

Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, § 39.13 of Part 39 of the Federal Aviation Regulations (14 CFR 39.13) is amended by adding the following new Airworthiness Directive:

British Aerospace: Applies to BAC 1-11 200 and 400 series airplanes, certificated in all categories. Compliance is required as indicated.

For airplanes fitted with pilots windshield No. 1, left and right-hand part numbers AB31A705 and AB31A706 respectively, produced in 1979 and 1980 with serial numbers beginning with 9-H and 0-H, manufactured by P.P.G. Industries, Inc., accomplish the following, unless already accomplished:

A. Check the bus-to-bus electrical resistance of the windshield NESA coat within the next 200 hours time in service or 28 days, whichever occurs first, after the effective date of this AD in accordance with paragraph 2.1 of the Accomplishment Instructions of British Aerospace Alert Service Bulletin 56-A-PM5836, dated March 19, 1982.

Note.—If windshield is replaced with another windshield produced in 1979 or 1980, repeat paragraph A after 200 hours time in service but not later than 300 hours time in service on the replacement windshield.

B. Accomplish the actions of paragraph 2.2, 2.03, or 2.4 of the service bulletin based upon the resistance values obtained in the check done in paragraph A.

C. Alternate means of compliance which provide an equivalent level of safety may be used when approved by the Manager, Seattle Aircraft Certification Office, FAA, Northwest Mountain Region.

D. Special flight permits may be issued in accordance with FAR 21.197 and 21.199 to operate airplanes to a base for the accomplishment of inspections and/or modifications required by this AD.

This amendment becomes effective May 31, 1983.

(Secs. 313(a), 601, and 603, Federal Aviation Act of 1958, as amended (49 U.S.C. 1354(a), 1421, and 1423); Sec. 6(c) Department of Transportation Act (49 U.S.C. 1655(c)); and 14 CFR 11.89)

Note.—The FAA determined that this regulation is an emergency regulation that is not major under Section 8 of Executive Order 12291. It is impracticable for the agency to follow the procedures of Order 12291 with respect to this rule since the rule must be issued immediately to correct an unsafe condition in aircraft. It has been further determined that this document involves an emergency regulation under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979). If this action is subsequently determined to involve a significant/major regulation, a final regulatory evaluation or analysis, as appropriate, will be prepared and placed in the regulatory docket (otherwise, an evaluation or analysis is not required). A copy of it, when filed, may be obtained by

contacting the person identified under the caption "For Further Information Contact."

Issued in Seattle, Washington on May 11, 1983.

Charles R. Foster,

Director, Northwest Mountain Region.

[FR Doc. 83-12438 Filed 5-18-83; 9:45 am]

BILLING CODE 4910-13-M

14 CFR Part 39

[Docket No. 83-ASW-25; Amdt. No. 39-4648; Predecessor Docket No. 78-NE-21]

Airworthiness Directives; Sikorsky S-61 Series Helicopters Certificated in All Categories

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: This amendment amends an existing Airworthiness Directive (AD) which requires ultrasonic inspections of the main rotor blade spindles of S-61 type helicopters. This amendment revises the AD by clarifying the applicability; decreasing the initial and repetitive inspection intervals; updating a mailing address; and referencing the latest revision of the Sikorsky service bulletin. The amendment is needed to preclude the possibility of failure of main rotor spindles.

DATE: Effective date May 25, 1983.

Compliance schedule.—As prescribed in the body of AD.

ADDRESSES: The applicable service bulletin may be obtained from the United Technologies Corporation, Sikorsky Aircraft, North Main Street, Stratford, Connecticut 06601. Attn: S-61 Commercial Product Support Department.

Copies of the service bulletin are contained in the Rules Docket at the Office of the Regional Counsel, Southwest Region, Federal Aviation Administration, 4400 Blue Mound Road, Fort Worth, Texas 76106.

FOR FURTHER INFORMATION CONTACT: Cheryl McCabe, Aerospace Engineer, ANE-152, Boston Aircraft Certification Branch, Aircraft Certification Division, New England Region, Federal Aviation Administration, 12 New England Executive Park, Burlington, Massachusetts 01803; telephone (617) 273-7338.

SUPPLEMENTARY INFORMATION: This amendment further amends Amendment 39-3305 (43 FR 44476), AD 78-20-05, as amended by Amendment 39-3425 (44 FR 12021), Amendment 39-3444 (44 FR 19184), and Amendment 39-3838 (45 FR 47130), which currently requires

repetitive ultrasonic inspection of the main rotor blade spindles of Sikorsky S-61 series helicopters.

After issuing Amendment 39-3838, the FAA determined that:

1. The applicability requires clarification because the AD only applies to certain non-modified spindles and this is not clearly specified in the AD as evidenced by a recent inquiry from a foreign authority;

2. The ultrasonic inspection interval and the initial inspection time for the main rotor spindles must be decreased from 180 to 70 hours' time in service because during a periodic ultrasonic inspection on a military helicopter a crack greater than one-half the cross section of the spindle lug was found. The crack origin was located in the outboard edge of the large chamfer (the spindle incorporated nickel sulfamate plating).

3. The FAA mailing address for reporting requires updating due to the recent reorganization in the FAA.

4. The latest revision of the Sikorsky service bulletin should be referenced in the AD to agree with the decreased inspection intervals.

The information collection requirement contained in this regulation (§ 39.13) has been approved by the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511) and has been assigned OMB control number 2120-0056.

Since a situation exists that requires immediate adoption of this regulation, and since this amendment also provides an applicability clarification which imposes no additional burden on any person, it is found that notice and public procedure hereon are impracticable and unnecessary and good cause exists for making this amendment effective in less than 30 days.

Approximately 14 aircraft could be affected by the requirements of this AD for an estimated impact of \$70 per aircraft per 180 flight hours.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, § 39.13 of Part 39 of the Federal Aviation Regulations (14 CFR 39.13) is amended by further amending Amendment 39-3305 (43 FR 44476), AD 78-20-05, as amended by Amendment 39-3425 (44 FR 12021), Amendment 39-3444 (44 FR 19184), and Amendment 39-3838 (45 FR 47130), as follows:

1. In the first paragraph and paragraph 1, delete "P/Ns S6112-23027, S6112-23025, and S6110-23325 main rotor spindles" and insert in its place: "main rotor P/N S6112-23025-1 spindles (S6112-23027-006 spindle assemblies) and S6110-23325 series spindles (S6110-23327 series spindle assemblies)."

2. In paragraph 1, delete "Prior to further flight, unless already accomplished within the last 180 hours' time in service," and insert in its place "Within the next 20 hours' time in service, unless already accomplished within the last 50 hours' time in service, after the effective date of this amendment."

3. In paragraph 1, delete the number "180" from the second and third places where it occurs and insert in its place: "70."

4. In paragraphs 1 and 3, delete "Chief, Engineering and Manufacturing Branch" and insert in its place: "Manager, Boston Aircraft Certification Branch."

5. In paragraph 1, delete "61B10-33C" and insert in its place: "61B10-33F."

The manufacturer's specifications and procedures identified and described in this directive are incorporated herein and made a part hereof pursuant to U.S.C. 552(a)(1). All persons affected by this directive who have not already received these documents from the manufacturer may obtain copies upon request to United Technologies Corporation, Sikorsky Aircraft, North Main Street, Stratford, Connecticut 06601, Attn: S-61 Commercial Product Support Department. These documents also may be examined in the Office of the Regional Counsel, Federal Aviation Administration, Southwest Region, 4400 Blue Mound Road, Fort Worth, Texas 76106.

