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List of Subjects in 23 CFR Part 655

Design standards, Grant programs—Transportation, Highways and roads, Incorporation by reference, Signs, Traffic regulations.

Issued on: December 13, 2007.

J. Richard Capka,

Federal Highway Administrator.

■ In consideration of the foregoing, the FHWA is amending title 23, Code of Federal Regulations, part 655, subpart F as follows:

PART 655—TRAFFIC OPERATIONS

1. The authority citation for part 655 continues to read as follows:

Authority: 23 U.S.C. 101(a), 104, 109(d), 114(a), 217, 315 and 402(a); 23 CFR 1.32; and 49 CFR 1.48(b).

Subpart F—Traffic Control Devices on Federal-Aid and Other Streets and Highways—[Amended]

■ 2. Revise § 655.601(a), to read as follows:

§ 655.601 Purpose.

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(a) Manual on Uniform Traffic Control Devices for Streets and Highways (MUTCD), 2003 Edition, including Revision No. 1, FHWA, dated November 2004, and revision No. 2, FHWA, dated January 2008. This publication is incorporated by reference in accordance with 5 U.S.C. 552(a) and 1 CFR part 51 and is on file at the National Archives and Record Administration (NARA). For information on the availability of this material at NARA call (202) 741-6030, or go to http://www.archives.gov/federal_register/code_of_federal_regulations/ibr_locations.html. It is available for inspection at the Federal Highway Administration, 1200 New Jersey Ave., SE., Washington, DC 20590, as provided in 49 CFR part 7. The text is also available from the FHWA Office of Transportation Operations' Web site at <http://mutcd.fhwa.dot.gov>.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9368]

RIN 1545-BG55

Reduction of Foreign Tax Credit Limitation Categories Under Section 904(d)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary Income Tax Regulations regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Internal Revenue Code (Code). Section 404 of the American Jobs Creation Act of 2004 (AJCA) reduced the number of section 904(d) separate categories from eight to two, effective for taxable years beginning after December 31, 2006. These temporary regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the AJCA. The text of these temporary regulations also serves as the text of the proposed regulations (REG-114126-07) set forth in the notice of proposed rulemaking on this subject published elsewhere in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on December 21, 2007.

Applicability Dates: For dates of applicability, see §§ 1.904-2T(i)(3), 1.904-4T(n), 1.904-5T(o)(3), 1.904-7T(g)(6), and 1.904(f)-12T(h)(6). These regulations apply to taxable years of United States taxpayers beginning after December 31, 2006, and ending on or after December 21, 2007, and to taxable years of foreign corporations which end with or within taxable years of their domestic corporate shareholders beginning after December 31, 2006, and ending on or after December 21, 2007.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry (202) 622-3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the regulations under section 904 relating to the application of separate foreign tax credit limitations to certain categories of income under section 904(d), as amended by the AJCA. Prior to the effective date of the AJCA amendments (that is, for taxable years

beginning before January 1, 2007 (“pre-2007 taxable years”), the foreign tax credit limitation applied separately to the following categories of income: passive income, high withholding tax interest, financial services income, shipping income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, certain distributions from a FSC or former FSC, and any other income not described in this sentence (“general limitation income”). Other provisions of the Code that subject other categories of income to separate foreign tax credit limitations were not amended by the AJCA. See, for example, sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(h)(10); see also H.R. Rep. No. 108-755, at 383 (October 7, 2004).

Effective for taxable years beginning after December 31, 2006 (“post-2006 taxable years”), the AJCA reduced the number of section 904(d) separate categories to two categories for “passive category income” and “general category income.” New section 904(d)(2)(A) defines passive category income as passive income and specified passive category income, and general category income as income other than passive category income. In addition, new section 904(d)(2)(C) and (D) provides rules concerning the treatment of financial services income and companies.

These temporary regulations modify the regulations under section 904 to reflect the new separate categories for passive category income and general category income, and provide transition rules for the treatment of earnings and profits and foreign income taxes of controlled foreign corporations and noncontrolled section 902 corporations accumulated in pre-2007 taxable years, overall foreign losses and separate limitation losses under section 904(f), and the carryover and carryback of excess foreign taxes under section 904(c).

Explanation of Provisions

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

Section 904(d)(2)(K)(i), as added by the AJCA, provides that excess taxes carried from a pre-2007 taxable year to a post-2006 taxable year shall be assigned to the post-2006 separate categories based on where the related income would have been assigned had such taxes been paid or accrued in a post-2006 taxable year.

Consistent with this statutory amendment, § 1.904-2T(i)(1)(i) provides that if a taxpayer carries over to a post-2006 taxable year any excess taxes that

were paid, accrued, or deemed paid with respect to income in any pre-2007 separate category, the excess taxes are assigned to the appropriate post-2006 separate category as if the taxes had been paid or accrued in a post-2006 taxable year. For example, to the extent that any taxes were related to income that would have been treated as high-taxed income under section 904(d)(2)(B)(iii)(II), such taxes will be assigned to the post-2006 separate category for general category income.

Because the IRS and the Treasury Department recognize that taxpayers may face difficulties in reconstructing excess taxes accounts, § 1.904-2T(i)(1)(ii) of the temporary regulations provides a safe harbor. Under the safe harbor, a taxpayer may assign excess taxes in any pre-2007 separate category, except the passive category, to the post-2006 separate category for general category income. The safe harbor provides that excess taxes in the pre-2007 passive category will be assigned to the post-2006 separate category for passive category income.

Section 904(d)(2)(K)(ii), as added by the AJCA, authorizes the Secretary to issue regulations for allocating carrybacks of excess taxes with respect to income from a post-2006 taxable year to a pre-2007 taxable year for purposes of allocating the excess taxes among the separate categories in effect for the taxable year to which carried. The IRS and the Treasury Department believe that it is appropriate to allow a taxpayer to reconstruct separate categories of income earned and excess taxes paid or accrued in its first post-2006 taxable year as if the pre-2007 rules applied. Accordingly, § 1.904-2T(i)(2)(i) provides that if a taxpayer carries back excess taxes paid, accrued, or deemed paid with respect to income in the post-2006 separate category for passive category income or general category income to a pre-2007 taxable year, the excess taxes are assigned to the appropriate pre-2007 separate category or categories as if the taxes had been paid or accrued in a pre-2007 taxable year. Section 1.904-2T(i)(2)(ii) provides that a taxpayer may, in lieu of reconstruction, assign excess taxes in the separate category for general category income to the pre-2007 general category, and excess taxes in the separate category for passive category income to the pre-2007 passive category.

