1.902–1(a)(4)(i) and (a)(4)(ii).

2. Revise the entry for §1.902–1(b).

3. Revise the entry for §1.902–1(c)(8), and add entries for §§1.902–1(c)(8)(i) and (ii).

4. Remove the entry for §1.902–1(c)(9).

5. Revise the entry for §1.902–1(d).

6. Remove the entries for §1.902–1(d)(3), (d)(3)(i), and (d)(3)(ii).

7. Revise the entries for §§1.902–2, 1.902–2(a), and 1.902–2(b).

The revisions and additions read as follows:

1.902–0 Outline of 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) * * *

(4) Third- or lower-tier corporation. (i) Third-tier corporation.

(ii) Fourth-, fifth-, or sixth-tier corporation.

(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, or lower-tier corporation.

(c) * * *

(8) Effect of certain liquidations, reorganizations, or similar transactions on certain foreign taxes paid or accrued in taxable years beginning on or before August 5, 1997.

(i) General rule.

(ii) Example.

(d) Dividends from controlled foreign corporations and noncontrolled section 902 corporations.

§1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first- or lower-tier corporation for purposes of computing an amount of foreign taxes deemed paid under §1.902–1.

(a) Carryback of deficits in post-1986 undistributed earnings of a first- or lower-tier corporation to pre-effective date taxable years.

(b) Carryforward of deficit in pre-1987 accumulated profits of a first- or lower-tier corporation to post-1986 undistributed earnings for purposes of section 902.

Par. 5. Section 1.902–1 is amended as follows:

1. Revise paragraph (a)(4).

2. Revise paragraph (a)(6).

3. Revise paragraph (a)(7).

4. Revise paragraph (a)(8)(i).

5. In paragraph (a)(8)(iii), add the language “in a taxable year beginning on or before December 31, 2002” after the language “(as defined in section 904(d)(2)(E))” and add the language “(26 CFR revised as of April 1, 2006)” after the language “§1.904–4(g)(2)(iii)”.

6. Revise the heading of paragraph (b).

7. Revise paragraph (c)(8).

8. Remove paragraph (c)(9).

9. Revise paragraphs (d)(1) and (d)(2)(i).

10. Remove paragraph (d)(3).

11. Revise paragraph (g).

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) * * *

(4) Third- or lower-tier corporation. (i) In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation’s voting stock and the product of the following equals at least 5 percent—

(A) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(B) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(C) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.
(ii) Fourth-, fifth-, or sixth-tier corporation. [Reserved]. For further guidance, see §1.902–1T(a)(4)(ii).

(6) Upper- and lower-tier corporations. [Reserved]. For further guidance, see §1.902–1T(a)(6).

(7) Foreign income taxes. [Reserved]. For further guidance, see §1.902–1T(a)(7).

(8) * * * (i) In general. [Reserved]. For further guidance, see §1.902–1T(a)(8)(i).

(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, or lower-tier corporation. *

(c) * * *

(8) Effect of certain liquidations, reorganizations, etc. on certain foreign income taxes paid or accrued in taxable years beginning on or before August 5, 1997. [Reserved]. For further guidance, see §1.902–1T(c)(8).

(d) Dividends from controlled foreign corporations and noncontrolled section 902 corporations—(1) General rule. [Reserved]. For further guidance, see §1.902–1T(d)(1).

(2) Look-through—(i) Dividends. [Reserved]. For further guidance, see §1.902–1T(d)(2)(i).

(g) Effective date. [Reserved]. For further guidance, see §1.902–1T(g).

See §1.902–1T Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation (temporary).

(i) Fourth-, fifth-, or sixth-tier corporation. In the case of dividends paid to a third-, fourth-, or fifth-tier corporation by a foreign corporation in a taxable year beginning after August 5, 1997, the foreign corporation is a fourth-, fifth-, or sixth-tier corporation, respectively, if at the time the dividend is paid, the corporation receiving the dividend owns at least 10 percent of the foreign corporation’s voting stock, the chain of foreign corporations that includes the foreign corporation is connected through stock ownership of at least 10 percent of their voting stock, the domestic shareholder in the first-tier corporation in such chain indirectly owns at least 5 percent of the voting stock of the foreign corporation through such chain, such corporation is a controlled foreign corporation (as defined in section 957) and the domestic shareholder is a United States shareholder (as defined in section 951(b)) in the foreign corporation. Taxes paid by a fourth-, fifth-, or sixth-tier corporation shall be taken into account in determining post-1986 foreign income taxes only if such taxes are paid with respect to taxable years beginning after August 5, 1997, in which the corporation was a controlled foreign corporation.

(4) Foreign income taxes. [Reserved]. For further guidance, see §1.902–1T(a)(5).


(7) Foreign income taxes. The term foreign income taxes means income, war profits, and excess profits taxes as defined in §1.902–1(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations thereunder. See sections 901(e), (h), (j), (k), and (l), and paragraphs (c)(4) and (c)(8) of this section.

(ii) Post-1986 foreign income taxes—(i) In general. Except as provided in paragraphs (a)(10) and (a)(13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation’s prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not attributable to dividends distributed to, or earnings otherwise included (e.g., under section 304, 367(b), 551, 951(a), 1248, or 1293) in the income of, a foreign or domestic shareholder in prior taxable years. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by the foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (e.g., an individual or a corporation that owns less than 10% of the foreign corporation’s voting stock), or to a foreign person that does not meet the definition of an upper-tier corporation under paragraph (a)(6) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. Further, if a domestic shareholder chooses to deduct foreign taxes paid or accrued for the taxable year of the distribution or inclusion, it shall nonetheless be deemed to have paid a proportionate share of the foreign
corporation’s post-1986 foreign income taxes under section 902(a), and the foreign income taxes deemed paid must be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(a)(8)(ii) through (c)(7) [Reserved]. For guidance, see § 1.902–1(a)(8)(ii) through (c)(7).

(b) Effect of certain liquidations, reorganizations, or similar transactions on certain foreign taxes paid or accrued in taxable years beginning on or before August 5, 1997—(i) General rule. Notwithstanding the effect of any liquidation, reorganization, or similar transaction, foreign taxes paid or accrued by a member of a qualified group (as defined in section 902(b)(2)) shall not be eligible to be deemed paid if they were paid or accrued in a taxable year beginning on or before August 5, 1997, by a corporation that was a fourth-, fifth- or sixth-tier corporation with respect to the taxpayer on the first day of the corporation’s first taxable year beginning after August 5, 1997.

(ii) Example. P, a domestic corporation, has owned 100 percent of the voting stock of foreign corporation S at all times since January 1, 1987. Until June 30, 2002, S owned 100 percent of the voting stock of foreign corporation T. T owned 100 percent of the voting stock of foreign corporation U, and U owned 100 percent of the voting stock of foreign corporation V. P, S, T, U, and V each use the calendar year as their U.S. taxable year. Thus, beginning in 1998 V was a fourth-tier controlled foreign corporation, and its foreign taxes paid or accrued in 1998 and later taxable years were eligible to be deemed paid. On June 30, 2002, T was liquidated, causing S to acquire 100 percent of the stock of U. As a result, V became a third-tier controlled foreign corporation. In 2003, V paid a dividend to U. Under paragraph (c)(8) of this section, foreign taxes paid by V in taxable years beginning before 1998 are not taken into account in computing the foreign taxes deemed paid with respect to the dividend paid by V to U.

(d) Dividends from controlled foreign corporations and noncontrolled section 902 corporations—(1) General rule. If a dividend is described in paragraphs (d)(1)(A) through (D) of this section, the following rules apply. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of a foreign corporation attributable to more than one separate category, the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to each separate category out of which the dividend is paid. See §§ 1.904–5T(c)(4), 1.904–5(i), and paragraph (d)(2) of this section. The separately computed deemed-paid taxes shall be added to other foreign taxes paid by the domestic shareholder or upper-tier corporation with respect to income in the appropriate separate category. The rules of this paragraph (d)(1) apply to dividends received by—

(A) A domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)) from a first-tier corporation that is a controlled foreign corporation;

(B) A domestic shareholder from a first-tier corporation that is a controlled foreign corporation;

(C) An upper-tier controlled foreign corporation from a lower-tier controlled foreign corporation if the corporations are related look-through entities within the meaning of § 1.904–5T(i)(3); or

(D) A foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1), from a controlled foreign corporation or a noncontrolled section 902 corporation (i.e., both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2) (see § 1.904–5T(i)(4)).

(2) Look-through—(i) Dividends. Any dividend distribution by a controlled foreign corporation or a noncontrolled section 902 corporation to a domestic shareholder or a foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1), from a controlled foreign corporation or a noncontrolled section 902 corporation (i.e., both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2) (see § 1.904–5T(i)(4)).