This amendment becomes effective May 25, 1983.

This amendment amends Amendment 39-3305 (43 FR 44476), AD 78-20-05, as amended by Amendment 39-3425 (44 FR 12021), Amendment 39-3444 (44 FR 19184) and Amendment 39-3838 (45 FR 47130). (Secs. 313(a), 601, and 603, Federal Aviation Act of 1958, as amended (49 U.S.C. 1354(a), 1421, and 1423); Sec. 6(c), Department of Transportation Act (49 U.S.C. 1655(c)); 14 CFR 11.89)

Note.—The FAA has determined that this regulation only involves 14 aircraft that could be affected by the requirements of this AD for an estimated impact of \$70 per aircraft. Therefore, I certify that this action (1) is not a "major rule" under Executive Order 12291, and (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979). A copy of the final evaluation prepared for this action is contained in the regulatory docket. A copy of it may be obtained by contacting the person

identified under the caption "FOR FURTHER INFORMATION CONTACT."

Issued in Fort Worth, Texas, on May 4, 1983.

F. E. Whitfield,

Acting Director, Southwest Region.

[FR Doc. 83-13439 Filed 5-18-83; 8:45 am]

BILLING CODE 4910-13-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

(T.D. 7893)

Amendment of Income Tax Regulations To Conform to Repeal of Subpart F Exception for Investments in Less Developed Countries and to Foreign Base Company Shipping Income Regulations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the taxation of shipping income of controlled foreign corporations and their shareholders. The document also contains regulations concerning investments in less developed countries by controlled foreign corporations. Changes to the applicable tax law were made by the Tax Reduction Act of 1975. The regulations provide the public with guidance needed to comply with the provisions. The regulations affect certain foreign corporations which are controlled by U.S. persons and the U.S. shareholders of those corporations.

DATE: The regulations are effective for taxable years of controlled foreign corporations beginning after December 31, 1975, and for taxable years of U.S. shareholders within which or with which the taxable years of such controlled foreign corporations end; except that the amendments to §§ 1.959-1(d)(2) and 1.964-1(c)(3)(ii) are effective June 20, 1983.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman of the Legislation & Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Attention: CC:LR:T, 202-566-3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

On February 9, 1978, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under

sections 864, 881, 951, 952, 954, 955, 958, 959, 964, 970, and 972 of the Internal Revenue Code of 1954 (43 FR 5529). On August 9, 1976, the Federal Register published proposed amendments to the Income Tax Regulations under several sections of the Internal Revenue Code, including section 955. The August 9, 1976, Notice of Proposed Rulemaking proposed a new § 1.955-0. The February 9, 1978, Notice of Proposed Rulemaking proposed a paragraph (a) to this § 1.955-0. All of these amendments were proposed to conform the regulations to sections 602 (c) and (d) of the Tax Reduction Act of 1975 (89 Stat. 58). The proposed amendments which were published on August 9, 1976, are being finalized (with some changes) at the same time as these amendments. No public comments were received concerning the amendments proposed on February 9, 1978. A public hearing was neither requested nor held. The changes to the regulations as proposed are only of a correcting and clarifying nature. The amendments are to be issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7895).

Statutory Bases

The United States taxes foreign corporations only on certain United States source income and income from any source which is connected with the conduct of a trade or business in the United States. As a result, the United States generally does not impose a tax on foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. When the foreign corporation actually remits its foreign source income to U.S. shareholders as a dividend, the United States imposes a tax. The tax is imposed on the U.S. shareholder, not the foreign corporation. The fact that no U.S. tax is imposed until the income is distributed is what generally is referred to as tax "deferral."

The Internal Revenue Code provides for an exception to the general rule of deferral under the "subpart F" provisions of the Code (sections 951 through 964). Under these provisions, income from certain tax haven activities is taxed at the shareholder level whether or not the income is actually received in the form of a dividend. These rules apply only to U.S. persons owning 10 percent or more of the voting power of a foreign corporation and only if more than 50 percent of the voting power of the corporation is owned by U.S. persons who each own 10 percent or larger interests.

Among the types of subpart F income is "foreign base company income." Before enactment of the Tax Reduction Act of 1975, section 954(b)(1) of the Code excluded from foreign base company income certain dividends, interest, and gains from qualified investments in less developed countries. Under sections 951(a)(1)(A)(ii) and 955, a U.S. shareholder was taxed on its pro rata share of this excluded income only when it was withdrawn from investment in less developed countries. Section 602(c) of the Tax Reduction Act repealed the section 954(b)(1) exclusion. In addition, section 602(c) repealed the provisions of section 955, as it existed before the Tax Reduction Act of 1975, and added a new section 955 concerning amounts invested in foreign base company shipping operations. Congress did not, however, repeal the section 951(a)(1)(A)(ii) imposition of tax on a U.S. shareholder's pro rata share of excluded income when withdrawn from investment in less developed countries. As a result of the retention of section 951(a)(1)(A)(ii), repealed section 955 (as in effect before amendment by the Tax Reduction Act) retains some vitality.

Section 602(d) of the Tax Reduction Act of 1975 also added a new category of income to foreign base company income. The new category is called "foreign base company shipping income." Under section 954(b)(2), foreign base company shipping income is not included in foreign base company income to the extent that the shipping income is reinvested in qualified investments in foreign base company shipping operations. Under sections 951(a)(1)(A)(iii) and 955 (as amended by the Tax Reduction Act of 1975), previously excluded subpart F income withdrawn from investment in foreign base company shipping operations is included in the gross income of U.S. shareholders.

Summary of Regulations, Changes, and Public Comment

The amendments to the regulations provided by this document generally reflect the repeal of the less developed country exception to subpart F and coordinate the existing subpart F regulations with the foreign base company shipping income regulations proposed on August 9, 1976, and which are being adopted on the same day as these regulations. The amendments also update and correct certain cross references to and within the subpart F regulations. In addition, the proposed amendments change certain reporting requirements under subpart F by requiring that taxpayer identification numbers also be furnished in cases in

which taxpayer names and addresses are currently required to be furnished. The requirement that taxpayer identification numbers be furnished applies only with respect to reports required to be filed after June 20, 1983.

Regulatory Flexibility Act and Executive Order 12291

This regulation was published as a proposed regulation before January 1, 1981, the effective date of the Regulatory Flexibility Act [5 U.S.C. Chapter 6]. In addition, the Service has concluded that the regulations do not constitute regulations subject to the Regulatory Flexibility Act [5 U.S.C. Chapter 6]. The Commissioner of Internal Revenue has also determined that this regulation is not a major regulation as defined in Executive Order 12291 and therefore a regulatory impact analysis is not required.

Drafting Information

The principal author of these regulations is Kenneth Klein of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations both on matters of substance and style.

List of Subjects in 26 CFR 1.861-1 Through 1.997-1

Incomes taxes, Aliens, Export, Domestic International Sales Corporation (DISC), Foreign investments in U.S., Foreign tax credit, Source of income, United States investments abroad.

Adoption of Amendments to the Regulations

The amendments to 26 CFR Part 1 which were set forth in the Notice of Proposed Rulemaking appearing in the Federal Register of February 9, 1978 (43 FR 5529), are adopted, subject to the revisions set forth below. In addition, other amendments to 26 CFR Part 1 are adopted, as set forth below.