II. Definition of Passive Category Income

New section 904(d)(2)(A)(i) defines passive category income as passive income and specified passive category income. New section 904(d)(2)(B)(i)

generally defines passive income as “any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as defined in section 954(c)).” Passive income includes amounts includible in gross income under section 1293, except as provided in section 904(d)(3)(H) (providing that look-through treatment applies to an amount included in gross income under section 1293 if the passive foreign investment company is a controlled foreign corporation (CFC) and the taxpayer is a United States shareholder in such CFC) and section 904(d)(2)(E)(ii) (providing that an inclusion under section 1293 with respect to a foreign corporation that is a noncontrolled section 902 corporation with respect to the taxpayer shall be treated as a dividend from such corporation). See section 904(d)(2)(B)(ii). Passive income does not include export financing interest and high-taxed income. See section 904(d)(2)(B)(iii). New section 904(d)(2)(B)(iv) provides that in determining whether income is of a kind which would be foreign personal holding company income, the rules of section 864(d)(6) apply only in the case of income of a CFC.

New section 904(d)(2)(B)(v) defines specified passive category income as dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States, taxable income attributable to foreign trade income (FTI) within the meaning of section 923(b), and distributions from a FSC or former FSC out of earnings and profits attributable to FTI (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in FTI (as defined in section 923(b)).

The temporary regulations reflect the new definitions of passive category income, passive income, and specified passive category income. Section 1.904-4T(b)(3) incorporates the definition of specified passive category income in section 904(d)(2)(B)(v), which includes dividends from DISCs, distributions from FSCs, and FTI. Because these types of income constitute specified passive category income and not passive income, such income can never qualify as financial services income that could be treated as general category income.

The final regulations at § 1.904-5(h)(3) currently provide that gain from the sale of a partnership interest is assigned to the separate category for passive income. Section 954(c)(4), which was enacted by the AJCA, provides a look-through rule for sales of

25-percent-owned partnerships. Because the definition of passive income in section 904(d)(2)(B) refers to section 954(c), these temporary regulations revise § 1.904-5(h)(3) to reflect that gain on the sale of a partnership interest by a 25-percent partner is assigned to the separate category for general category income, to the extent that, under the section 954(c)(4) look-through rule, the gain is not classified as foreign personal holding company income.

III. Definition of Financial Services Income

Section 904(d)(2)(C)(i), as amended by the AJCA, provides that financial services income shall be treated as general category income in the case of a member of a financial services group and any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business. New section 904(d)(2)(C)(ii) defines a financial services group as “any affiliated group (as defined in section 1504(a) without regard to paragraphs (2) and (3) of section 1504(b)) which is predominantly engaged in the active conduct of a banking, insurance, financing or similar business.” In determining whether a group is so engaged, only the income of members of the group that are U.S. corporations or CFCs in which U.S. corporations own, directly or indirectly, at least 80 percent of the vote or value of the stock are taken into account. Section 904(d)(2)(C)(iii) provides that the Secretary “shall by regulation specify for purposes of this subparagraph the treatment of financial services income received or accrued by partnerships and by other pass-thru entities which are not members of a financial services group.”

Section 904(d)(2)(D), as amended by the AJCA, generally adopts the definition of financial services income of former section 904(d)(2)(C)(i) and (ii), except that it includes neither the rule providing that financial services income includes export financing interest that would be high withholding tax interest, nor the exception in former section 904(d)(2)(C)(iii) for high withholding tax interest and export financing interest that would not be high withholding tax interest. New section 904(d)(2)(D)(i) defines financial services income as “any income which is received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing or similar business,” and which is either described in section 904(d)(2)(D)(ii) (which provides a general description of financial services income) or is passive income (determined without regard to

whether it is high-taxed). An item of income satisfies the general description of financial services income if such income is (1) derived in the active conduct of a banking, financing, or similar business; (2) derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business; or (3) of a kind which would be insurance income as defined in section 953(a) determined without regard to section 953(a)(1)(A), which limits insurance income to income from countries other than the country in which the corporation was created or organized. See section 904(d)(2)(D)(ii).

The final regulations at § 1.904-4(e) provide rules concerning the separate category for financial services income. Section 1.904-4(e)(1) provides a general definition of financial services income. Section 1.904-4(e)(2) provides an exclusive list describing items of income that are treated as active financing income. Section 1.904-4(e)(3)(i) provides that a person is considered to be predominantly engaged in the active financing business for any taxable year if for that year at least 80 percent of its gross income is active financing income, as defined in § 1.904-4(e)(2).

On June 26, 2007, the IRS and the Treasury Department issued Notice 2007-58, 2007-29 IRB 88 (see § 601.601(d)(2)(ii)(b)), in which the IRS and the Treasury Department announced that in light of the amendments to the foreign tax credit rules in the AJCA, they were reviewing the provisions relating to financial services income, active financing income, and financial services entities in § 1.904-4(e). The Notice also solicited comments relating to these definitions. The IRS and the Treasury Department received several written comments and are continuing to study this issue. Accordingly, the rules of § 1.904-4(e) of the current final regulations are not being revised at this time.

IV. Pre-2007 Separate Categories

To reflect the reduction of separate categories, §§ 1.904-4(d) (definition of high withholding tax interest), 1.904-4(f) (definition of shipping income), and 1.904-4(g) (treatment of dividends from a noncontrolled section 902 corporation) are reserved.