(ii) For further guidance, see § 1.902–1(e) through (f).

(iii) Effective dates. This section and § 1.902–1 apply to any distribution made in and after a foreign corporation’s first taxable year beginning on or after January 1, 1987, except that the provisions of paragraphs (a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), and (c)(8) of this section apply to distributions made in taxable years of foreign corporations beginning after April 25, 2006, and, except as provided in § 1.904–7T(f)(9), the provisions of paragraph (d) of this section apply to distributions in taxable years of foreign corporations beginning after December 31, 2002.

Par. 7. Section 1.902–2 is amended as follows:

1. Revise the section heading and the headings for paragraphs (a) and (b).

2. In paragraph (a)(1), remove two instances of the language “a first-, second- or third-tier corporation” and add the language “a first- or lower-tier corporation” in its place.

3. In paragraph (b)(1), remove the language “a first-, second- or third-tier corporation” and add the language “a first- or lower-tier corporation” in its place.

The revisions read as follows:

§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first- or lower-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902–1.

(a) Carryback of deficits in post-1986 undistributed earnings of a first- or lower-tier corporation to pre-effective date taxable years.

(b) Carryforward of deficits in pre-1987 accumulated profits of a first- or lower-tier corporation to post-1986 undistributed earnings for purposes of section 902.

Par. 8. Section 1.904–0 is amended as follows:

1. Add the entries for § 1.904–2(h), (h)(1), and (h)(2).

2. Revise the entry for § 1.904–4(c)(4).
§ 1.904–4(c)(5)(iv), and redesignate the entry for § 1.904–4(c)(5)(v) as § 1.904–4(c)(5)(iv).
§ 4. Remove the entries for § 1.904–4(g)(1) through (g)(3).
§ 5. Redesignate the entries for § 1.904–5(c)(2)(iii) and (iv) as § 1.904–5(c)(2)(iv) and (v), respectively, and add the entry for § 1.904–5(c)(2)(iii).
§ 6. Revise the entry for § 1.904–5(c)(4)(i), redesignate the entry for § 1.904–5(c)(4)(ii) as § 1.904–5(c)(4)(iv), and add the entry for § 1.904–5(c)(4)(iii).
§ 7. Remove the entry for § 1.904–5(f)(2), and redesignate the entries for § 1.904–5(f)(3) and (4) as § 1.904–5(f)(2) and (3), respectively.
§ 8. Revise the entry for § 1.904–5(m)(2)(i), redesignate the entry for § 1.904–5(m)(2)(ii) as § 1.904–5(m)(2)(iii), and add the entry for § 1.904–5(m)(2)(iv).
§ 9. Add the entries for § 1.904–5(o)(1) and (2).
§ 10. Revise the entry for § 1.904–5(a) through (g).
§ 11. Add the entry for § 1.904–7(f).
§ 12. Add the entry for § 1.904–12(g).

The revisions and additions read as follows:

**§ 1.904–0 Outline of regulations provisions for section 904.**

**§ 1.904–2 Carryback and carryover of unused foreign tax.**

(a) Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations.
(b) Carryback of unused foreign tax.
(c) Carryover of unused foreign tax.
(d) Treatment of non-look-through pools of a noncontrolled section 902 corporation or a controlled foreign corporation in post-2002 taxable years.
(e) Recapture in years beginning after December 31, 2002, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2003, with respect to the separate category for dividends from a noncontrolled section 902 corporation.

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

(a) Dividends and inclusions from controlled foreign corporations.
(b) Dividends and inclusions from noncontrolled section 902 corporations, and income of foreign QBUs.

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

(a) Credit for foreign tax carryback or carryover. [Reserved]. For further guidance, see § 1.904–27(a).
(b) Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations. [Reserved].

**§ 1.904–6 Allocation and apportionment of taxes.**

(a) * * *
(b) Reserve.

**§ 1.904–7 Transition rules.**

(a) * * *

**§ 1.904–12 Transition rules.**

(a) * * *

**§ 1.904–27 Carryback and carryover of unused foreign tax (temporary).**

(a) Credit for foreign tax carryback or carryover (temporary). A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(c). However, the taxes so deemed paid or accrued shall not be allowed as a deduction under section 164(a).

(b) through (g) of § 1.904–2 and § 1.904–3, providing rules for the computation of carryovers and carrybacks, do not reflect a number of intervening statutory amendments, including the redesignation of section 904(d) as section 904(c) for taxable years beginning after 1975, amendments to sections 904(d) and (f) regarding the application of separate limitations in taxable years beginning after 1986, the limitation of the carryback period to one year for unused foreign taxes arising in taxable years beginning after October 22, 2004, and the extension of the carryover period to ten years for unused foreign taxes that may be carried to any taxable year ending after October 22, 2004.

However, the principles of paragraphs (b) through (g) of § 1.904–2 and § 1.904–3 shall apply in determining carrybacks and carryovers of unused foreign taxes, modified so as to take into account the effect of statutory amendments. For transition rules relating to the carryover and carryback of unused foreign tax paid with respect to dividends from noncontrolled section 902 corporations, see paragraph (h) of this section. For special rules regarding these computations in case of taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907(f) and the regulations under that section.

(b) through (g) [Reserved]. For further guidance, see § 1.904–2(b) through (g).

(h) Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations (temporary). (1) Carryover of unused foreign tax. Except as provided in §§ 1.904–27(f)(9)(iv) and 1.904–12(f)(3), the rules of this paragraph (h)(1) apply to reallocate to the taxpayer’s other separate categories any unused foreign
taxes (as defined in §1.904–2(b)(2)) that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation beginning before January 1, 2003, which taxes were subject to a separate limitation for dividends from that noncontrolled section 902 corporation. To the extent any such unused foreign taxes are carried forward to a taxable year of a domestic shareholder beginning on or after the first day of the noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2002, such taxes shall be allocated among the taxpayer’s separate categories in the same proportions as the related dividend would have been assigned had such dividend been eligible for look-through treatment when paid. Accordingly, the taxes shall be allocated in the same percentages as the reconstructed earnings in the noncontrolled section 902 corporation’s non-look-through pool and pre-1987 accumulated profits that were accumulated in taxable years beginning before January 1, 2003, out of which the dividend was paid, in accordance with the rules of §1.904–7(f), or, if the taxpayer elects the safe harbor of §1.904–7(f)(4)(ii), in the same percentages as the taxpayer properly characterizes the stock of the noncontrolled section 902 corporation for purposes of apportioning its interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2002. See §1.904–7(f)(2) and (f)(4). In the case of unused foreign taxes allocable to dividends from a noncontrolled section 902 corporation with respect to which the taxpayer was no longer a domestic shareholder (as defined in §1.902–1(a)) as of the first day of such taxable year, such taxes shall be allocated among the taxpayer’s separate categories in the same percentages as the earnings in the noncontrolled section 902 corporation’s non-look-through pool or pre-1987 accumulated profits would have been assigned had they been distributed in the last taxable year in which the taxpayer was a domestic shareholder in such corporation. The unused foreign taxes that are carried forward shall be treated as allocable to general limitation income to the extent that such taxes would otherwise have been allocable to passive income, either on a look-through basis or as a result of inadequate substantiation under the rules of §1.904–7(f)(4).

(2) Carryback of unused foreign tax. The rules of this paragraph (b)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of a noncontrolled section 902 corporation beginning after December 31, 2002, which dividends were eligible for look-through treatment. To the extent any such unused foreign taxes are carried back to a prior taxable year of a domestic shareholder, a credit for such taxes shall be allowed only to the extent of the excess limitation in the same separate category or categories to which the related look-through dividend was assigned and not in any separate category for dividends from noncontrolled section 902 corporations.

Par. 11. Section 1.904–4 is amended as follows:

1. Revise paragraphs (c)(2)(i), (c)(3), (c)(4), and (c)(6)(iv)(B).
2. Remove paragraph (c)(5)(iv), and redesignate paragraph (c)(5)(v) as paragraph (c)(5)(iv).
3. In paragraph (e)(5)(iii), remove the language “and paragraph (9) of this section” and add the language “paid in taxable years beginning before January 1, 2003” in its place.
4. In paragraph (f), remove the language “received or accrued from a noncontrolled section 902 corporation,” and add the language “paid by a noncontrolled section 902 corporation in a taxable year beginning before January 1, 2003” in its place.
5. Revise the text of paragraph (g).

The revisions and additions read as follows:

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

* * * * *

(c) * * * (2) * * *

(i) Effective dates. [Reserved]. For further guidance, see §1.904–4T(c)(2)(i).

* * *

(3) and (4) [Reserved]. For further guidance, see §1.904–4T(c)(3) and (4).