PART 1—[AMENDED]

Paragraph 1. The amendments to § 1.951-1, as set forth in paragraph 4 of the Notice of Proposed Rulemaking, are changed as follows:

1. The last sentence of instructional paragraph 4 is revised by inserting the phrase "of subparagraphs (1)(c), 3, and 5 above" between the words "provisions" and "read".
2. The heading of § 1.951-1(c)(1) is revised by inserting the phrase

"countries," immediately after the word "developed".

Par. 2. The amendments to § 1.951-3, as set forth in paragraph 5 of the Notice of Proposed Rulemaking, are changed as follows:

1. The third sentence of paragraph (a) of Example (4) of § 1.951-3 is revised by placing the symbol "\$" between the abbreviation "CFR" and the number "1.954-1(b)(1)".

2. New paragraph (c) of Example (4) of § 1.951-3 is revised by deleting the word "or" and inserting in its place the word "of".

Par. 3. The amendment to § 1.952-1, as set forth in paragraph 6 of the Notice of Proposed Rulemaking, is revised by adding the symbol "\$" in paragraph (b)(1) between the abbreviation "CFR" and the number "1.952-1(b)(1)".

Par. 4. The proposed amendments to § 1.954-1(b)(3)(v), as set forth in paragraph 8 of the Notice of Proposed Rulemaking, are deleted.

Par. 5. The amendments to § 1.954-2, as set forth in paragraph 9 of the Notice of Proposed Rulemaking, are changed as follows: Instructional subparagraph 1 of instructional paragraph 9 is revised by deleting the word "Subdivision" and inserting in its place the phrase "Subdivision (i) is revised by deleting the period at the end and inserting a comma in its place and subdivision".

Par. 6. The amendment to § 1.954-3, as set forth in paragraph 10 of the Notice of Proposed Rulemaking is revised by deleting "paragraph(b)(3)(iv)" in the first sentence of subparagraph (2)(i)(d) and inserting in lieu thereof "paragraph (b)(4)(ii)".

Par. 7. The amendment to § 1.954-5, as set forth in paragraph 11 of the Notice of Proposed Rulemaking, is revised by inserting the symbol "\$" between the abbreviation "CFR" and the number "1.954-5".

Par. 8. The amendment to § 1.955, as set forth in paragraph 12 of the Notice of Proposed Rulemaking, is deleted.

Par. 9. Proposed § 1.955-0, as set forth in paragraph 13 of the Notice of Proposed Rulemaking, is changed as follows: The second sentence of § 1.955-0(a)(2) is revised by placing the symbol "\$" between the abbreviation "CFR" and the number "1.954-1".

Par. 10. The amendments to § 1.959-1, as set forth in paragraph 17 of the Notice of Proposed Rulemaking, are changed as follows:

1. The second sentence of § 1.959-1(c) is revised by adding a comma immediately after the word "operations".
2. The amendment to § 1.959-1(d)(2) is revised by inserting the phrase "(in the

case of information required to be furnished after [date which is 30 days after publication of these final regulations in the Federal Register]] between the words "and" and "taxpayer".

Par. 11. The amendments to § 1.964-1, as set forth in paragraph 19 of the Notice of Proposed Rulemaking, are changed as follows:

1. Instructional subparagraphs (1) and (3) of instructional paragraph 19 are revised by deleting the phrase "or (3)(B)", and inserting in its place both times the phrase "of 1975".

2. Instructional subparagraph (3) of instructional paragraph 19 is revised by inserting a comma immediately after the number "1.954-6(f)".

3. The last sentence of instructional paragraph 19 is revised by inserting the phrase "of subparagraphs (4), (5), and (6)(d) above" between the words "provisions" and "read".

4. Section 1.964-1(c)(3)(ii) is revised by inserting the phrase "(in the case of statements required to be filed after [date which is 30 days after publication of these final regulations in the Federal Register])" immediately after the phrase "taxpayer identification numbers" the first time it appears and immediately before the phrase "taxpayer identification numbers" the second time it appears.

Par. 12. Instructional paragraph 20 of the Notice of Proposed Rulemaking, amending §§ 1.964-2 (a) and (b)(1), is revised by deleting the phrase "955," and inserting in its place the phrase "955" and before the comma immediately thereafter."

Par. 13. The amendments to § 1.964-3, as set forth in paragraph 22 of the Notice of Proposed Rulemaking, are changed as follows:

1. The last sentence of instructional paragraph 22 is revised by adding the phrase "of subparagraphs (1)(b) and (2) above" between the words "provisions" and "read".

2. Section 1.964-3(c)(1)(i) is revised by deleting the period after the phrase "taxable year", deleting the period after the phrase "April 1, 1975)", and by adding the symbols "\$" between the abbreviation "CFR" and the number "1.954-1(d)(3)(i)".

Par. 14. The amendments to § 1.964-4, as set forth in paragraph 23 of the Notice of Proposed Rulemaking, are changed as follows:

1. Instructional subparagraph (2)(b) of instructional paragraph 23 is revised by deleting the word "both", deleting the comma after the number "1976" and inserting in its place a semicolon, and by deleting the phrase "1.954 and" and inserting in its place the symbol "\$".

2. The last sentence of instructional paragraph 23 is revised by adding the phrase "of subparagraphs (1)(a), (1)(c), and 3 above" between the words "provisions" and "read".

3. Section 1.964-4(d)(4) is revised by inserting the symbol "\$" between the abbreviation "CFR" and the number "1.964-4(d)(4)".

4. Section 1.964-4(d)(5) is revised by inserting the symbol "\$" between the abbreviation "CFR" and the number "1.964-4(d)(5)".

5. Section 1.964-4(d)(6)(v) is revised by deleting the phrase "§ 1.954-6(f)," and inserting in its place the phrase "§§ 1.954-6(f) and 1.954-6(b)(1)(viii)."

6. The flush language at the beginning of § 1.964-4(g-2) is revised by adding the word "operations" immediately after the word "shipping".

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Approved: April 26, 1983.

John E. Chapoton,

Assistant Secretary of the Treasury.

PART 1—[AMENDED]

Part 1 of Title 26 of the Code of Federal Regulations is amended as follows:

Paragraph 1. Section 1.864-5(d)(2) is amended as follows:

1. Subdivision (i) is revised.

2. Subdivision (ii) is revised by changing "30 percent" to "10 percent."

3. Subdivision (ii) is revised by inserting "(30 percent in the case of taxable years of foreign corporations ending before January 1, 1976)" immediately after "10 percent."

The revised provision reads as follows:

§ 1.864-5 Foreign source income effectively connected with U.S. business.

(d) Excluded foreign source income.

(2) Subpart F income of a controlled foreign corporation. . . .

(i) Foreign base company shipping income which is excluded under section 954(b)(2).

(ii) Foreign base company income amounting to less than 10 percent (30 percent in the case of taxable years of foreign corporations ending before January 1, 1976) of gross income which by reason of section 954(b)(3)(A) does not become subpart F income for the taxable year.

Par. 2. Section 1.881-1 (e)(4)(i) is amended to read as follows:

§ 1.881-1 Manner of taxing foreign corporations.

(e) Other provisions applicable to foreign corporations. . . .

(4) Controlled foreign corporations.—

(i) Subpart F income and increase of earnings invested in U.S. Property. For the mandatory inclusion in the gross income of the U.S. shareholders of the subpart F income, of the previously excluded subpart F income withdrawn from investment in less developed countries, of the previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and of the increase in earnings invested in U.S. property, of a controlled foreign corporation, see sections 951 through 964, and the regulations thereunder.