It should be noted that the separate category for shipping income remained effective for taxable years beginning before January 1, 2007. Section 415 of the AJCA repealed the foreign base company shipping income rules of section 954(f), effective for taxable years

of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Notice 2007-13, 2007-5 IRB 410, stated that in light of the repeal of section 954(f), § 1.954-1(e)(4)(i)(A) (providing a trump rule for income that qualifies as foreign base company shipping income) is obsolete, and § 1.954-6 (providing rules for determining foreign base company shipping income) is effective only for purposes of applying the rules for the withdrawal of previously excluded subpart F income from qualified investments. However, a technical correction in the Tax Increase Prevention and Reconciliation Act of 2005 confirmed that the separate category for shipping income is defined by reference to shipping income as defined in section 954(f) prior to its repeal. Accordingly, the subpart F shipping regulations continued to apply for section 904(d) purposes, and the separate category for shipping income continued to exist, through the end of taxable years beginning before 2007. See § 601.601(d)(2)(ii)(b).

The final regulations at §§ 1.904-4(h) (definition of and rules relating to treatment of export financing interest), 1.904-4(i) (concerning the interaction of section 907(c) and § 1.904-4), 1.904-4(j) (concerning DASTM gain or loss), 1.904-4(l) (priority rules for income meeting the definitions of more than one pre-2007 separate category), and 1.904-5 have been revised to reflect the new separate categories for passive category income and general category income.

V. Post-1986 Undistributed Earnings and Post-1986 Foreign Income Taxes of a Foreign Corporation as of the End of the Corporation's Last Pre-2007 Taxable Year

A. General Rule of Reconstruction

If a dividend is paid, or an amount is included in the gross income of a U.S. shareholder under section 951, 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 upper-tier corporation under section 902 or 960 is computed separately with respect to the post-1986 undistributed earnings (or pre-1987 accumulated profits) in each separate category out of which the dividend is paid or to which the subpart F inclusion is attributable. See §§ 1.902-1T(d)(1); 1.960-1(i)(1). The temporary regulations implement the reduction of

separate categories under the AJCA by recharacterizing the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the pre-2007 separate categories as pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the separate categories for passive category income and general category income on the first day of the foreign corporation's first post-2006 taxable year.

Section 1.904-7T(g)(2) of the temporary regulations provides that in the case of a CFC or noncontrolled section 902 corporation that has pools of post-1986 undistributed earnings and post-1986 foreign income taxes in any pre-2007 separate category, the earnings and foreign income taxes that exist as of the end of the foreign corporation's last pre-2007 taxable year are treated as if they were accumulated and paid during a period when the post-2006 rules applied, including the rules under section 904(d)(3)(E). Recharacterized amounts of earnings and taxes are taken into account in determining the opening balance of the post-1986 undistributed earnings and post-1986 foreign income taxes pools in each of the foreign corporation's post-2006 separate categories on the first day of the foreign corporation's first post-2006 taxable year.

Section 1.904-7T(g)(3)(i) of the temporary regulations provides that in order to substantiate the recharacterization of the pools of post-1986 undistributed earnings and post-1986 foreign income taxes in any pre-2007 separate category, the pools must be reconstructed for each pre-2007 taxable year, beginning with the first year in which earnings were accumulated in the pool with respect to each such pre-2007 separate category. Earnings are treated as if they were accumulated in a period when the post-2006 rules applied, taking into account earnings distributed and taxes deemed paid pro rata from the amounts that were added to the pools in each separate category in subsequent pre-2007 taxable years. As reconstructed, the pools of earnings and taxes in a pre-2007 separate category are assigned to the post-2006 separate categories on the first day of the foreign corporation's first post-2006 taxable year. (A hovering deficit is subject to the same rules for purposes of identifying the post-2006 separate categories to which the deficit is assigned, but the hovering deficit is not included in determining the opening balance of the pool. See § 1.367(b)-7.)

Similar rules apply to assign to the post-2006 separate categories amounts

of previously-taxed earnings and profits described in section 959(c)(1)(A), accumulated deficits, and pre-1987 accumulated profits in pre-2007 separate categories. For example, if there is an accumulated deficit in any pre-2007 separate category as of the end of a CFC's or noncontrolled section 902 corporation's last pre-2007 taxable year, the deficit and associated taxes (if any) are treated in the same manner as if there had been positive accumulated earnings and taxes in the separate category, that is, the deficit and taxes are treated as if the post-2006 rules applied in the year the deficit was accumulated and the taxes were paid. The earnings and deficits in earnings making up the accumulated deficit are assigned to the post-2006 separate categories based on where those items of income and expenses or losses would have been assigned had they been incurred when the post-2006 rules were in effect. As reconstructed, the deficit is taken into account in determining the opening balance of the post-1986 undistributed earnings pool in the appropriate post-2006 separate category or categories on the first day of the foreign corporation's first post-2006 taxable year.

The IRS and the Treasury Department recognize that shareholders may face difficulties in reconstructing historical accumulated earnings and taxes accounts of a foreign corporation. Therefore, a reasonable approximation of the amounts properly included in the post-2006 separate categories, based on available records obtained through reasonable, good-faith efforts by the taxpayer, will adequately substantiate reconstruction.

B. Safe Harbors

1. In General

For pools of undistributed earnings and foreign income taxes in the pre-2007 separate categories of CFCs and noncontrolled section 902 corporations, the temporary regulations provide that a taxpayer may elect to apply one of two safe harbors in lieu of reconstructing historical accumulated earnings and taxes accounts of the foreign corporation. See § 1.904-7T(g)(3)(ii). The safe harbors apply to allocate post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and pre-1987 accumulated profits and associated foreign income taxes in a foreign corporation's pre-2007 separate categories. Amounts allocated to the post-2006 separate categories under a safe harbor are taken into account in computing the opening balance of the post-1986 undistributed

earnings and post-1986 foreign income taxes pools, as well as pre-1987 accumulated profits and pre-1987 foreign income taxes, in each of the foreign corporation's post-2006 separate categories on the first day of the foreign corporation's first post-2006 taxable year.

2. General Safe Harbor

Under § 1.904-7T(g)(3)(ii)(B)(1) of the temporary regulations, the safe harbor for post-1986 undistributed earnings and post-1986 foreign income taxes (as well as deficits and previously-taxed earnings, and pre-1987 accumulated profits, if any) in a CFC's or noncontrolled section 902 corporation's pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC provides that such earnings and taxes are allocated to the post-2006 separate category for passive category income. Under § 1.904-7T(g)(3)(ii)(B)(2), the safe harbor for post-1986 undistributed earnings and post-1986 foreign income taxes (as well as deficits, previously-taxed earnings, and pre-1987 accumulated profits, if any) in a CFC's or noncontrolled section 902 corporation's pre-2007 separate category for financial services income, shipping income, or general limitation income provides that such earnings and taxes are allocated to the post-2006 separate category for general category income.