* * * * *

(c)(6) * * * (iv) * * * (A) * * *

(B) Exception. For a special rule applicable to distributions prior to August 6, 1997, to U.S. shareholders not entitled to look-through treatment, see 26 CFR 1.904–4(c)(6)(iv)(B) (revised as of April 1, 2006).

* * * * *

(g) Noncontrolled section 902 corporation. See §1.904–5 for the treatment of dividends paid by a noncontrolled section 902 corporation in taxable years beginning after December 31, 2002. For rules applicable to dividends paid by noncontrolled section 902 corporations in taxable years beginning before January 1, 2003, see 26 CFR 1.904–4 (revised as of April 1, 2006).

* * * * *

Par. 12. Section 1.904–4T is added to read as follows:

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

(a) through (b) [Reserved]. For further guidance, see §1.904–4(a) through (b).

(c)(1) [Reserved]. For further guidance, see §1.904–4(c)(1).

(2) Grouping of items of income in order to determine whether passive income is high-taxed income—(i) Effective dates. For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3) and (c)(4) of this section apply to taxable years beginning after December 31, 2002. For corresponding rules applicable to taxable years beginning before January 1, 2003, see 26 CFR §1.904–4(c)(2)(i) (revised as of April 1, 2006).

(c)(2)[i] [Reserved]. For further guidance, see §1.904–4(c)(2)(ii).

(3) Amounts received or accrued by United States persons. Except as otherwise provided in §1.904–4(c)(5), all passive income received by a United States person shall be subject to the rules of this paragraph (c)(3). However, subpart F inclusions that are passive income, dividends from a controlled foreign corporation or noncontrolled section 902 corporation that are passive income, and income that is earned by a United States person through a foreign qualified business unit (foreign QBU) that is passive income shall be subject to the rules of this paragraph only to the extent provided in paragraph (c)(4) of this section. For purposes of this section, a foreign QBU is a QBU (as defined in section 989(a)), other than a controlled foreign corporation or noncontrolled section 902 corporation, that has its principal place of business outside the United States. These rules shall apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder, from a noncontrolled section 902 corporation of which the United States person is a domestic corporation meeting the stock ownership requirements of section 902(a), or from any other person. For purposes of determining whether passive income is high-taxed income, the following rules apply:

- - -
[i] All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.

(ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.

(iii) All passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income.

(iv) All passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled section 902 corporations, and income of foreign QBU's. Except as provided in paragraph (c)(5) of this section, all dividends and all amounts included in gross income of a United States shareholder under section 951(a)(1) with respect to the foreign corporation that (after application of the look-through rules of sections 904(d)(3) and §1.904–5) are attributable to passive income received or accrued by a controlled foreign corporation, all dividends from a noncontrolled section 902 corporation that are received or accrued by a domestic corporate shareholder meeting the stock ownership requirements of section 902(a) that (after application of the look-through rules of section 904(d)(4) and §1.904–5) are treated as passive income, and all amounts of passive income received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). This paragraph (c)(4) shall be applied separately to dividends and inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder and to dividends with respect to each noncontrolled section 902 corporation of which the taxpayer is a domestic corporate shareholder meeting the stock ownership requirements of section 902(a). This paragraph (c)(4) also shall be applied separately to income attributable to each QBU of a controlled foreign corporation, noncontrolled section 902 corporation, or any other look-through entity as defined in §1.904–5(i), except that if the entity subject to the look-through rules is a United States person, then this paragraph (c)(4) shall be applied separately only to each foreign QBU of that United States person.

(c)(4)(i) through (m) [Reserved]. For further guidance, see §1.904–4(c)(4)(i) through (m).

§ Par. 13. Section 1.904–5 is amended as follows:

1. Revise paragraph (a)(1).
2. Add paragraph (a)(4).
3. Revise paragraph (b).
4. Revise the heading of paragraph (c)(2)(i), redesignate paragraphs (c)(2)(ii) and (2)(iv) as paragraphs (c)(2)(iv) and (2)(v) and add a new paragraph (c)(2)(iii).
5. Revise the heading of paragraph (c)(4)(i), redesignate paragraph (c)(4)(iii) as paragraph (c)(4)(iv), and add a new paragraph (c)(4)(iii).
6. Remove paragraph (f)(2).
7. Redesignate paragraphs (f)(3) and (f)(4) as paragraphs (f)(2) and (f)(3), respectively.
8. Revise paragraphs (i)(1) and (i)(3), redesignate paragraph (i)(4) as paragraph (i)(5), add a new paragraph (i)(6), and add two examples at the end of newly designated paragraph (i)(5).
9. Revise paragraph (m)(1), redesignate paragraph (m)(2) as paragraph (m)(2)(i) and add a heading for newly designated paragraph (m)(2)(i), add new paragraph (m)(2)(ii), and revise paragraph (m)(4)(i).
10. Revise paragraph (n).
11. Revise the heading for paragraph (o), redesignate paragraph (o) as paragraph (o)(1), add a heading for newly redesignated paragraph (o)(1), and add new paragraph (o)(2).

The revisions read as follows:

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

(a) Definitions. For purposes of sections 904(d)(3) and 904(d)(4) and the regulations under section 904, the following definitions apply:

1. The term separate category means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (F), (G), (H), or (I) and in §1.904–4(b), (d), (e), and (f), 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.

2. and (3) [Reserved]. For further guidance, see §1.904–5(a)(2) and (3).

3. The term noncontrolled section 902 corporation means any foreign corporation with respect to which the taxpayer makes the stock ownership requirements of section 902(a), or, with respect to a lower-tier foreign corporation, the taxpayer meets the requirements of section 902(b). Except as provided in section 902 and the regulations under that section and paragraphs (i)(3) and (i)(4) of this section, a controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902(a) or (b) will be made with respect to the taxpayer’s indirect ownership, and not

(n) [Reserved]. For further guidance, see §1.904–5(n)

(o) Effective dates—(1) Rules for controlled foreign corporations and other look-through entities. * * *

(2) [Reserved]. For further guidance, see §1.904–5(o)(2).

§ Par. 14. Section 1.904–5T is added as follows:

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

(a) Definitions. For purposes of sections 904(d)(3) and 904(d)(4) and the regulations under section 904, the following definitions apply:

(i) * * *

(ii) Allocating and apportioning expenses of a controlled foreign corporation including interest paid to a related person. * * *

(iii) [Reserved]. For further guidance, see §1.904–5T(c)(2)(iii).

(i) Look-through rule for controlled foreign corporations. * * *

(ii) [Reserved]. For further guidance, see §1.904–5T(c)(4)(iii).

(i) [Reserved]. For further guidance, see §1.904–5T(l)(1).

(j) [Reserved]. For further guidance, see §1.904–5T(l)(3) and (4).

(m) * * *

(1) [Reserved]. For further guidance, see §1.904–5T(m)(1).

(2) * * *

(i) Interest payments from controlled foreign corporations. * * *

(2) [Reserved]. For further guidance, see §1.904–5T(m)(2).

* * *

(n) [Reserved]. For further guidance, see §1.904–5T(n)
the partnership’s direct ownership, in the foreign corporation. See section 902(b)(7).

(b) In general. Except as otherwise provided in section 904(d)(3) and (4) and this section, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as general limitation income. See § 1.904–5T(c)(4)(iii) for the treatment of dividends received by a domestic corporation from a noncontrolled section 902 corporation in which the domestic corporation meets the stock ownership requirements of section 902(a).

(c)(1) through (c)(2)(ii) [Reserved]. For further guidance, see § 1.904–5(c)(1) through (c)(2)(ii).

(iii) Allocating and apportioning expenses of a noncontrolled section 902 corporation. Expenses of a noncontrolled section 902 corporation shall be allocated and apportioned in the same manner as expenses of a controlled foreign corporation under § 1.904–5(c)(2)(iii), except that the related person interest rule of § 1.904–5(c)(2)(ii)(C) and (D) shall not apply.

(c)(2)(iv) through (c)(4)(ii) [Reserved]. For further guidance, see § 1.904–5(c)(2)(iv) through (c)(4)(ii).

(iii) Look-through rule for dividends from noncontrolled section 902 corporations. Except as otherwise provided in this subparagraph (iii), any dividend that is distributed by a noncontrolled section 902 corporation and received or accrued by a domestic corporation that meets the stock ownership requirements of section 902(a) shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the noncontrolled section 902 corporation. A dividend distributed by a noncontrolled section 902 corporation shall be treated as passive income if the look-through characterization of such dividend is not substantiated to the satisfaction of the Commissioner, or if such dividend is received or accrued by a shareholder that is neither a domestic corporation meeting the stock ownership requirements of section 902(a) nor a foreign corporation meeting the requirements of section 902(b). See § 1.904–5T(j)(4). See § 1.904–7 for transition rules concerning the treatment of undistributed earnings (or a deficit) of a noncontrolled section 902 corporation that were accumulated in taxable years beginning before January 1, 2003.