Par. 3. Section 1.951-1 is amended as follows:

1. Paragraph (a)(2) is amended as follows:

a. Subdivision (ii) is revised by deleting "paragraph (c)" and inserting in lieu thereof "paragraph (c) (1)," and by deleting the word "and" at the end thereof.

b. Subdivision (iii) is redesignated as subdivision (iv).

c. Immediately after subdivision (ii) new subdivision (iii) is added.

2. Paragraph (b)(1) is amended by deleting "paragraph (a)(1)" and inserting in lieu thereof "paragraph (a)(2)(i)."

3. Paragraph (c) is revised.

4. Paragraph (d) is amended by deleting "paragraph (a)(3)" both times it appears and inserting in lieu thereof "paragraph (a)(2)(iv)."

5. Paragraph (e)(1) is revised. The added and revised provisions read as follows:

§ 1.951-1 Amounts included in gross income of U.S. shareholders.

(a) In general. . . .

(2)

(iii) Such shareholder's pro rata share (determined under paragraph (c)(2) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for such taxable year of the corporation, and

(c) Limitation on a United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investments.—(1) Investments in less developed countries. For purposes of paragraph (a)(2)(ii) of this section, a United States shareholder's pro rata share (determined

in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3), as in effect before the enactment of the Tax Reduction Act of 1975, and paragraph (c) of § 1.955-1 for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955-1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(2) *Investments in foreign base company shipping operations.* For purposes of paragraph (a)(2)(iii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3) and paragraph (c) of § 1.955A-1 for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955A-1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(e) *"Pro rata share" defined.*—(1) *In general.* For purposes of paragraphs (b), (c), and (d) of this section, a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, or increase in earnings invested in United States property, respectively, for any taxable year is his pro rata share determined under paragraph (a) of § 1.952-1, paragraph (c) of § 1.955-1, paragraph (c) of § 1.955A-1, or paragraph (c) of § 1.956-1, respectively.

Par. 4. Section 1.951-3 is amended as follows:

1. Example (4) is amended as follows:
a. Paragraph (a) is amended by deleting "paragraph (b)(1) of § 1.954-1" in the third sentence and inserting in lieu thereof "26 CFR § 1.954-1(b)(1) (Rev. as of Apr. 1, 1975)" and by inserting in the sixth sentence ", as in effect before the enactment of the Tax Reduction Act of 1975," immediately after "section 955(a)."

b. A new paragraph (c) is added.
2. Example (5) is amended by deleting "paragraph (a)(3)" each time it appears in paragraphs (a) and (b) and inserting in lieu thereof "paragraph (a)(2)(iv)".

The added provision reads as follows:

§ 1.951-3 Coordination of subpart F with foreign personal holding company provisions.

Example (4). . . .

(c) The principles of this example also apply to withdrawals (determined under section 955(a), as in effect before the enactment of the Tax Reduction Act of 1975) of previously excluded subpart F income from investment in less developed countries effected after the effective date of such Act, and to withdrawals (determined under section 955(a), as amended by such Act) of previously excluded subpart F income from investment in foreign base company shipping operations.

Par. 5. Section 1.952-1 is amended as follows:

1. Paragraph (a)(2) is amended by deleting "1.954-5." and inserting in lieu thereof "1.954-7."

2. Paragraph (b)(1) is revised to read as follows:

§ 1.952-1 Subpart F income defined.

(b) *Exclusion of U.S. income.*—(1) *Taxable years beginning before January 1, 1967.* For rules applicable to taxable years beginning before January 1, 1967, see 26 CFR § 1.952-1(b)(1) (Rev. as of April 1, 1975).

Par. 6. Section 1.952-2(c)(5)(i) is revised to read as follows:

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

(c) *Special rules for purposes of this section.*

(5) *Treatment of capital loss and net operating loss.*

(i) *Capital loss carryback and carryover.* The capital loss carryback and carryover provided by section 1212(a) shall not be allowed.

Par. 7. Section 1.954-2(d)(2)(iv)(b)(2) is amended as follows:

1. Subdivision (ii) is amended by deleting "and" at the end thereof.

2. Subdivision (iii) is amended by deleting the period at the end thereof and inserting in lieu thereof ", and".

3. A new subdivision (iv) is added to read as follows:

§ 1.954-2 Foreign personal holding company income.

(d) *Certain income received from unrelated persons in the active conduct of a trade or business*

(2) *Dividends, interest, and gains on securities, received in banking or other financing business from unrelated persons*

(iv) *Income of foreign corporations owned by Edge Act or Agreement corporations*

(b) *Foreign corporations included.*

(2)

(iv) *Foreign base company shipping income, as defined in § 1.954-6.*

Par. 8. Section 1.954-3(b) is amended as follows:

1. The first sentence of subparagraph (2)(i)(d) is amended by deleting "paragraph (b)(3)(iv)" and inserting in lieu thereof "paragraph (b)(4)(ii)".

2. The second sentence of subparagraph (3) is amended by deleting "30 percent" and inserting in lieu thereof "10 percent".

Par. 9. Section 1.954-5 is revised to read as follows:

§ 1.954-5 Increase in qualified investments in less developed countries; taxable years of controlled foreign corporations beginning before January 1, 1976.

For rules applicable to taxable years of controlled foreign corporations beginning before January 1, 1976, see section 954(b)(1) (as in effect before the enactment of the Tax Reduction Act of 1975) and 26 CFR § 1.954-5 (Rev. as of April 1, 1975).

Par. 10. Section 1.955-0, as reserved in paragraph 9 of the appendix to the notice of proposed rule making published on August 9, 1976 (41 FR 33296), is added, consisting of paragraph (a) to read as follows:

§ 1.955-0 Effective dates.

(a) *Section 955 as in effect before the enactment of the Tax Reduction Act of 1975.*—(1) *In general.* In general, §§ 1.955-1 through 1.955-6 are applicable with respect to withdrawals

of previously excluded subpart F income from qualified investment in less developed countries for taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. However, such sections are effective with respect to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before the enactment of the Tax Reduction Act of 1975) only for taxable years of foreign corporations beginning before January 1, 1976, and for taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. For rules applicable to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before such enactment), in taxable years of foreign corporations beginning after December 31, 1975, see section 955(b)(5) (as amended by such Act) and §§ 1.955A-1 through 1.955A-4.

(2) *References.* Except as otherwise provided therein, all references contained in §§ 1.955-1 through 1.955-6 to section 954 or 955 or to the regulations under section 954 are to those sections and regulations as in effect before the enactment of the Tax Reduction Act of 1975. For regulations under section 954 (as in effect before such enactment), see 26 CFR §§ 1.954-1 through 1.954-5 (Rev. as of April 1, 1975). For taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end, the definitions of less developed countries and less developed country corporations contained in section 902(d) (as amended by such Act) and § 1.902-2 apply for purposes of determining the credit for corporate stockholders in foreign corporations under section 902.

Par. 11. Paragraph (a) of § 1.955-1 is revised to read as follows:

§ 1.955-1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.

(a) *In general.* Pursuant to section 951(a)(1)(A)(ii) and the regulations thereunder, a United States shareholder of a controlled foreign corporation must include in its gross income its pro rata share (as determined in accordance with paragraph (c) of this section) of the

amount of such controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries. Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1962, that is withdrawn from investment in less developed countries for any taxable year of the corporation beginning before January 1, 1976. Except for investment in less developed country shipping companies, section 955 also provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1975, which is withdrawn from investment in less developed countries in taxable years of the corporation beginning after December 31, 1975. To determine the amount of a controlled foreign corporation's previously excluded subpart F income withdrawn from investment in less developed country shipping companies described in section 955(c)(2) in taxable years of a controlled foreign corporation beginning after December 31, 1975, see section 955(b)(5) (as in effect after amendment by the Tax Reduction Act of 1975) and §§ 1.955A-1 through 1.955A-4. For effective dates, see § 1.955-0.