Under § 1.904-7T(g)(3)(ii)(B)(3), the safe harbor for post-1986 undistributed earnings and post-1986 foreign income taxes (as well as deficits, previously-taxed earnings, and pre-1987 accumulated profits, if any) in a CFC's or noncontrolled section 902 corporation's pre-2007 separate category for high withholding tax interest generally provides that such earnings and taxes are allocated to the post-2006 separate category for passive category income. However, § 1.904-7T(g)(3)(ii)(B)(4) provides that if a CFC has positive post-1986 undistributed earnings or pre-1987 accumulated profits and foreign income taxes attributable to high-withholding tax interest, such earnings and taxes are allocated to the post-2006 separate category for general category income if the earnings would qualify as income subject to high foreign taxes under section 954(b)(4) if the entire amount of earnings in the pre-2007 pool in the separate category for high withholding tax interest were treated as a net item of income subject to the rules of § 1.954-1(d). If the earnings would not qualify as income subject to high

foreign taxes under section 954(b)(4), the earnings and taxes are allocated to the post-2006 separate category for passive category income. The IRS and the Treasury Department believe that, given that high withholding tax interest generally constitutes subpart F income unless it is high-taxed, this safe harbor is an appropriate alternative to reconstructing earnings and taxes in a CFC's separate category for high withholding tax interest.

3. Interest Apportionment Safe Harbor

A second safe harbor is provided under § 1.904-7T(g)(3)(ii)(C) which allows taxpayers to allocate the post-1986 undistributed earnings and post-1986 foreign taxes (and deficits, previously-taxed earnings, and pre-1987 accumulated profits, if any) in a CFC's or noncontrolled section 902 corporation's pre-2007 pools following the principles of the safe harbor method described in the transition rules under § 1.904-7T(f)(4)(ii) for post-1986 undistributed earnings and post-1986 foreign income taxes in the non-look-through pool of a controlled foreign corporation or noncontrolled section 902 corporation.

4. Election of Safe Harbor

To allocate pools of undistributed earnings (and deficits, previously-taxed earnings, and pre-1987 accumulated profits, if any) and foreign income taxes in the pre-2007 separate categories of a CFC or noncontrolled section 902 corporation to the foreign corporation's post-2006 separate categories, the temporary regulations at § 1.904-7T(g)(3)(iii) provide that a taxpayer may elect to apply a safe harbor in lieu of reconstruction on a separate-category-by-separate-category basis. If a taxpayer elects to apply a safe harbor to allocate pre-2007 pools of more than one pre-2007 separate category of a foreign corporation, the same safe harbor (that is, the general safe harbor described in § 1.904-7T(g)(3)(ii)(B) or the interest apportionment safe harbor described in § 1.904-7T(g)(3)(ii)(C)) shall then apply to allocate the pre-2007 pools of all of the foreign corporation's pre-2007 separate categories for which the taxpayer elects to apply a safe harbor method in lieu of reconstructing the pre-2007 pools.

C. Post-1986 Undistributed Earnings and Taxes of Lower-Tier Foreign Corporations

The transition rules described in Sections V.A. and B in this preamble apply to post-1986 undistributed earnings and post-1986 foreign income taxes (as well as deficits, previously-

taxed earnings, and pre-1987 accumulated profits, if any) not only of a first-tier foreign corporation but also of lower-tier foreign corporations as well. See § 1.904-7T(g)(5). Accordingly, to the extent a lower-tier foreign corporation has pools of post-1986 undistributed earnings (attributable to amounts not yet included in gross income by the U.S. shareholder) and foreign income taxes in a pre-2007 separate category, the rules of § 1.904-7T(g) apply in treating the earnings and taxes as the opening balance of the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate post-2006 separate category or categories on the first day of the foreign corporation's first post-2006 taxable year. Similarly, pre-1987 accumulated profits and pre-1987 foreign income taxes in a pre-2007 separate category of a lower-tier foreign corporation are allocated to the appropriate post-2006 separate categories in accordance with the rules of § 1.904-7T(g).

VI. Separate Limitation Losses and Overall Foreign Losses

Because the AJCA reduced the number of section 904(d) separate categories from eight to two for post-2006 taxable years, the temporary regulations provide transition rules for recapture in a post-2006 taxable year of an overall foreign loss (OFL) or separate limitation loss (SLL) in a pre-2007 separate category that offset U.S. source income or income in another pre-2007 separate category, respectively, in a pre-2007 taxable year.

Section 1.904(f)-12T(h)(1) of the temporary regulations provides that to the extent a taxpayer has an OFL or SLL at the end of the taxpayer's last pre-2007 taxable year in the pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC, such OFL or SLL is allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category for passive category income. Accordingly, such OFL or SLL will be subject to recapture in subsequent taxable years out of the taxpayer's passive category income. Where a taxpayer has an SLL in some other pre-2007 separate category (for example, a general limitation SLL) that offset passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC, the SLL will be

recaptured in subsequent taxable years as passive category income.

Section 1.904(f)-12T(h)(2) of the temporary regulations provides that to the extent a taxpayer has an OFL or SLL at the end of the taxpayer's last pre-2007 taxable year in the pre-2007 separate category for financial services income, shipping income, or general limitation income, such OFL or SLL is allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category for general category income. Accordingly, such OFL or SLL will be subject to recapture in subsequent taxable years out of the taxpayer's general category income. Where a taxpayer has an SLL in some other pre-2007 separate category (for example, a passive SLL) that offset financial services income, shipping income, or general limitation income, the SLL will be recaptured in subsequent taxable years as general category income.