(c)(4)(iv) through (h) [Reserved]. For further guidance, see § 1.904–5(c)(4)(iv) through (h).

(i) Application of look-through rules to related entities—(1) In general. Except as provided in paragraphs (j)(2), (3), and (4) of this section, the principles of this section shall apply to distributions and payments that are subject to the look-through rules of section 904(d)(3) and this section from a controlled foreign corporation or other entity otherwise entitled to look-through treatment (a “look-through entity”) under this section to a related look-through entity. A noncontrolled section 902 corporation shall be considered a look-through entity only to the extent provided in paragraph (j)(4) of this section. Two look-through entities shall be considered to be related to each other if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of voting stock of the other entity or more than 50 percent of the total value of such entity. In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 318 and the regulations thereunder.

(2) [Reserved]. For further guidance, see § 1.904–5(i)(2).

(3) Special rule for dividends between controlled foreign corporations. Solely for purposes of dividend payments between controlled foreign corporations, two controlled foreign corporations shall be considered related look-through entities if the same United States shareholder owns, directly or indirectly, at least 10 percent of the total voting power of all classes of stock of each foreign corporation. If two controlled foreign corporations are not considered related look-through entities for purposes of this section because a United States shareholder does not satisfy the ownership requirement set forth in this paragraph (j)(3), the dividend payment will be characterized under the look-through rules of section 904(d)(4)(iv) of this section because the requirements set forth in paragraph (j)(4) of this section are satisfied.

(4) Payor and recipient of dividend are members of same qualified group. Solely for purposes of dividend payments in taxable years beginning after December 31, 2002, between controlled foreign corporations, noncontrolled section 902 corporations, or a controlled foreign corporation and a noncontrolled section 902 corporation, the payor and recipient corporations shall be considered related look-through entities if the corporations are members of the same qualified group as defined in section 902(b)(2) and the recipient corporation is eligible to compute foreign taxes deemed paid with respect to the dividend under section 902(b)(1).

(5) Examples. The following examples illustrate the provisions of this paragraph (j):

Examples 1 through 3. For further guidance, see § 1.904–5(j)(5) Examples 1 through 3.

Example 4. P, a domestic corporation, owns all of the voting stock of S, a controlled foreign corporation. S owns 5 percent of the voting stock of T, a controlled foreign corporation. The remaining 95 percent of the stock of T is owned by P. In 2006, T pays a $10 dividend to S and a $95 dividend to P. The dividend to S is not eligible for look-through treatment under paragraph (j)(4) of this section, and S is not eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are not members of the same qualified group (S owns less than 10 percent of the voting stock of T). See section 902(b) and § 1.902–1(a)(3). However, the dividend is eligible for look-through treatment under paragraph (j)(3) of this section because P owns at least 10 percent of the voting power of all classes of stock of both S and T. The dividend is subpart F income of S that is taxable to P.

Example 5. P, a domestic corporation, owns 50 percent of the voting stock of S, a controlled foreign corporation. S owns 10 percent of the voting stock of T, a controlled foreign corporation. The remaining 5 percent of the stock of S and the remaining 95 percent of the stock of T are owned, respectively, by X and Y. X and Y are each United States shareholders of T but are not related to P, S, or each other. In 2006, T pays a $100 dividend to S. The dividend is not eligible for look-through treatment under paragraph (j)(3) of this section because no United States shareholder owns at least 10 percent of the voting power of all classes of stock of both S and T (P and X each own only 5 percent of T). However, the dividend is eligible for look-through treatment under paragraph (j)(4) of this section, and S is eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are members of the same qualified group. See section 902(b) and § 1.902–1(a)(3). The dividend is subpart F income of S that is taxable to P and X.

(j) through (l) [Reserved]. For further guidance, see § 1.904–5(j) through (l).
(m) Application of section 904(g)—(1) In general. This paragraph (m) applies to certain amounts derived from controlled foreign corporations and noncontrolled section 902 corporations that are treated as United States-owned foreign corporations as defined in section 904(g)(6). For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation or noncontrolled section 902 corporation from sources within the United States under section 904(g)(3), the rules in paragraph (m)(2) of this section apply. For purposes of determining the portion of a dividend (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) that is received or accrued by a United States income under section 904(g)(1)(A) that is attributable to United States under section 904(g)(2), 904(g)(4), the rules in paragraph (m)(4) of this section apply. In order to determine the portion of an amount included in gross income under section 951(a)(1)(A) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904(g)(2), the rules in paragraph (m)(5) of this section apply. In order to determine whether section 904(g) applies, section 904(g)(5) (exception if a United States-owned foreign corporation has a de minimis amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation or noncontrolled section 902 corporation for a taxable year without regard to the characterization of those earnings under section 904(d).

(ii) Interest payments from noncontrolled section 902 corporations. If interest is received or accrued by a shareholder from a noncontrolled section 902 corporation (where the shareholder is a domestic corporation that meets the stock ownership requirements of section 902(a)), the rules of subparagraph (m)(2)(ii) apply in determining the portion of the interest payment that is from sources within the United States, except that the related party interest rules of subparagraph (c)(2)(ii)(C) shall not apply.

(3) [Reserved]. For further guidance, see §1.904–5(m)(3).

(4) Treatment of dividend payments—(i) Rule. Any dividend or distribution treated as a dividend under this section (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation, or any dividend that is received or accrued by a domestic corporate shareholder meeting the stock ownership requirements of section 902(a) from a noncontrolled section 902 corporation, shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation or noncontrolled section 902 corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation or noncontrolled section 902 corporation in that separate category.

(m)(4)(ii) through (7). [Reserved] For further guidance, see §1.904–5(m)(4)(ii) through (7).

(n) Order of application of sections 904(d) and (g). In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation or noncontrolled section 902 corporation to determine the amount of income and earnings and profits derived by the controlled foreign corporation or noncontrolled section 902 corporation in each separate category. The income and earnings and profits in each separate category that are from United States sources shall then be determined. Sections 904(d)(3), 904(d)(4), and 904(g), and this section shall then be applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder in the controlled foreign corporation or a domestic corporate shareholder that meets the stock ownership requirements of section 902(a) with respect to a noncontrolled section 902 corporation that is attributable or allocable to income or earnings and profits of the foreign corporation.

(o)(1) [Reserved]. For further guidance, see §1.904–5(o)(1).

(2) Rules for noncontrolled section 902 corporations. Except as provided in §1.904–7(f)(9), section 904(d)(4) and this section apply to distributions from a noncontrolled section 902 corporation that are paid during the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002, and thereafter, without regard to whether the corresponding taxable year of the recipient of the distribution begins after December 31, 2002, except that the provisions of paragraphs (m)(1), (m)(2)(ii), (m)(4)(i), and (n) apply to distributions from a noncontrolled section 902 corporation paid in taxable years of such corporation beginning after April 25, 2006. For corresponding rules applicable to taxable years beginning before January 1, 2003, see 26 CFR §1.904–5 (revised as of April 1, 2006).

Par. 15. Section 1.904–6 is amended as follows:

1. Revise paragraph (a)(2).
2. Revise paragraph (c) Example 6.
3. Remove paragraph (c) Example 7.
4. Redesignate paragraph (c) Example 8 as paragraph (c) Example 7.

The revisions read as follows:

§1.904–6 Allocation and apportionment of taxes.

(a) * * *

(2) [Reserved].

* * * * *

(c) Examples. * * *

Example 6. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that is incorporated in country X. In 2004, S has $100 of passive income, $200 of shipping income and $200 of general limitation income. S also has $100 of related person interest expense and $100 of other expenses that under foreign law are directly allocable to the general limitation income of S. S has no other expenses. Country X imposes a tax of 25 percent on all of the net income of S and S, therefore, pays $75 in foreign tax. Under paragraph (a)(1)(i) of this section, the passive income of S is first reduced by the amount of related person interest for purposes of determining the net amount for purposes of allocating the $75 of tax. Under paragraph (a)(1)(ii) of this section, the general limitation income of S is reduced by the $100 of other expenses. Therefore, $50 of the foreign tax is allocated to the shipping income of S ($50 = $75 × $200/$300), $25 is allocated to the general limitation income of S ($25 = $75 × $100/$300), and no taxes are allocated to S’s passive income.

* * * * *

Par. 16. Section 1.904–7 is amended by adding paragraph (f) to read as follows:

§1.904–7 Transition rules.

* * * * *

(f) [Reserved]. For further guidance, see §1.904–7(f).

Par. 17. Section 1.904–7T is added as follows:

§1.904–7T Transition rules (temporary).

(a) through (e) [Reserved]. For further guidance, see §1.904–7(a) through (e).