Par. 12. Section 1.955-3 is amended as follows:

1. The first sentence of paragraph (a) is amended by deleting "In lieu of determining the increase under" and inserting in lieu thereof "In lieu of determining the increase for a taxable year of a foreign corporation beginning before January 1, 1976, under".

2. Immediately after the last sentence of paragraph (b)(1) a new sentence is added to read as follows:

§ 1.955-3 Election as to date of determining qualified investments in less developed countries

(b) *Time and manner of making election.*—(1) *Without consent.* *** For taxable years of a foreign corporation beginning after December 31, 1975, no election under this section with respect to a controlled foreign corporation may be made without the consent of the Commissioner.

Par. 13. The first sentence of § 1.958-1(a) is revised to read as follows:

§ 1.958-1 Direct and indirect ownership of stock.

(a) *In general.* Section 958(a) provides that, for purposes of sections 951 to 964 (other than sections 955(b)(1)(A) and (B) and 955(c)(2)(A)(ii) (as in effect before the enactment of the Tax Reduction Act of 1975), and 960(a)(1)), stock owned means—

- (1) Stock owned directly; and
- (2) Stock owned with the application of paragraph (b) of this section.

Par. 14. Section 1.959-1 is amended as follows:

1. The second and third sentences of paragraph (a) are revised.
2. The third sentence of paragraph (b) is revised.
3. The second sentence of paragraph (c) is revised.
4. Paragraph (d)(2) is revised.

The revised provisions read as follows:

§ 1.959-1 Exclusion from gross income of United States persons of previously taxed earnings and profits

(a) *In general.* *** The amounts so taxed to certain United States shareholders are described as subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and increases in earnings invested in United States property. Section 959 provides that amounts taxed as subpart F income, as previously excluded subpart F income withdrawn from investment in less developed countries, or as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations are not taxed again as increases in earnings invested in United States property. ***

(b) *Actual distributions to United States persons.* *** Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, or under section 951(a)(1)(B) as earnings invested in United States property, shall not be again included in the gross income of such shareholder when such amounts are actually

distributed, directly or indirectly, to such shareholder. * * *

(c) *Excludable investment of earnings in United States property.* * * * Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, or under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, may be invested in United States property without being again included in such shareholder's income under section 951(a). * * *

(d) *Application of exclusions to shareholder's successor in interest.* * * *

(2) The name, address, and (in the case of information required to be furnished after June 20, 1983) taxpayer identification number of the person from whom the stock interest was required; * * *

Par. 15. Section 1.959-3 is amended as follows:

1. Paragraph (a) is amended by inserting "previously excluded subpart F income withdrawn from investment in foreign base company shipping operations," immediately after "countries,".

2. Paragraph (b) is amended by deleting "Earnings" the first time it appears in the fifth sentence of subparagraph (3) and inserting in its place "For example, earnings".

3. Paragraph (b) is amended further by inserting "or foreign base company shipping operations" immediately after "assets" in the fifth sentence of subparagraph (3).

Par. 16. Section 1.964-1 is amended as follows:

1. The second sentence of the flush material following paragraph (b)(2)(ii) is amended by inserting a comma after "section 957" and by inserting a comma after "of 1975", and by inserting before the period ", or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954-6(f)".

2. The first sentence of example (2) of paragraph (b)(3) is amended by deleting "Corporation N" and inserting in lieu thereof "In 1973, Corporation N".

3. The first sentence of paragraph (c)(2) is amended by inserting a comma after "section 957)", by inserting a

comma after "of 1975)", and by deleting "section 952(d)," and inserting in lieu thereof "section 952(d), or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954-6(f)".

4. Paragraph (c)(3)(ii) is revised.

5. Paragraph (c)(5) is amended by adding at the end thereof a new sentence.

6. Paragraph (c)(6) is amended as follows:

a. Subdivision (ii) is amended by deleting "section 955(c)" and inserting in lieu thereof "section 955(c), as in effect before the enactment of the Tax Reduction Act of 1975)".

b. Subdivision (iii) is amended by deleting the word "or" from the end thereof.

c. Subdivision (iv) is amended by deleting the period from the end thereof and inserting in lieu thereof "; or".

d. A new subdivision (v) is added.

e. The second sentence of the flush material following new subdivision (v) is amended by inserting immediately before the period "or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954-6(f)".

The added provisions read as follows:

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

(c) *Tax adjustments.* * * *

(3) *Action on behalf of a corporation* * * *

(ii) *Written statement.* The written statement required by subdivision (i) of this subparagraph shall be jointly executed by the controlling United States shareholders, shall be filed with the Director of the Internal Revenue Service Center, 11801 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, within 180 days after the close of the taxable year of the foreign corporation with respect to which the election is made or the adoption or change of method effected, or before May 1, 1965, whichever is later, and shall set forth the name and country or organization of the foreign corporation, the names, addresses, taxpayer identification numbers (in the case of statements required to be filed after June 20, 1983), and stock interests of the controlling United States shareholders, the nature of the action taken, the names, addresses, and (in the case of statements required to be filed after June 20, 1983) taxpayer identification numbers of all other United States shareholders notified of the election or adoption or change of method, and such

other information as the Commissioner may by forms require. * * *

(5) *Controlling United States shareholders.* * * *

In the event that a foreign corporation is not a controlled foreign corporation but pays a dividend to a controlled foreign corporation that is attributable to foreign base company shipping income under § 1.954-6(f), the controlling United States shareholders (as defined in this subparagraph) of the controlled foreign corporation shall be considered the controlling United States shareholders of the foreign corporation. * * *

(6) *Action not required until significant.* * * *

(v) It is sought to be established that the corporation has foreign base company shipping income (within the meaning of section 954(f)). * * *

Par. 17. Section 1.964-2 (a) and (b)(1) are amended by inserting "(as in effect both before and after the enactment of the Tax Reduction Act of 1975)" immediately after "section 955" and before the comma.

Par. 18. Section 1.964-2(c)(1)(i)(b)) and (c)(1)(ii) are revised to read as follows:

§ 1.964-2 Treatment of blocked earnings and profits. * * *

(c) *Removal of restriction or limitation—(1) In general.* * * *

(i) *Treatment of deferred income.* * * *

(b) The applicable limitations under paragraph (c) of § 1.952-1, paragraph (b)(2) of § 1.955-1, paragraph (b)(2) of § 1.955A-1, or paragraph (b) of § 1.956-1, determined as of the last day of the immediately preceding taxable year, taking into account the provisions of subdivision (ii) of this subparagraph.

(ii) *Treatment of earnings and profits.* For purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956, the earnings and profits which are no longer subject to a currency or other restriction or limitation shall be treated as included in the corporation's earnings and profits for the year in which such earnings and profits were derived. * * *

Par. 19. Section 1.964-3 is amended as follows:

1. Paragraph (b) is amended as follows:

a. Subparagraphs (3) and (4) are redesignated subparagraphs (4) and (5) respectively.

b. A new subparagraph (3) is inserted immediately after subparagraph (2).

2. Paragraph (c)(1)(i) is revised.

The added and revised provisions read as follows:

§ 1.964-3 Records to be provided by United States shareholders.