Section 1.904(f)-12T(h)(3) provides that to the extent a taxpayer has an OFL or SLL at the end of the taxpayer's last pre-2007 taxable year in the pre-2007 separate category for high withholding tax interest, the allocation of such OFL or SLL to the taxpayer's post-2006 separate categories depends on the taxpayer's allocation of excess taxes in the high withholding tax interest loss category for carryover purposes. Accordingly, if the excess taxes are assigned to the appropriate post-2006 separate category or categories based on reconstruction (that is, treating the taxes as if they had been paid or accrued in a post-2006 taxable year under § 1.904-2T(i)(1)(i)), the OFL or SLL is allocated pro rata to the taxpayer's post-2006 separate categories based on the proportions in which the excess high withholding taxes are assigned to the post-2006 separate categories. If instead the taxpayer elects to assign the excess taxes to the post-2006 separate category for general category income under the safe harbor described in § 1.904-2T(i)(1)(ii), the OFL or SLL is also allocated to the same post-2006 general category. If there are no excess taxes in the loss category that are carried over to post-2006 taxable years, an OFL or SLL in the pre-2007 separate category for high withholding tax interest is allocated to the post-2006 separate category for passive category income.

Similarly, where a taxpayer has an SLL in a pre-2007 separate category that offset high withholding tax interest, the SLL will be recaptured in subsequent taxable years pro rata as income in the post-2006 separate categories for general category income and passive category income based on how the taxpayer

allocated excess taxes in the pre-2007 separate category for high withholding tax interest under § 1.904-2T(i)(1). If no excess taxes in the pre-2007 separate category for high withholding tax interest are carried over to post-2006 taxable years, the SLL will be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income.

Section 1.904-12T(h)(4) provides that after application of paragraphs (1) through (3), any separate limitation loss account allocated to the post-2006 separate category for passive category income for which income is to be recaptured as passive category income will be eliminated, since "recapture" to and from the same category would be meaningless. For the same reason, any separate limitation loss accounts allocated to the post-2006 separate category for general category income for which income is to be recaptured as general category income will be eliminated.

Section 1.904-12T(h)(5) provides that taxpayers may in the alternative determine the treatment of OFLs and SLLs in pre-2007 separate categories following the principles of the transition rules of § 1.904-12T(g)(1) and (2) concerning the treatment of OFLs and SLLs in the separate category for dividends from a noncontrolled section 902 corporation.

Effective/Applicability Date

The effective date for these regulations is December 21, 2007. The temporary regulations apply to taxable years of United States taxpayers beginning after December 31, 2006, and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within a taxable year of its domestic corporate shareholder beginning after December 31, 2006, and ending on or after December 21, 2007.

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, this regulation

has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

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

■ **Par. 2.** Section 1.904-0 is amended as follows:

- 1. Add the entry for § 1.904-2(i).
- 2. Remove and reserve the entries for § 1.904-4(a), (b), (d), (f), (g), (h)(3), and (l).
- 3. Remove and reserve the entry for § 1.904-5(h)(3).
- 4. Add and reserve the entry for § 1.904-5(o)(3).
- 5. Add the entry for § 1.904-7(g).
- 6. Add the entry for § 1.904(f)-12(h).

The revisions and additions read as follows:

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

* * * * *

§ 1.904-2 Carryback and carryover of unused foreign tax.

* * * * *

(i) [Reserved].

* * * * *

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

(a) [Reserved].

(b) [Reserved].

* * * * *

(d) [Reserved].

* * * * *

(f) [Reserved].

(g) [Reserved].

* * * * *

(h)(3) [Reserved].

* * * * *

(l) [Reserved].

* * * * *

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

* * * * *

(h) * * *

(3) [Reserved].

* * * * *

(o) * * *

(3) [Reserved].

§ 1.904-7 Transition rules.

* * * * *

(g) [Reserved].

§ 1.904(f)-12 Transition rules.

* * * * *

(h) [Reserved].

■ **Par. 3.** Section 1.904-2 is amended by adding paragraph (i) to read as follows:

§ 1.904-2 Carryback and carryover of unused foreign tax.

* * * * *

(i) [Reserved.] For further guidance, see § 1.904-2T(i).

■ **Par. 4.** Section 1.904-2T is amended by adding paragraph (i) to read as follows:

§ 1.904-2T Carryback and carryover of unused foreign tax (temporary).

* * * * *

(i) *Transition rules for carryovers and carrybacks of pre-2007 and post-2006 unused foreign tax*—(1) *Carryover of unused foreign tax*—(i) *General rule.* For purposes of this paragraph (i), the terms *post-2006 separate category* and *pre-2007 separate category* have the meanings set forth in § 1.904-7T(g)(1)(ii) and (iii). The rules of this paragraph (i)(1) apply to reallocate to the taxpayer's post-2006 separate categories for general category income and passive category income 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 income in a pre-2007 separate category (other than a category described in § 1.904-4(m)). To the extent any such unused foreign taxes are carried forward to a taxable year beginning after December 31, 2006, such taxes shall be allocated to the taxpayer's post-2006 separate categories to which those taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning after December 31, 2006. For example, any foreign taxes paid or accrued or deemed paid with respect to financial services income in a taxable year beginning before January 1, 2007, that are carried forward to a taxable year beginning after December 31, 2006, will be allocated to the general category because the financial services income to which those taxes relate would have been allocated to the general category if it had been earned in a taxable year beginning after December 31, 2006.

(ii) *Safe harbor.* In lieu of applying the rules of paragraph (i)(1)(i) of this section, a taxpayer may allocate all unused foreign taxes in the pre-2007 separate category for passive income to the post-2006 separate category for passive category income, and allocate all other unused foreign taxes described in paragraph (i)(1)(i) of this section to the post-2006 separate category for general category income.

(2) *Carryback of unused foreign tax*—(i) *General rule.* The rules of this paragraph (i)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to income in a post-2006 separate category (other than a category described in § 1.904-4(m)). To the extent any such unused foreign taxes are carried back to a taxable year beginning before January 1, 2007, a credit for such taxes shall be allowed only to the extent of the excess limitation in the pre-2007 separate category, or categories, to which the taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning before January 1, 2007. For example, any foreign taxes paid or accrued or deemed paid with respect to income in the general category in a taxable year beginning after December 31, 2006, that are carried back to a taxable year beginning before January 1, 2007, will be allocated to the same separate categories to which the income would have been allocated if it had been earned in a taxable year beginning before January 1, 2007.