(f) Treatment of non-look-through pools of a noncontrolled section 902 corporation or a controlled foreign corporation in post-2002 taxable years—(1) Definition of non-look-through pools. The term non-look-through pools means the pools of post-1986 undistributed earnings (as defined in §1.902–1(a)(9)) that were accumulated, and post-1986 foreign income taxes (as defined in §1.902–1(a)(8)) paid, accrued, or deemed paid, in and after the first
taxable year in which the foreign corporation had a domestic shareholder (as defined in §1.902–1(a)(1)) but before any such shareholder was eligible for look-through treatment with respect to dividends from the foreign corporation.

(2) Treatment of non-look-through pools of a noncontrolled section 902 corporation. Any undistributed earnings in the non-look-through pool that were accumulated in taxable years beginning before January 1, 2003, by a noncontrolled section 902 corporation as of the last day of the corporation’s last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning after December 31, 2002, as they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation to a domestic shareholder under section 951 that is the gross income of a United States controlled foreign corporation out of such undistributed earnings and taxes are properly assigned on a look-through basis to the general limitation section to allocate the earnings and taxes in the non-look-through pool of S. As of December 31, 2002, S had $100 of post-1986 undistributed earnings and $100 of post-1986 foreign income taxes in its non-look-through pools. P does not elect the safe harbor method under paragraph (f)(4)(ii) of this section to allocate the earnings and taxes in the non-look-through pools to S’s other separate categories and does not attempt to substantiate the look-through characterization of S’s non-look-through pools. The Commissioner, however, reasonably determines, based on information used to characterize S’s stock for purposes of apportioning P’s interest expense in P’s 2003 and 2004 taxable years, that 100u of the earnings and all $100 of the taxes in the non-look-through pools are properly assigned to S’s other general limitation category, and 100u of earnings and no taxes are properly assigned on a look-through basis to the passive category. Therefore, in accordance with the Commissioner’s look-through characterization of the earnings and taxes in S’s non-look-through pools, on
corporation’s passive category. If, as of the end of a taxable year beginning after December 31, 2002, in which it pays a dividend, the foreign corporation has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), the deficit in post-1986 undistributed earnings shall be carried back to reduce pre-1987 accumulated profits, if any, on a last-in-first-out basis. See § 1.902–2(a)(1). If, as of the end of a taxable year beginning after December 31, 2002, in which the foreign corporation pays a dividend out of current earnings and profits, it has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), and the sum of current plus accumulated earnings and profits is zero or less than zero, no foreign taxes shall be deemed paid with respect to the dividend. See § 1.902–1(b)(4).

(6) Treatment of pre-1987 accumulated profits. Any pre-1987 accumulated profits (as defined in § 1.902–1(a)(10)) of a controlled foreign corporation or nonsection 902 corporation shall be treated in taxable years beginning after December 31, 2002, as if they were accumulated during a period in which a dividend paid by the foreign corporation would have been eligible for look-through treatment. In the case of a noncontrolled section 902 corporation, the deficit and taxes, if any, in the non-look-through pools shall constitute the opening balance of the look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the noncontrolled section 902 corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. In the case of a controlled foreign corporation, the deficit and taxes, if any, in the non-look-through pools shall be added to the balance of the look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the controlled foreign corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(4) of this section. If a taxpayer does not elect the safe harbor described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the deficit and taxes cannot reasonably be determined based on the available information, the Commissioner shall allocate the deficit and taxes, if any, in the non-look-through pools to the foreign corporation’s passive category. If, as of the end of a taxable year beginning after December 31, 2002, in which it pays a dividend, the foreign corporation has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), the deficit in post-1986 undistributed earnings shall be carried back to reduce pre-1987 accumulated profits, if any, on a last-in-first-out basis. See § 1.902–2(a)(1). If, as of the end of a taxable year beginning after December 31, 2002, in which the foreign corporation pays a dividend out of current earnings and profits, it has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), and the sum of current plus accumulated earnings and profits is zero or less than zero, no foreign taxes shall be deemed paid with respect to the dividend. See § 1.902–1(b)(4).

(7) Treatment of post-1986 undistributed earnings or a deficit of a controlled foreign corporation attributable to dividends from a noncontrolled section 902 corporation paid in taxable years beginning before January 1, 2003—(i) Look-through treatment of post-1986 undistributed earnings at controlled foreign corporation level. Dividends paid by a noncontrolled section 902 corporation to a controlled foreign corporation in post-1986 taxable years of the noncontrolled section 902 corporation beginning before January 1, 2003, were assigned to a separate category for dividends from that noncontrolled section 902 corporation. Beginning on the first day of the controlled foreign corporation’s first taxable year beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002, any post-1986 undistributed earnings, or previously-taxed earnings and profits described in section 959(c)(1) or (2), of the controlled foreign corporation in such a separate category shall be treated as if they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation would have been eligible for look-through treatment. Any post-1986 foreign income taxes in such a separate category shall also be treated as if they were paid, accrued or deemed paid during a period when such a dividend would have been eligible for look-through treatment. Any such post-1986 undistributed earnings and post-1986 foreign income taxes in a separate category for dividends from a noncontrolled section 902 corporation shall be added to the opening balance of the controlled foreign corporation’s look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the controlled foreign corporation’s first taxable year beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of such earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section.

(ii) Look-through treatment of deficit in post-1986 undistributed earnings at controlled foreign corporation level. If a controlled foreign corporation has a deficit in a separate category for dividends from a lower-tier noncontrolled section 902 corporation that is a member of the controlled foreign corporation’s qualified group as defined in section 902(b)(2), such deficit shall be treated in taxable years of the upper-tier corporation beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002, as if the deficit had been accumulated during a period in which a dividend from the...
lower-tier corporation would have been eligible for look-through treatment. Any post-1986 foreign income taxes in the separate category for dividends from the noncontrolled section 902 corporation shall also be treated as if they were paid, accrued or deemed paid during a period when the dividends were eligible for look-through treatment. The deficit and related post-1986 foreign income taxes, if any, shall be added to the opening balance of the controlled foreign corporation’s look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the controlled foreign corporation’s first taxable year beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section.

(iii) Substantiation required for look-through treatment. The taxpayer must substantiate the look-through characterization of post-1986 undistributed earnings, previously-taxed earnings and profits, or a deficit in post-1986 undistributed earnings in a separate category for dividends paid by a noncontrolled section 902 corporation in taxable years beginning before January 1, 2003, by making a reasonable, good-faith effort to reconstruct the earnings (or deficit) and taxes in the separate category at the level of the controlled foreign corporation on a look-through basis, in accordance with the principles of paragraph (f)(4)(i) of this section. Alternatively, the taxpayer may allocate the earnings (or deficit) and taxes to the controlled foreign corporation’s look-through pools by electing to apply the safe harbor described in paragraph (f)(4)(ii) at the level of the controlled foreign corporation. If the taxpayer so elects, the earnings (or deficit) and taxes shall be allocated to the controlled foreign corporation’s look-through pools in the appropriate separate categories on the first day of the controlled foreign corporation’s first taxable year beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002. The allocation shall be made in the same percentages as the controlled foreign corporation would properly characterize the stock of the lower-tier noncontrolled section 902 corporation in the separate categories for purposes of apportioning the controlled foreign corporation’s interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2002. Under §1.861–12T(c)(3), the apportionment ratios properly used by the controlled foreign corporation are in turn based on the apportionment ratios properly used by the noncontrolled section 902 corporation to apportion its interest expense in its first taxable year beginning after December 31, 2002. In the case of a taxpayer that elects to use the safe harbor rule where the lower-tier noncontrolled section 902 corporation uses the modified gross income method described in §1.861–9T(i) to apportion interest expense for its first taxable year beginning after December 31, 2002, earnings (or a deficit) and taxes in the separate category for dividends from the noncontrolled section 902 corporation shall be allocated to the look-through pools based on the average of the noncontrolled section 902 corporation’s modified gross income ratios for its taxable years beginning in 2003 and 2004. In the case of a controlled foreign corporation that has in its qualified group a chain of lower-tier noncontrolled section 902 corporations, the safe harbor applies first to characterize the stock of the third-tier corporation and then to characterize the stock of the second-tier corporation. Where a taxpayer elects the safe harbor with respect to a lower-tier noncontrolled section 902 corporation with respect to which the taxpayer did not meet the requirements of section 902(a) as of the end of the upper-tier controlled foreign corporation’s last taxable year beginning before January 1, 2003, the earnings (or deficit) and taxes in the separate category for dividends from the lower-tier corporation shall be allocated to the upper-tier corporation’s look-through pools in the separate categories in the same percentages as the stock of the lower-tier corporation would have been characterized for purposes of apportioning the upper-tier corporation’s interest expense in the last year the taxpayer met the ownership requirements of section 902(a) with respect to the lower-tier corporation if the look-through rules had applied in that year. If a taxpayer does not elect the safe harbor method described in this subparagraph (f)(7)(iii), and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the Commissioner shall allocate the earnings (or deficit) and associated foreign income taxes to the controlled foreign corporation’s passive category.