(b) *Records to be provided.* * * *

(3) The previously excluded subpart F income of such corporation withdrawn from investment in foreign base company shipping operations.

(c) *Special rules.* * * *

(1) * * *

(i) The locus and nature of such corporation's activities were such as to make it unlikely that the foreign base company income of such corporation (determined in accordance with paragraph (c)(3) of § 1.952-3) exceeded 5 percent of its gross income (determined in accordance with paragraph (b)(1) of § 1.952-3) for the taxable year. (For taxable years to which § 1.952-3 does not apply, such amounts shall be determined under 26 CFR §§ 1.954-1(d)(3) (i) and (ii) (Rev. as of April 1, 1975)), and

Par. 20. Section 1.964-4 is amended as follows:

1. Paragraph (d) is amended as follows:

a. Subparagraphs (4) and (5) are revised.

b. Subparagraphs (6) and (7) are redesignated subparagraphs (7) and (10), respectively.

c. New subparagraphs (6), (8), and (9) are added.

d. Subparagraph (10) as redesignated is amended by changing "(1) through (6)" to "(1) through (9)".

2. Paragraph (g) is redesignated paragraph (g-1) and amended as follows:

a. The heading is revised by inserting "*in less developed countries*" immediately after "*investment*".

b. Subparagraph (1) is amended by inserting "(as in effect for taxable years beginning before January 1, 1976; see 26 CFR § 1.954-1(b)(1) (Rev. as of April 1, 1975))" immediately after "§ 1.954-1".

c. Subparagraph (2) is amended by inserting "(as in effect before the enactment of the Tax Reduction Act of 1975)" immediately after "section 955(a)".

d. Subparagraph (3) is amended by inserting "(as in effect before the enactment of the Tax Reduction Act of 1975)" immediately after "section 955(a)".

3. A new paragraph (g-2) is added immediately after redesignated paragraph (g-1).

The revised and added provisions read as follows:

§ 1.964-4 Verification of certain classes of income.

(d) *Foreign base company income and exclusions therefrom* * * *

(4) *Qualified investments in less developed countries.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see 26 CFR § 1.964-4(d)(4) (Rev. as of April 1, 1975).

(5) *Income derived from aircraft or ships.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see CFR § 1.964-4(d)(5) (Rev. as of April 1, 1975).

(6) *Foreign base company shipping income.* The foreign base company shipping income to which section 954(f) and § 1.954-6 apply, for which purpose there must be established—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, as determined under § 1.954-6(c),

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, as determined under § 1.954-6(d),

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as determined under § 1.954-6(e),

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used (by the seller or by a person related to the seller) in foreign commerce,

(v) Dividends, interest, and gains described in §§ 1.954-6(f) and 1.954(b)(1)(viii),

(vi) Income described in § 1.954-6(g) (relating to partnerships, trusts, etc.), and

(vii) Exchange gain, to the extent allocable to foreign base company shipping income, as determined under § 1.952-2(c)(2)(v)(b).

If the controlled foreign corporation has income derived from or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, it shall be necessary to establish, from the books and records of the controlled foreign corporation, that such aircraft or vessel was used in

foreign commerce within the meaning of subparagraphs (3) and (4) of § 1.954-6(b).

(8) *Qualified investments in foreign base company shipping operations.* The foreign base company shipping income that is excluded from foreign base company income under section 954(b)(2) and § 1.954-1(b)(1).

(9) *Special rule for shipping income.* The distributions received through a chain of ownership described in section 958(a) which are excluded from foreign base company income under section 954(b)(6)(B) and § 1.954-1(b)(2).

(g-2) *Withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations.*

Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in foreign base company shipping operations for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(2) and paragraph (b)(1) of § 1.954-1 for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years, as determined under section 955(a) and paragraph (b) of § 1.955A-1,

(3) The amount withdrawn from investment in foreign base company shipping operations for the taxable year as determined under section 955(a) and paragraph (b) of § 1.955A-1, and

(4) If the carryover (as described in § 1.955A-1(b)(3)) of amounts relating to investments in less developed country shipping companies (as described in § 1.995-5(b)) is applicable, (i) the amount of the corporation's qualified investments (determined under § 1.955-2 other than paragraph (b)(5) thereof) in less developed country shipping companies at the close of the last taxable year of the corporation beginning before January 1, 1976, and (ii) the amount of the limitation with respect to previously excluded subpart F income (determined under § 1.955-1(b)(1)(i)(b)) for the first taxable year of the corporation beginning after December 31, 1975.

Par. 21. Section 1.970-1(c)(1) is amended by inserting "(as in effect before the enactment of the Tax Reduction Act of 1975)" immediately

after "section 955", found in the flush paragraph following subparagraph (iii).

Par. 22. Section 1.972-1(b)(3)(i) is amended by inserting "(as in effect before the enactment of the Tax Reduction Act of 1975)" immediately after "section 955".

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26 CFR Parts 1 and 9

[T.D. 7894]

Foreign Base Company Shipping Income

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to shipping income of controlled foreign corporations and the taxation of their shareholders. Certain provisions were added to the applicable tax law by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. The regulations provide the public with the guidance needed to comply with the provisions. The regulations affect certain foreign corporations which are controlled by U.S. persons and the U.S. shareholders of those corporations.

DATE: The regulations are effective for taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of U.S. shareholders within which, or with which, the taxable years of such foreign corporations end.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

On August 9, 1976, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 952, 954, and 955 of the Internal Revenue Code of 1954 (41 FR 33285). On August 25, 1976, the Federal Register published corrections to the proposed regulations under sections 952 and 955 (41 FR 35855). On March 3, 1977, the Federal Register proposed additional amendments to the Income Tax Regulations under section 954 (42 FR 12199). On August 22, 1977, the Federal Register published amendments to the Temporary Income Tax Regulations

under the Tax Reduction Act of 1975 (26 CFR Part 9) under sections 954 and 955 (42 FR 42198). The August 22, 1977, amendments adopted as temporary regulations §§ 1.954-7(b) and 1.955A-4, which were proposed on August 9, 1976. The proposed (or adopted) amendments would conform the regulations to certain changes in the tax law made by sections 602(c)-(e) of the Tax Reduction Act of 1975 (89 Stat. 60) and section 1024 of the Tax Reform Act of 1976 (90 Stat. 1620). The amendments are to be issued under the authority contained in sections 7805, 955(b)(2), and 955(b)(3) of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805; 89 Stat. 63, 26 U.S.C. 955(b)(2); 89 Stat. 64, 26 U.S.C. 955(b)(3)). After consideration of all comments submitted regarding the proposed amendments, the amendments are adopted as revised by this Treasury Decision.

Statutory Bases

The United States taxes foreign corporations only on certain United States source income and income from any source which is connected with the conduct of a trade or business in the United States. As a result, the United States generally does not impose tax on foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. When the foreign corporation actually remits its foreign source income to its U.S. shareholders as a dividend, the United States imposes a tax.

The tax is imposed on the U.S. shareholder, not the foreign corporation. The fact that no U.S. tax is imposed until the income is distributed is what generally is referred to as tax "deferral."

The Internal Revenue Code provides for an exception to the general rule of deferral under the so-called "subpart F" provisions of the Code (sections 951 through 964). Under these provisions, income received by foreign corporations from certain tax haven activities is taxed at the shareholder level whether or not the income is actually received by the shareholder in the form of a dividend. These special rules apply only to U.S. persons owning 10 percent or more of the voting power of a foreign corporation and only if more than 50 percent of the voting power of the corporation is owned by U.S. persons who each own 10 percent or larger interests.