(ii) *Safe harbor.* In lieu of applying the rules of paragraph (i)(2)(i) of this section, a taxpayer may allocate all unused foreign taxes in the post-2006 separate category for passive category income to the pre-2007 separate category for passive income, and may allocate all other unused foreign taxes described in paragraph (i)(2)(i) of this section to the pre-2007 separate category for general limitation income.

(3) *Effective/applicability date.* This paragraph (i) applies to taxable years of United States taxpayers beginning after December 31, 2006 and ending on or after December 21, 2007.

(4) *Expiration date.* The applicability of this paragraph (i) expires on December 20, 2010.

■ **Par. 5.** Section 1.904-4 is amended as follows:

- 1. In the table below, for each section listed in the left column, remove the language in the middle column and add the language in the right column.
- 2. Paragraphs (a),(b), (d), (f), (g), (h)(3) and (l) are revised.
- 3. Paragraph (h)(4) *Example 2* is removed.

- 4. Paragraph (h)(4) *Example 3* is redesignated as *Example 2*.
- 5. Paragraph (h)(4) (*Example 4*) is redesignated as *Example 3* and in the last sentence the language “general

- limitation” is removed and the language “general category” is added in its place.
- 6. Paragraphs (h)(5)(iii) *Example 2* and (h)(5)(iii) *Example 4* are removed.
- 7. Paragraph (h)(5)(iii) *Example 3* is redesignated as *Example 2* and in the

last sentence the language “general limitation” is removed and the language “general category.” is added in its place.
The revisions read as follows:

Section	Remove	Add
1.904-4(c)(1), third sentence	general limitation	general category.
1.904-4(c)(1), third sentence	general limitation	general category.
1.904-4(c)(1), fourth sentence	general limitation	general category.
1.904-4(c)(6)(iii), second sentence	general limitation	general category.
1.904-4(c)(6)(iii), fifth sentence	general limitation	general category.
1.904-4(c)(6)(iv)(A), first sentence	general limitation	general category.
1.904-4(c)(7)(i), second sentence	general limitation	general category.
1.904-4(c)(7)(iii), third sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 1</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 1</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 2</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 3</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 5</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 6</i> , seventh sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 8</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 9</i> (i), last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 9</i> (ii), first sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 9</i> (ii), last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 11</i> , first sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 11</i> , last sentence	general limitation	general category.
1.904-4(c)(8) <i>Example 12</i> , third sentence	general limitation	general category.
1.904-4(h)(2)	general limitation	general category.
1.904-4(h)(5)(i), first sentence	that is not a financial services entity	
1.904-4(h)(5)(i), first sentence	general limitation	general category.
1.904-4(h)(5)(i), last sentence	If a financial services entity receives or accrues that income, the income shall not be considered to be export financing interest and, therefore, shall be treated as financial services income.	
1.904-4(h)(5)(ii), first sentence	904(d)(2)(A)(iii)(II)	904(d)(2)(B)(iii)(I).
1.904-4(h)(5)(ii), first sentence	general limitation	general category.
1.904-4(h)(5)(ii), first sentence	unless the interest is received or accrued by a financial services entity.	
1.904-4(h)(5)(ii), last sentence	If that interest also would be high withholding tax interest but for section 904(d)(2)(B)(ii), then the interest shall be treated as financial services income.	
1.904-4(h)(5)(iii) <i>Example 1</i> , last sentence	general limitation	general category.
1.904-4(i), second sentence	Thus, for example, if a taxpayer receives or accrues a dividend distribution from two separate noncontrolled section 902 corporations out or earnings and profits attributable to income received or accrued by the non-controlled section 902 corporations that is income described in section 907(c), the rules provided in section 907 shall apply separately to the dividends received from each noncontrolled section 902 corporation..	
1.904-4(j), last sentence	904(d)(2)(A)(iii)(III)	904(d)(2)(B)(iii)(II).
1.904-4(m)	904(g)(10)	904(h)(10)
1.904-4(m)	and (d)(3)(F)(i).	

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

- (a) [Reserved]. For further guidance, see § 1.904-4T(a).
- (b) [Reserved]. For further guidance, see § 1.904-4T(b).
- * * * * *
- (d) [Reserved].
- * * * * *
- (f) [Reserved]. For further guidance, see § 1.904-4T(f).

- (g) [Reserved]. For further guidance, see § 1.904-4T(g).
- * * * * *
- (h) * * *
- (3) [Reserved]. For further guidance, see § 1.904-4T(h)(3).
- * * * * *
- (l) [Reserved]. For further guidance, see § 1.904-4T(l).
- * * * * *
- **Par. 6.** Section 1.904-4T is amended as follows:
- 1. Revise paragraphs (a), (b), (c)(4)(i), (c)(4)(ii), (c)(4)(iii), (c)(5), (c)(6), (7),

- (c)(8), (d), (e), (f), (g), (h), (i), (j), (k), (l), and (m).
 - 2. Add paragraphs (n) and (o).
- The revisions and additions read as follows:

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

- (a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive category income), 904(d)(1)(B)

(general category income), or § 1.904-4(m) (additional separate categories).

(b) *Passive category income*—(1) *In general.* The term *passive category income* means passive income and specified passive category income.

(2) *Passive income*—(i) *In general.* The term *passive income* means any—

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 1293.

(ii) *Exceptions.* Passive income does not include any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high-taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the look-through rules of section 904(d)(3), (d)(4), and (d)(6)(C) and the regulations under those provisions. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d)(5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related person factoring income may be eligible for the exception for export financing interest.

(iii) *Active rents or royalties*—(A) *In general.* For rents and royalties paid or accrued after September 20, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. Except as provided in paragraph (b)(2)(iii)(B) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term taxpayer shall

be substituted for the term controlled foreign corporation if the recipient of the rents or royalties is not a controlled foreign corporation.

(B) *Active conduct of trade or business.* Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(iii)(B), an affiliated group includes only domestic corporations and foreign corporations that are controlled foreign corporations in which domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock. For purposes of this paragraph (b)(2)(iii)(B), indirect ownership shall be determined under section 318 and the regulations under that section.

(iv) *Examples.* The following examples illustrate the application of paragraph (b)(2) of this section.