(8) Treatment of distributions received by an upper-tier corporation from a lower-tier noncontrolled section 902 corporation when the corporations do not have the same taxable years—(i) Rule. In the case of dividends paid by a lower-tier noncontrolled section 902 corporation to an upper-tier corporation where both are members of the same qualified group as defined in section 902(b)(2), the following rules apply. Dividends paid by the lower-tier corporation in taxable years beginning before January 1, 2003, are assigned to a separate category for dividends from that corporation, regardless of whether the corresponding taxable year of the recipient corporation began after December 31, 2002. Post-1986 undistributed earnings, previously-taxed earnings and profits, and post-1986 foreign income taxes in such a separate category shall be treated, beginning on the first day of the upper-tier corporation’s first taxable year beginning on or after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002, as if they were accumulated during a period when a dividend paid by the lower-tier corporation would have been eligible for look-through treatment under section 904(d)(2), and §1.904–5. Dividends paid by a lower-tier corporation in taxable years beginning after December 31, 2002, are eligible for look-through treatment when paid, without regard to whether the corresponding taxable year of the recipient upper-tier corporation began after December 31, 2002.

(ii) Example. The following example illustrates the application of paragraph (f) of this section:

Example. M, a domestic corporation, has directly owned 50 percent of the stock of X, and X has directly owned 50 percent of the stock of Y, at all times since X and Y were organized on January 1, 1990. Accordingly, X and Y are noncontrolled section 902 corporations with respect to M, and X and Y are members of the same qualified group. M and Y use the calendar year as their U.S. taxable year, and X uses a taxable year beginning on July 1. Under §1.904–4(g) and paragraph (f)(10) of this section, a dividend paid to M by X on January 15, 2003 (during X’s last pre-2003 taxable year) is not eligible for look-through treatment in 2003. However, under §1.861–12T(c)(4), M will characterize the stock of X on a look-through basis for purposes of interest expense apportionment in its 2003 taxable year. Under §1.904–4(b)(1), any unused foreign taxes in M’s separate category for dividends from X will be carried over to M’s other separate categories on a look-through basis for M’s taxable years beginning on and after January 1, 2004. Under paragraph (f)(2) of this section, any undistributed earnings and taxes in X’s non-look-through pools will be
allocated to X’s other separate categories on July 1, 2003. Under § 1.904–5(f)(4) and paragraphs (f)(8)(i) and (f)(10) of this section, a dividend paid to X by Y on January 15, 2003 (during Y’s first post-2002 taxable year) is eligible for look-through treatment when paid, notwithstanding that it is received in a pre-2002 taxable year of X.

(9) Election to apply pre-AJCA rules to 2003 and 2004 taxable years—(i) Definition. The term single category for dividends from all noncontrolled section 902 corporations means the separate category described in section 904(d)(1)(E) as in effect for taxable years beginning after December 31, 2002, and prior to its repeal by the American Jobs Creation Act (AJCA), Public Law 108–357, 118 Stat. 1418 (October 22, 2004).

(ii) Time, manner, and form of election. A taxpayer may elect not to apply the provisions of section 403 of the AJCA and to apply the rules of this paragraph (f)(9) to taxable years of noncontrolled section 902 corporations beginning after December 31, 2002, and before January 1, 2005, without regard to whether the corresponding taxable years of the taxpayer or any upper-tier corporation begin or after such dates. A taxpayer shall be eligible to make such an election provided that—

(A) The taxpayer’s tax liability as shown on an original or amended tax return for each of its affected taxable years is consistent with the rules of this paragraph (f)(9), the guidance set forth in Notice 2003–3 (2003–1 C.B. 294) (see §601.601(d)(2) of this chapter), and the principles of §1.861–12T(c)(4) for each such year for which the statute of limitations does not preclude the filing of an amended return;

(B) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this paragraph (f)(9) to years that are not open for assessment; and

(C) The taxpayer attaches a statement to its next tax return for which the due date (with extensions) is more than 90 days after April 25, 2006, indicating that the taxpayer elects not to apply the provisions of section 403 of the AJCA to taxable years of its noncontrolled section 902 corporations beginning in 2003 and 2004, and that the taxpayer has filed original returns or will file amended returns reflecting tax liabilities for each affected year that satisfy the requirements described in this paragraph (f)(9)(i).

(iii) Treatment of non-look-through pools in taxable years beginning after December 31, 2004. Undistributed earnings (or a deficit) and taxes shall be added to the foreign corporation’s pools of post-1986 foreign income taxes in the appropriate separate categories on the first day of the foreign corporation’s first taxable year beginning after December 31, 2004. In accordance with the principles of paragraph (f)(4) of this section, the taxpayer must reconstruct the non-look-through pools or, if the taxpayer elects the safe harbor, allocate the earnings and taxes in the non-look-through pools to the foreign corporation’s look-through pools in the appropriate separate categories on the first day of the foreign corporation’s first taxable year beginning after December 31, 2004. Under the safe harbor, this allocation is made in the same percentages as the taxpayer properly characterized the stock of the foreign corporation for purposes of apportioning the taxpayer’s interest expense in the taxpayer’s first taxable year ending after the first day of the foreign corporation’s first taxable year beginning after December 31, 2002. See §1.861–12T(c)(3) and (4). If a taxpayer does not elect the safe harbor described in paragraph (f)(4)(ii) and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the earnings (or deficit) and taxes shall be allocated to the foreign corporation’s passive category.

(iv) Carryover of unused foreign tax. To the extent that a taxpayer has unused foreign taxes in the single category for dividends from all noncontrolled section 902 corporations, such taxes shall be carried forward to the appropriate separate categories in the taxpayer’s taxable years beginning on or after the first day of the relevant noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2004. Such unused taxes shall be carried forward in the same manner as §1.904–27T(h)(1) provides that unused foreign taxes in the separate categories for dividends from each noncontrolled section 902 corporation are carried over to taxable years beginning on or after the first day of the noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2002, in the case of a taxpayer that does not make the election under paragraph (f)(9) of this section. The electing taxpayer shall determine which noncontrolled section 902 corporations paid the dividends to which the unused foreign taxes are attributable and assign the taxes to the appropriate separate categories as if such dividends had been eligible for look-through treatment when paid. Accordingly, the taxpayer must substantiate the look-through characterization of the unused foreign taxes in accordance with paragraph (f)(4) of this section by reconstructing the non-look-through pools or, if the taxpayer elects the safe harbor, by allocating the unused foreign taxes to other separate categories in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer’s interest expense for its first taxable year ending after the first day of the noncontrolled section 902 corporation’s first taxable year beginning after December 31, 2002. The rule described in this paragraph (f)(9)(iv) shall apply only to unused foreign taxes attributable to dividends out of earnings that were accumulated by noncontrolled section 902 corporations in taxable years of such corporations beginning before January 1, 2003, because only unused foreign taxes attributable to distributions out of pre-2003 earnings are included in the single category for dividends from all noncontrolled section 902 corporations.

To the extent that unused foreign taxes carried forward to the single category for dividends from all noncontrolled section 902 corporations under the rules of Notice 2003–5 (see §601.601(d)(2) of this chapter) were either absorbed by low-taxated dividends paid by noncontrolled section 902 corporations out of the non-look-through pool in taxable years of such corporations beginning in 2003 or 2004, or expired unused, the amount of taxes carried forward to the separate categories on a look-through basis will be smaller than the aggregate amount of taxes initially carried forward to the single category for dividends from all noncontrolled section 902 corporations. In this case, the unused foreign taxes arising in each taxable year shall be deemed attributable to each noncontrolled section 902 corporation in the same ratio as the dividends included in the separate category that were paid by such corporation in such year bears to all dividends paid by the noncontrolled section 902 corporations in such year. Unused foreign taxes
of apportioning the taxpayer’s interest expense for its first taxable year ending after the first day of such corporation’s first taxable year beginning after December 31, 2002, under § 1.861–12T(c)(3) or (c)(4), as the case may be. To the extent that a taxpayer has a balance in a separate limitation loss account for the single category for dividends from all noncontrolled section 902 corporations with respect to another separate category, and the separate limitation loss account would otherwise be assigned to that other category under this paragraph (f)(9)(vi), such balance shall be eliminated.