Among the types of subpart F income is "foreign base company income." Section 602(d) of the Tax Reduction Act of 1975 added a category of income to foreign base company income. The new category is called "foreign base company shipping income." Foreign

base company shipping income, as defined in section 954(f), generally includes income derived from, or in connection with, the use of an aircraft or vessel in foreign commerce, or from services directly related to such use. Foreign base company shipping income also includes dividends and interest received from certain foreign corporations, and gains from the sale of stock or obligations of certain foreign corporations, if the dividends, interest, or gains are attributable to foreign base company shipping income. Section 954(b)(7), as added by section 1024(a) of the Tax Reform Act of 1976, provides that foreign base company shipping income does not include income from, or in connection with, the use of an aircraft or vessel between two points within the foreign country in which a foreign corporation is created or organized and in which the aircraft or vessel is registered.

Sections 954(b)(2) and (g) provide an important exception to the taxation of foreign base company shipping income. Shipping income is not included in foreign base company income to the extent the shipping income is reinvested in certain shipping assets. The exclusion operates so that to the extent that a controlled foreign corporation increases its "qualified investments in foreign base company shipping operations" during a taxable year, the shipping income for that year is excluded from foreign base company income. If a controlled foreign corporation decreases its qualified investments in foreign base company shipping operations during a year, the amount of the decrease generally will be taxed to the shareholders under section 951(a)(1)(A)(iii).

Section 955(b)(1) defines "qualified investments in foreign base company shipping operations" as investments in any aircraft or vessel used in foreign commerce, and other assets used in connection with the performance of services directly related to the use of the aircraft or vessel. Qualified investments include investments in stock or obligations of other controlled foreign corporations which hold qualified shipping assets.

Section 955(b)(2) permits the Treasury Department to issue regulations establishing rules under which a group of related corporations can combine their foreign base company shipping income and their qualified investments for purposes of determining the amount of income subject to current taxation under subpart F. Section 955(b)(3) provides a special rule whereby the Treasury Department may allow a U.S.

shareholder of a controlled foreign corporation to elect to compute the corporation's increase or decrease in qualified investments as of a different or a longer period of time than the one year which is generally required.

Summary of Regulations, Changes, and Public Comments

The following summary of the final regulations includes a description of the more important changes from the regulations as proposed. A number of the changes were made in response to comments received from the public. The more important of those comments will be mentioned, including those which did not result in a change.

Section 1.952-3 provides step-by-step instructions to guide taxpayers through the complexities of the foreign base company income calculations. Section 954(b)(6) provides a general rule that foreign base company shipping income, when distributed through a chain of related companies, shall not be included in foreign base company income of more than one of the related companies. *Example (2)* of § 1.952-3(d) illustrates that such dividends are, nevertheless, included in foreign base company shipping income if required to do so by section 954(b)(3)(B), which provides that, if the foreign base company income exceeds 70 percent of gross income, the entire gross income shall (except as provided in sections 954(b)(2), (4), and (5)) be treated as foreign base company income. The example also illustrates that such dividends may be reinvested in foreign base company shipping operations in order to avoid current taxation.

Several public commenters suggested that these Code provisions should be interpreted as not requiring reinvestment in order to avoid current taxation. No change was made because the Service believes that if Congress had intended such a rule, paragraph (b)(6) of section 954 would have been included in the exceptions to section 954(b)(3)(B), in addition to paragraphs (b)(2), (4), and (5).

Section 1.954-1(b)(1) provides that reinvested shipping income shall not be included in foreign base company shipping income. Section 1.954-1(b)(2) provides a "chain rule" such that generally shipping income which previously has been included in foreign base company income of a related controlled foreign corporation shall not again be included in foreign base company income when distributed through a chain of ownership. In response to a public comment, § 1.954-1(b)(2) provides that the chain rule applies to all distributions, whether by

dividend, redemption of stock, or complete or partial liquidation. The proposed regulations would have applied the chain rule only to dividends. However, the regulation provides that the chain rule for shipping income does not apply to the characterization of income for purposes of the foreign personal holding company rules of sections 551 through 558.

Sections 1.954-1(b)(3) and (4) concern the section 954(b)(4) exclusion from foreign base company income. If it is established to the satisfaction of the Service that neither (1) the creation nor organization of a controlled foreign corporation, nor (2) the effecting of a transaction giving rise to what would otherwise be foreign base company income, had as one of its significant purposes a substantial reduction of income taxes, then the income is excluded. Section 1.954-1(b)(4)(ii) generally applies the same mechanical test to foreign base company shipping income as is applied to foreign personal holding company income to determine whether such income qualifies for the exclusion. Several public commenters suggested that the foreign base company shipping income should more appropriately be included in the mechanical test applied to foreign base company sales and services income, rather than foreign personal holding company income. Another public commenter suggested that even if the personal holding company income test were to apply, that it should be modified in several respects. The Internal Revenue Service believes that the foreign personal holding company income test is the more appropriate test to apply to shipping income. One important modification is made to the test as it applies to foreign base company shipping income, however. A new § 1.954-1(b)(4)(ii)(b) is added to the regulations as proposed. The new section addresses the situation where over a period of three years a controlled foreign corporation's increase in qualified investments in foreign base company shipping operations equals or exceeds its foreign base company shipping income for those years even though for certain of those years the amount of the increase is less than the amount of shipping income. In such a situation, under the general rules, there would have been current taxation of the excess of the shipping income over the increase in qualified investments. Under the new rule, generally, if over three years the increase in qualified investments equals or exceeds the amount of shipping income, the Service will determine that there has not been a significant purpose of substantial

income tax reduction, as the Congressional policy encouraging reinvestment would have been met.

Section 1.954-1(f)(3) provides that foreign base company shipping income shall not also be considered as another type of foreign base company income. Two public commenters suggested that the rule also should provide that shipping income will not be included in foreign personal holding company income described in section 553. The suggestion has not been followed because the Service has found no indication of such a Congressional intent. A cross-reference to the section 553 foreign personal holding company income rules has been added to § 1.954-1(f)(3) to alert taxpayers to potential application of those rules.

Section 1.954-6 sets forth rules for determining foreign base company shipping income. Section 1.954-6(b)(1) generally defines foreign base company shipping income. Two public commenters suggested that the rule in § 1.954-6(a)(2)(ii), that foreign base company shipping income does not include amounts earned by a foreign corporation before 1976, should be changed so that pre-1976 income, when distributed by a foreign corporation, will not be currently taxed if it is reinvested in shipping assets. A new § 1.954-6(b)(1)(viii) has been added in the final regulations to provide that if the pre-1976 income is dividends, interest, or gains attributable to income derived from aircraft and ships by a less developed country shipping company (described in § 1.955-5(b)) before 1976, then that income will be treated as foreign base company shipping income.

Section 1.954-6(b)(3) defines "foreign commerce." The provisions of that section have been amended in the final regulations to exclude from foreign base company shipping income that income derived from commerce between points in the same foreign country if both (1) the foreign corporation is created or organized and (2) the aircraft or vessel is registered in that foreign country. The change of the definition implements the amendments by section 1024 of the Tax Reform Act of 1976 to section 954(b)(7).