Example 1. P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 2008, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign corporation because the gain is directly related to the business needs of P. The currency gain is, therefore, general category income to P because it is not income of a kind that would be foreign personal holding company income.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of § 1.904-5 to the royalties S receives from the franchisees. Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A)

and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general category income to S under § 1.904-4(b)(2)(iii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general category income to P under the look-through rules of § 1.904-5(c)(1)(i) and (c)(3), respectively.

(3) *Specified passive category income* means—

(i) Dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States;

(ii) Taxable income attributable to foreign trade income (within the meaning of section 923(b)); or

(iii) Distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b)).

* * * * *

(c)(4)(i) through (h)(2) [Reserved]. For further guidance, see § 1.904-4(c)(i) through (h)(2).

(3) *Exception.* Unless it is received or accrued by a financial services entity, export financing interest shall be treated as passive category income if that income is also related person factoring income. For this purpose, related person factoring income is—

(i) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(ii) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

(h)(4) through (k) [Reserved]. For further guidance, see § 1.904-4(h)(3)(iii) through (k).

(l) *Priority rule.* Income that meets the definitions of a separate category described in paragraph (m) of this section and another category of income described in section 904(d)(2)(A)(i) and (ii) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general category income described in section 904(d)(2)(A)(ii).

(m) [Reserved]. For further guidance, see § 1.904-4(m).

(n) *Effective/applicability date.*

Paragraphs (a), (b), (h)(3), and (l) of this section shall apply to taxable years of United States taxpayers beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

(o) *Expiration date.* The applicability of paragraphs (a), (b), (h)(3)(ii) and (l) of this section expires on December 20, 2010.

■ **Par. 7.** Section 1.904-5 is amended by revising paragraph (h)(3) and adding paragraph (o)(3) to read as follows:

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

* * * * *

(h) * * *

(3) [Reserved]. For further guidance, see § 1.904-5T(h)(3).

* * * * *

(o) * * *

(3) [Reserved]. For further guidance, see § 1.904-5T(o)(3).

■ **Par. 8.** Section 1.904-5T is amended by revising paragraphs (c)(4)(iv), (d), (e), (f), (g), and (h) and adding paragraph (o)(3) to read as follows:

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

* * * * *

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

(3) *Income from the sale of a partnership interest*—(i) *In general.* To the extent a partner recognizes gain on the sale of a partnership interest, that income shall be treated as passive category income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(B)(iii)(II) and § 1.904-4(c).

(ii) *Exception for 25-percent owned partnership.* In the case of a sale of an interest in a partnership by a partner that is a 25-percent owner of the partnership under the principles of section 954(c)(4)(B), income recognized on the sale of the partnership interest shall be treated as general category income to the extent that such gain would not be classified as foreign personal holding company income under the look-through rule of section 954(c)(4).

* * * * *

(o) * * *

(3) *Rules for income from the sale of a partnership interest*—(i) *Effective/*

applicability date. Paragraph (h)(3) of this section shall apply to taxable years of United States taxpayers beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

(ii) *Expiration date.* The applicability of paragraph (h)(3) of this section expires on December 20, 2010.

■ **Par. 9.** Section 1.904-7 is amended by adding paragraph (g) to read as follows:

§ 1.904-7 Transition rules.

* * * * *

(g) [Reserved]. For further guidance, see § 1.904-7T(g).

■ **Par. 10.** Section 1.904-7T is amended by adding paragraph (g) to read as follows:

§ 1.904-7T Transition Rules (temporary).

* * * * *

(g) *Treatment of earnings and foreign taxes of a controlled foreign corporation or a noncontrolled section 902 corporation accumulated in taxable years beginning before January 1, 2007*—(1) *Definitions*—(i) *Pre-2007 pools* means the pools in each separate category 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 taxable years beginning before January 1, 2007.

(ii) *Pre-2007 separate categories* means the separate categories of income described in section 904(d) as applicable to taxable years beginning before January 1, 2007, and any other separate category of income described in § 1.904-4(m).

(iii) *Post-2006 separate categories* means the separate categories of income described in section 904(d) as applicable to taxable years beginning after December 31, 2006, and any other separate category of income described in § 1.904-4(m).

(2) *Treatment of pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation.* Any post-1986 undistributed earnings in a pre-2007 pool of a controlled foreign corporation or a noncontrolled section 902 corporation shall be treated in taxable years beginning after December 31, 2006, as if they were accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Post-1986 foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they

were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories (including the rules of section 904(d)(3)(E)) applied as well. Any such earnings and taxes in pre-2007 pools shall constitute the opening balance of the foreign corporation's post-1986 undistributed earnings and post-1986 foreign income taxes on the first day of the foreign corporation's first taxable year beginning after December 31, 2006, in accordance with the rules of paragraph (g)(3) of this section. Similar rules shall apply to characterize any deficits in the pre-2007 pools and previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to earnings in the pre-2007 pools.

(3) *Substantiation of post-2006 character of earnings and taxes in a pre-2007 pool*—(i) *Reconstruction of earnings and taxes pools.* In order to substantiate the post-2006 characterization of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation, the taxpayer shall make a reasonable, good-faith effort to reconstruct the pre-2007 pools of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes following the rules governing the determination of post-2006 separate categories for each taxable year beginning before January 1, 2007, beginning with the first year in which post-1986 undistributed earnings were accumulated in the pre-2007 pool. Reconstruction shall be based on reasonably available books and records and other relevant information. To the extent any pre-2007 separate category includes earnings that would be allocated to more than one post-2006 separate category, the taxpayer must account for earnings distributed and taxes deemed paid in these years for such category as if they were distributed and deemed paid pro rata from the amounts that were added to that category during each taxable year beginning before January 1, 2007.

(ii) *Safe harbor method*—(A) *In general.* Subject to the rules of paragraph (g)(3)(iii) of this section, a taxpayer may allocate the post-1986 undistributed earnings and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation (as well as deficits and previously-taxed earnings, if any) under one of the safe harbor methods described in paragraphs

(g)(3)(ii)(B) and (g)(3)(ii)(C) of this section.

(B) *General safe harbor method*—(1) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC shall be allocated to the post-2006 separate category for passive category income.