(vii) Recapture of separation limitation losses in other separate categories. To the extent that a taxpayer has a balance in any separate limitation loss account in a separate category with respect to the single category for dividends from all noncontrolled section 902 corporations at the end of the taxpayer’s last taxable year with or within which ends the last taxable year of the relevant noncontrolled section 902 corporation beginning before January 1, 2005, such loss shall be recaptured in subsequent taxable years as income in the appropriate separate category. The separate limitation loss account shall be deemed attributable on a pro rata basis to those noncontrolled section 902 corporations that paid dividends out of earnings accumulated in taxable years beginning before January 1, 2003, in the years in which the separate limitation loss in the other separate category arose. The ratable portions of the separate limitation loss account shall be recaptured as income in the taxpayer’s separate categories in the same percentages as the taxpayer properly characterized the stock of the relevant noncontrolled section 902 corporation for purposes of apportioning the taxpayer’s interest expense in its first taxable year ending after the first day of such corporation’s first taxable year beginning after December 31, 2002, under § 1.861–12T(c)(3) or (c)(4), as the case may be. To the extent that a taxpayer has a balance in any separate limitation loss account in any separate limitation loss account in any separate category that would have been eligible for look-through treatment. If the taxpayer elects the safe harbor rule described in paragraph (f)(7)(iii) of this section, the earnings and taxes shall be allocated based on the apportionment ratios properly used by the lower-tier corporation to apportion its interest expense for its first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section. If the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the earnings cannot reasonably be determined based on the available information, the earnings and taxes shall be assigned to the upper-tier corporation’s passive category.

(ix) Treatment of a deficit in the single category for dividends from lower-tier noncontrolled section 902 corporations. Where a controlled foreign corporation or noncontrolled section 902 corporation had an aggregate deficit in the single category for dividends from all noncontrolled section 902 corporations as of the end of the upper-tier corporation’s last taxable year beginning before January 1, 2005, such deficit and the associated post-1986 foreign income taxes, if any, shall be allocated to the upper-tier corporation’s other separate categories in the same percentages in which the non-look-through pools of each lower-tier corporation to which the deficit is attributable were assigned to such corporation’s other separate categories in its first taxable year beginning after December 31, 2002. If the taxpayer
elects the safe harbor rule described in paragraph (f)(7)(iii) of this section, the deficit and taxes shall be allocated based on how the taxpayer properly characterized the stock of the lower-tier noncontrolled section 902 corporation for purposes of apportioning the upper-tier corporation’s interest expense for the upper-tier corporation’s first taxable year ending after the first day of the lower-tier corporation’s first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section. If the taxpayer does not elect the safe harbor and the Commissioner determines that the look-through characterization of the deficit cannot reasonably be determined based on the available information, the deficit and taxes shall be assigned to the upper-tier corporation’s passive category.

(10) Effective date. Except in the case of a taxpayer that makes the election under paragraph (f)(9) of this section, section 904(d)(4) and this paragraph (f) shall apply to dividends from a noncontrolled section 902 corporation that are paid during the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002, and thereafter, without regard to whether the corresponding taxable year of the recipient of the dividend begins after December 31, 2002. In the case of a taxpayer that makes the election under paragraph (f)(9) of this section, the provisions of section 403 of the AJCA, including section 904(d)(4), and this paragraph (f) shall apply to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2004, without regard to whether the corresponding taxable year of the recipient of the dividend begins after December 31, 2004.

§1.904(f)(12T) Transition rules (temporary).

(a) through (f) [Reserved]. For further guidance, see §1.904(f)(12T)(a) through (f).

(g) Recapture in years beginning after December 31, 2002, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2003, with respect to the separate category for dividends from a noncontrolled section 902 corporation—(1) Section 1.904(f). Recapture of separate limitation loss or overall foreign loss incurred in a separate category for dividends from a noncontrolled section 902 corporation. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a separate category for dividends from a noncontrolled section 902 corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer’s last taxable year beginning before January 1, 2003, the amount of such balance shall be allocated on the first day of the taxpayer’s next taxable year to the taxpayer’s other separate categories. The amount of such balance shall be allocated in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer’s interest expense for its first taxable year ending after the first day of such corporation’s first taxable year beginning after December 31, 2002, under §1.861–12T(c)(3) or (c)(4), as the case may be. To the extent a taxpayer has a balance in any separate limitation loss account in a separate category for dividends from a noncontrolled section 902 corporation with respect to another separate category, and the separate limitation loss would otherwise be assigned to that other category under this paragraph (g)(1), such balance shall be eliminated.

(2) Recapture of separate limitation loss in another separate category. To the extent that a taxpayer has a balance in any separate limitation loss account in a separate category with respect to a separate category for dividends from a noncontrolled section 902 corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer’s last taxable year with or within which ends the last taxable year of the noncontrolled section 902 corporation beginning before January 1, 2003, such loss shall be recaptured in subsequent taxable years as income in the appropriate separate categories. The separate limitation loss shall be recaptured as income in other separate categories in the same percentages as the taxpayer properly characterizes the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer’s interest expense in its first taxable year ending after the first day of the foreign corporation’s first taxable year beginning after December 31, 2002, under §1.861–12T(c)(3) or (c)(4), as the case may be. To the extent a taxpayer has a balance in a separate limitation loss account in a separate category that would have been recaptured as income in that same category under this paragraph (g)(2), such balance shall be eliminated.

(3) Exception. Where a taxpayer formerly met the stock ownership requirements of section 902(a) with respect to a foreign corporation, but did not meet the requirements of section 902(a) on December 20, 2002 (or on the first day of the taxpayer’s first taxable year beginning after December 31, 2002, in the case of a transaction that was the subject of a binding contract in effect on December 20, 2002), if the taxpayer has a balance in any separate limitation loss or overall foreign loss account for a separate category for dividends from that foreign corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer’s last taxable year beginning before January 1, 2003, then the amount of such balance shall not be subject to recapture under section 904(f) and this section. If a separate limitation loss or overall foreign loss account for such category is subject to recapture under this paragraph (g)(3), the taxpayer cannot carry over any unused foreign taxes in such separate category to any other limitation category. However, a taxpayer may elect to recapture the balances of all separate limitation loss and overall foreign loss accounts for all separate categories for dividends from such formerly-owned noncontrolled section 902 corporations under the rules of paragraphs (g)(1) and (2) of this section. If a taxpayer so elects, it may carry over any unused foreign taxes in these separate categories to the appropriate separate categories as provided in §1.904–27T(b).

(4) Examples. The following examples illustrate the application of this paragraph (g):

Example 1. X is a domestic corporation that meets the ownership requirements of
section 902(a) with respect to Y, a foreign corporation the stock of which X owns 50 percent. Therefore, Y is a noncontrolled section 902 corporation with respect to X. Both X and Y use the calendar year as their taxable year. As of December 31, 2002, X had a $100 balance in its separate limitation loss account for the separate category for dividends from Y, of which $80 offset general limitation income and $40 offset passive income. For purposes of apportioning X’s interest expense for its 2003 taxable year, X properly characterized the stock of Y as a multiple category asset (80% general and 20% passive). Under paragraph (g)(1) of this section, on January 1, 2003, $80 ($100 \times 80/100) of the $100 balance in the separate limitation loss account is assigned to the general limitation category. Of this $80 balance, $32 ($80 \times 40/100) is with respect to the passive category, and $48 ($80 \times 60/100) is with respect to the general limitation category and therefore is eliminated. The remaining $20 balance ($100 \times 20/100) of the $100 balance is assigned to the passive category. Of this $20 balance, $12 ($20 \times 60/100) is with respect to the general limitation category, and $8 ($20 \times 40/100) is with respect to the passive category and therefore is eliminated.

Example 2. The facts are the same as in Example 1, except that as of December 31, 2002, X had a $30 balance in its separate limitation loss account in the general limitation category, and a $20 balance in its separate limitation loss account in the passive category, both of which offset income in the separate category for dividends from Y. Under paragraph (g)(2) of this section, the separate limitation loss accounts in the general limitation and passive categories with respect to the separate category for dividends from Y will be recaptured on and after January 1, 2003, from income in other separate categories, as follows. Of the $30 balance in X’s separate limitation loss account in the general limitation category with respect to the separate category for dividends from Y, $6 ($30 \times 20/100) is with respect to the passive category, and $24 ($30 \times 80/100) is with respect to the general limitation category and therefore is eliminated. Of the $20 balance in X’s separate limitation loss account in the passive category with respect to the separate category for dividends from Y, $16 ($20 \times 80/100) will be recaptured out of general limitation income, and $4 ($20 \times 20/100) would otherwise be recaptured out of passive income and therefore is eliminated.

(5) Effective date. This paragraph (g) shall apply for taxable years beginning after December 31, 2002.

Par. 20. aSection 1.964–1 is amended as follows:

1. In the first sentence of paragraph (a) introductory text, remove the language “For purposes of section 951 through 964” and add “For taxable years beginning after December 31, 1986,” in its place, and remove the language “, except as provided in paragraph (f) of this section,”.