(2) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for financial services income, shipping income or general limitation income shall be allocated to the post-2006 separate category for general category income.

(3) Except as provided in paragraph (g)(3)(ii)(B)(4) of this section, any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for high withholding tax interest shall be allocated to the post-2006 separate category for passive category income.

(4) If a controlled foreign corporation has positive post-1986 undistributed earnings and post-1986 foreign income taxes in a pre-2007 separate category for high withholding tax interest, such earnings and taxes shall be allocated to the post-2006 separate category for general category income if the earnings would qualify as income subject to high foreign taxes under section 954(b)(4) if the entire amount of post-1986 undistributed earnings were treated as a net item of income subject to the rules of § 1.954-1(d). If the high withholding tax interest earnings would not qualify as income subject to high foreign taxes under section 954(b)(4), then the earnings and taxes shall be allocated to the post-2006 separate category for passive category income.

(C) *Interest apportionment safe harbor*. A taxpayer may allocate the post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation

following the principles of paragraph (f)(4)(ii) of this section.

(iii) *Consistency rule*. The election to apply a safe harbor method under paragraph (g)(3)(ii) of this section in lieu of the rules described in paragraph (g)(3)(i) of this section may be made on a separate category by separate category basis. However, if a taxpayer elects to apply a safe harbor to allocate pre-2007 pools of more than one pre-2007 separate category of a controlled foreign corporation or a noncontrolled section 902 corporation, such safe harbor (the general safe harbor described in paragraph (g)(3)(ii)(B) of this section or the interest apportionment safe harbor described in paragraph (g)(3)(ii)(C) of this section) shall apply to allocate post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes for the pre-2007 pools in each pre-2007 separate category of the foreign corporation for which the taxpayer elects to apply a safe harbor method in lieu of reconstructing the pre-2007 pools.

(4) *Treatment of pre-1987 accumulated profits*. Any pre-1987 accumulated profits (as defined in § 1.902-1(a)(10)) of a noncontrolled section 902 corporation or a controlled foreign corporation shall be treated in taxable years beginning after December 31, 2006, as if they had been accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories applied as well. The taxpayer must substantiate the post-2006 characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes in accordance with the rules of paragraph (g)(3) of this section, including the safe harbor provisions. Similar rules shall apply to characterize any deficits or previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to pre-1987 accumulated profits.

(5) *Treatment of earnings and foreign taxes in pre-2007 pools of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation*. The rules of paragraphs (g)(1) through (4) of this section apply to post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools, and pre-1987 accumulated profits and pre-1987 foreign income taxes, of a lower-tier

controlled foreign corporation or noncontrolled section 902 corporation.

(6) *Effective/applicability date*. This paragraph (g) shall apply to taxable years of United States taxpayers beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

(7) *Expiration date*. The applicability of this paragraph (g) expires on December 20, 2010.

■ **Par. 11.** Section 1.904(f)-12 is amended by adding paragraph (h) to read as follows:

§ 1.904(f)-12 Transition rules.

* * * * *

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

■ **Par. 12.** Section 1.904(f)-12T is amended by adding paragraph (h) to read as follows:

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

* * * * *

(h) *Recapture in years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2007*—(1) *Losses related to pre-2007 separate categories for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC*. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category (as defined in § 1.904-7T(g)(1)(ii)) for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC, at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category (as defined in § 1.904-7T(g)(1)(iii)) for passive category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate*

category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income.

(2) *Losses related to pre-2007 separate categories for shipping, financial services income or general limitation income*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for shipping income, financial services income or general limitation income.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category for general category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income.* To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years as income in the post-2006 separate category for general category income.

(3) *Losses related to a pre-2007 separate category for high withholding tax interest*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for high withholding tax interest.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for high withholding tax interest at the end of the taxpayer's

last taxable year beginning before January 1, 2007, the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year on a pro rata basis to the taxpayer's post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the same pre-2007 separate category for high withholding tax interest are allocated under § 1.904-2T(i)(1). If the taxpayer has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then any loss account balance in that category shall be allocated to the post-2006 separate category for passive category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate category for high withholding tax interest.* To the extent that a taxpayer has a balance in a separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for high withholding tax interest at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years on a pro rata basis as income in the post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the pre-2007 separate category for high withholding tax interest are allocated under § 1.904-2T(i)(1). If the taxpayer has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then the loss account balance shall be recaptured in subsequent taxable years solely as income in the post-2006 separate category for passive category income.

(4) *Elimination of certain separate limitation loss accounts.* After application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for passive category income for which income is to be recaptured as passive category income, as determined under those same provisions, shall be eliminated. Similarly, after application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for general category income for which income is to be recaptured as general category income, as determined under those same provisions, shall be eliminated.

(5) *Alternative method.* In lieu of applying the rules of paragraphs (h)(1) through (h)(3) of this section, a taxpayer may apply the principles of paragraphs (g)(1) and (g)(2) of this section to

determine recapture in taxable years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in taxable years beginning before January 1, 2007.

(6) *Effective/applicability date.* This paragraph (h) shall apply to taxable years of United States taxpayers beginning after December 31, 2006 and ending on or after December 21, 2007.

(7) *Expiration date.* The applicability of this paragraph (h) expires on December 20, 2010.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: December 14, 2007.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9371]

RIN 1545-BH14

Treatment of Overall Foreign and Domestic Losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 904(g) of the Internal Revenue Code (Code) relating to the recapture of overall domestic losses. Section 402 of the American Jobs Creation Act of 2004 (AJCA) enacted new section 904(g) of the Code to provide for the recapture of overall domestic losses. These regulations provide guidance needed to comply with these changes, as well as updated guidance with respect to overall foreign losses and separate limitation losses, and affect individuals and corporations claiming foreign tax credits. The text of these temporary regulations also serves as the text of the proposed regulations (REG-141399-07) published in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on December 21, 2007.

Applicability Dates: For dates of applicability, see §§ 1.904(f)-1T(g), 1.904(f)-2T(e), 1.904(f)-7T(f), 1.904(f)-8T(c), 1.904(g)-1T(f), 1.904(g)-2T(d), 1.904(g)-3T(i), and 1.1502-9T(e).