2. Remove paragraphs (a)(4) and (a)(5), add the word “and” at the end of paragraph (a)(2), replace the semicolon with a period at the end of paragraph (a)(3), and remove the language “may be made by following the procedures described in paragraphs (a)(1) through (5)” in the first sentence of the undesignated paragraph following paragraph (a)(3) and add the language “shall be made in the foreign corporation’s functional currency (determined under section 985 and the regulations under that section) and may be made by following the procedures described in paragraphs (a)(1) through (a)(3)” in its place.

3. Add a new sentence at the end of paragraph (a)(1).

4. Add a new paragraph (c)(1)(v).

5. Revise paragraphs (c)(2), (c)(3), (c)(4), (c)(5), and (c)(6).

6. Remove paragraphs (d), (e), and (f).

The revisions read as follows:

§ 1.964–1 Determination of the earnings and profits of a foreign corporation.

(a) * * * *(1) * * * For rules for determining the earnings and profits (or deficit in earnings and profits) of a foreign corporation for taxable years beginning before January 1, 1987, for purposes of sections 951 through 964, see 26 CFR 1.964–1(a) [revised as of April 1, 2006].

*(c) * * * * *(1) * * *

(v) [Reserved]. For further guidance, see § 1.964–1T(c)(1)(v).

(c)(2) through (c)(6) [Reserved]. For further guidance, see § 1.964–1T(c)(2) through (c)(6).

Par. 21. Section 1.964–1T is amended as follows:

1. Revise the section heading.

2. Add new paragraph (c)(1)(v).

3. Add new paragraphs (c)(2) through (8).

4. Add new paragraphs (d), (e), and (f).

The revisions and additions read as follows:

§ 1.964–1T Determination of the earnings and profits of a foreign corporation (temporary).

(a) Through (c)(1)(iv) [Reserved]. For further guidance, see § 1.964–1–1(a) through (c)(1)(iv).

(v) Taxable years. The period for computation of taxable income and earnings and profits known as the taxable year shall reflect the provisions of section 441 and the regulations thereunder.

(2) Adoption or change of method or taxable year. For the first taxable year of a foreign corporation beginning after April 25, 2006, in which a foreign corporation is a controlled foreign corporation (as defined in section 957 or 953) or a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)), any method of accounting or taxable year allowable under this section may be adopted, and any election allowable under this section may be made, by such foreign corporation or on its behalf notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. Any allowable methods adopted or elections made shall be reflected in the computation of the foreign corporation’s earnings and profits for such taxable year, prior taxable years, and (unless the Commissioner consents to a change) subsequent taxable years. However, see section 898 for the rules regarding the taxable year of a specified foreign corporation as defined in section 898(b). Any allowable method of accounting or election that relates to events that first arise in a subsequent taxable year may be adopted or made by or on behalf of the foreign corporation for such year. See paragraph (a)(3) of this section for the manner in which a method of accounting or a taxable year may be adopted or changed on behalf of the foreign corporation. See paragraph (c)(4) and (g)(3) of this section for applicable rules if the amount of the foreign corporation’s earnings and profits became significant for United States tax purposes before a method of accounting or taxable year was adopted by the foreign corporation or on its behalf in accordance with the rules of paragraph (c)(3) of this section. See paragraphs (c)(6) and (g)(2) of this section for special rules postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant for U.S. tax purposes.

(3) Action on behalf of corporation—

(i) In general. An election shall be deemed made, or an adoption or change in method of accounting or taxable year deemed effected, on behalf of the foreign corporation or on its behalf in accordance with the rules of paragraph (c)(3) of this section if it is controlling domestic shareholders (as defined in paragraph (c)(5) of this section)—

(A) Satisfy for such corporation any requirements imposed by the Internal Revenue Code or applicable regulations with respect to such election or such adoption or change in method or taxable year (including the provisions of sections 442 and 446 and the regulations thereunder, as well as any administrative provisions), such as the filing of forms, the execution of consents, securing the permission of the
Commissioner, or maintaining books and records in a particular manner. For purposes of this paragraph (c)(3)(i)(A), the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling domestic shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner;

(B) File the statement described in paragraph (c)(3)(ii) of this section, at the time and in the manner prescribed therein; and

(C) Provide the written notice required by paragraph (c)(3)(iii) of this section at the time and in the manner prescribed therein.

(ii) Statement required to be filed with a tax return. The statement required by this paragraph (c)(3)(ii) shall set forth the name, country of organization, and U.S. employer identification number (if applicable) of the foreign corporation, the nature and amount of the stock interests, and U.S. employer identification number of each controlling domestic shareholder (or, if applicable, the shareholder’s common parent) approving the action, and the names, addresses, U.S. employer identification numbers, and stock interests of all other domestic shareholders notified of the action taken. Such statement shall describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or its common parent). However, the failure of the controlling domestic shareholders to provide such notice to a person required to be notified shall not invalidate the election made or the adoption or change of method or taxable year effected.

(4) Effect of action or inaction by controlling domestic shareholders. Any action taken by the controlling domestic shareholders on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the tax liability of all domestic shareholders of the foreign corporation. See §1.964–1T(g)(5). In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in paragraph (c)(6) of this section and such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause, such action may be undertook during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. The principles of §1.964–1T(g)(5) and (g)(4) shall apply in determining the effect of a failure of the controlling domestic shareholders to take action on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section.

Accordingly, if the earnings and profits of a noncontrolled section 902 corporation became significant for United States income tax purposes in a taxable year beginning on or before April 25, 2006, the corporation’s earnings and profits shall be computed as if no elections had been made and any permitting accounting methods not requiring an election and reflected in the books of account regularly maintained by the foreign corporation for purposes of accounting to its shareholders had been adopted. Any change in accounting method may be made by or on behalf of the foreign corporation only with the Commissioner’s consent.

(5) Controlling domestic shareholders—(i) Controlled foreign corporation. For purposes of this paragraph, the controlling domestic shareholders of a controlled foreign corporation shall be its controlling United States shareholders. The controlling United States shareholders of a controlled foreign corporation shall be those United States shareholders (as defined in section 951(b) or 953(c)) who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote and who undertake to act on its behalf. In the event that the United States shareholders of the controlled foreign corporation do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote, the controlling United States shareholders of the controlled foreign corporation shall be all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation.

(ii) Noncontrolled section 902 corporations. For purposes of this paragraph, the controlling domestic shareholders of a noncontrolled section 902 corporation that is not a controlled foreign corporation shall be its majority domestic corporate shareholders. The majority domestic corporate shareholders of a noncontrolled section 902 corporation shall be those domestic corporations that meet the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as defined in section 902(b)(2) as the noncontrolled section 902 corporation) that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all of the voting stock of the noncontrolled section 902 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation (or a relevant first-tier foreign corporation).

(6) Action not required until significant. Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) to make an election or to adopt a taxable year or method of accounting shall not be required until the due date (including extensions) of the return for a controlling domestic shareholder’s first taxable year with or within which ends the foreign corporation’s first taxable year in which the computation of its earnings and profits is significant for United States shareholders or the foreign corporation’s stockholders or the foreign corporation pursuant to paragraph (c)(3) of this section.
tax purposes with respect to its controlling domestic shareholders (as defined in § 1.964–1T(c)(5)). The filing of the information return required by section 6038 shall not itself constitute a significant event. For taxable years beginning on or after April 25, 2006, events that cause a foreign corporation’s earnings and profits to have United States tax significance include, without limitation,

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

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

(iii) An amount is excluded from subpart F income of the foreign corporation by reason of section 952(c);

(iv) Any event making the foreign corporation subject to tax under section 882;

(v) The use by the foreign corporation’s controlling domestic shareholders of the tax book value (or alternative tax book value) method of allocating interest expense under section 864(e)(4); or

(vi) A sale or exchange of the foreign corporation’s stock of the controlling domestic shareholders that results in the recharacterization of gain under section 1248.

(c)(7) and (8) [Reserved]. For further guidance, see § 1.964–1T(c)(7) and (c)(8) and § 1.964–1T(g)(6).

(d) Through (f) [Reserved].

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 22. The authority citation for part 602 continues to read as follows:


Par. 23. In § 602.101, paragraph (b) is amended by adding the following entries in numerical order to the table to read, in part, as follows:

<table>
<thead>
<tr>
<th>CFR part or section where identified and described</th>
<th>Current OMB Control No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.904–7T ...........................................</td>
<td>1545–2104</td>
</tr>
<tr>
<td>1.964–1T ...........................................</td>
<td>1545–2104</td>
</tr>
</tbody>
</table>

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: April 14, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

[FR Doc. 06–3882 Filed 4–20–06; 3:51 pm]
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