Section 1.954-6(b)(3)(ii) defines the term "vessel." The term is used in a somewhat broader sense than when used (1) for certain investment tax credit purposes and (2) with respect to movable property used for the exploration or development of natural resources on the continental shelf for purposes of the exclusion from treatment as investment in U.S. property under section 956(b)(2)(C) (§ 1.956-2(b)(1)(ix)). Certain types of movable

property (such as barges), which could qualify as vessels for purposes of determining shipping income, may not be treated in some circumstances as vessels under certain investment tax credit provisions and for the cited exclusion from investment in U.S. property provision. Section 1.954-6(b)(3)(ii) is revised to provide that the definition of "vessel" does not apply for purposes of the cited exclusion from investment in U.S. property provision.

Section 1.954-6(c) defines and provides illustrations of "income derived from, or in connection with, the use . . . of any aircraft or vessel in foreign commerce." A public commenter suggested that *Example (2)* of paragraph (c)(2) be amended to make explicit that income derived from the transportation and sale of a commodity in foreign commerce does not constitute foreign base company shipping income to the extent that any portion of the sales price is allocable to transportation costs. No change has been made in the example.

Section 1.954-6(d) defines "income derived from, or in connection with, the performance of services directly related to the use of an aircraft or vessel in foreign commerce." The provision sets forth the type of services which, if performed for a related person, will be treated as "directly related" services: e.g., terminal services, stevedoring services, or maintenance services. Section 1.954-6(d)(4) provides a "70 percent test" by which all of a foreign corporation's income for a taxable year from a facility used in connection with the performance of "directly related" services will be included in foreign base company shipping income if more than 70 percent of the gross income from the facility is shipping income. For purposes of this test, § 1.954-6(d)(5) provides that gross income includes an arm's length charge for services performed by a foreign corporation for itself. One public commenter suggested that this 70 percent rule is inappropriate. While the final regulations generally retain the rules, the 70 percent rule is made optional.

Section 1.954-6(e)(1) provides that foreign base company shipping income includes all incidental income derived by a corporation in the course of the active conduct of foreign base company shipping operations. In response to a public comment, proposed § 1.954-6(e)(2) has been changed in the final regulations to provide that interest derived by a seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel is incidental shipping income.

Section 1.954-6(f) provides rules whereby foreign base company shipping

income of a controlled foreign corporation includes certain dividends, interest, and gains allocable to shipping income of another foreign corporation. One public commenter suggested that if such income is ultimately attributable to foreign base company shipping income, it should be treated as shipping income, even if it is received by a corporation which is not a controlled foreign corporation. The suggestion was not followed as a rule of practical necessity since neither U.S. shareholders nor the Internal Revenue Service will ordinarily have access to the books and records of a corporation which is not a controlled foreign corporation in order to determine whether income is attributable to foreign base company shipping income. Section 1.954-6(f)(1), as proposed, would have treated dividends, interest, and gains as shipping income only if received from a corporation of which it owns at least 10 percent of the voting stock. In response to a public comment, the final regulations have expanded the provision so that dividends, interest, and gains received from a related controlled foreign corporation or a less-developed country shipping company will be included in foreign base company shipping income because investments in such corporations may qualify as shipping assets.

Section 1.954-7 defines "increase in qualified investments in foreign base company shipping operations." The definition is important because, to the extent that a controlled foreign corporation's foreign base company shipping income for a taxable year exceeds such increase, there generally will be current taxation of the excess in the hands of the U.S. shareholders. The section provides that the increase is the amount by which the corporation's qualified investments at the close of a taxable year exceed its investments at the close of the preceding taxable year. Section 1.954-7(b)(1) permits a U.S. shareholder to elect to determine the increase one year later; i.e., instead of comparing the amount of qualified investments as of the close of the taxable year and the preceding taxable year, the amount of qualified investments at the close of the subsequent taxable year is compared to such amount at the close of the present taxable year. Section 1.954-7(b)(2) permits a U.S. shareholder to elect to have, in the first taxable year that a controlled foreign corporation has shipping income, the determination made over a two-year period. Two public commenters suggested that the rule should permit the determinations to be made over a longer period of time. No

change was made because of the additional complexity and the considerable delay in determining tax liability for a given taxable year that such a change would result in, the questionable benefits to a taxpayer of such a change, and because of the change previously mentioned to § 1.954-1(b)(4)(ii) concerning lack of significant purpose of substantial income tax reduction.

Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn from investment in foreign base company shipping operations. Generally, U.S. shareholders will currently be taxed on the amount of withdrawal. Section 1.955A-1(b) provides the general rule that the amount of withdrawal is the amount by which the amount of qualified investments in foreign base company shipping operations at the close of the preceding taxable year exceeds the amount of qualified investments at the close of the taxable year. The section also sets forth various limitations on the amount of withdrawal provided for by the statute. Among those limitations is the rule providing that the amount by which recognized losses on sales or exchanges of qualified investments exceed recognized gains on such sales or exchanges during the year be subtracted from the amount of withdrawal. Several public commenters suggested that other losses, such as operating losses or losses from worthless investments, should also be applied to reduce the amount of withdrawal. The suggested change was not made because the Service believes that the statutory language (section 955(a)(2)) does not permit such an interpretation. Other public commenters suggested that the regulations should permit a carryback and a carryforward of excess qualified investments from a taxable year, so that withdrawals in other years could be offset by the excess. The suggested change was not made because the Service believes that the pertinent statutory language is too specific to permit the change. However, as mentioned earlier, a rule with an effect similar to that suggested is adopted in § 1.954-1(b)(4)(ii)(b) in order to determine whether a significant purpose of substantial income tax reduction was present.

Section 1.955A-2(a) defines broadly "qualified investments in foreign base company shipping operations." Generally, a qualified investment includes an investment in an aircraft or vessel, related shipping assets, stock or

obligations of a related controlled foreign corporation if the assets of the corporation are used in foreign base company shipping operations, a partnership if the partnership is engaged in foreign base company shipping operations, and stock or obligations of a less developed country shipping company.

Section 1.955A-2(b) provides that a "related shipping asset" is any asset used for or in connection with the production of foreign base company shipping income. The section gives examples of related shipping assets. One commenter asserted that Congress intended that oil drilling ships constitute qualified investments in foreign base company shipping operations. H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 138 (1974). The final regulations (§§ 1.955A-2(b)(2) and 1.954-6(b)(3)(i)) provide that an oil drilling ship does not constitute a qualified investment. As oil drilling ships are not engaged in foreign commerce, as that term is defined in the statute and in the regulations, an oil drilling ship can not constitute a qualified investment, notwithstanding the statement to the contrary in one committee report to an unenacted bill. H. Rep. No. 93-1502, 93d Cong., 2d Sess. 138 (1974).

Two commenters suggested that the final regulations should include a "safe harbor" for amounts of working capital which should be treated as related shipping assets. Because the amount of required working capital can significantly vary from corporation to corporation, no change was made in the final regulations. The Service believes that the rule in § 1.955A-2(b)(2)(i) that "reasonably necessary" working capital constitutes a related shipping asset is satisfactory.

The regulations as proposed included as an example of a related shipping asset "amounts . . . deposited in bank accounts or invested in readily marketable securities pursuant to a specific, definite, and feasible plan to purchase any tangible asset for use in foreign base company shipping operations." Section 1.955A-2(b)(3) sets forth limitations on amounts that could be invested pursuant to such a plan. Among those limitations was that the amount accumulated could not exceed 110 percent of a reasonable down payment on the first vessel planned to be purchased. Numerous commenters suggested that this limitation was unduly restrictive and conflicted with the practices of the shipping industry. Shipowners often have plans to purchase more than one vessel over a relatively short period of time. Thus, it

often is necessary to accumulate far more than that which would have been permitted by the proposed regulation. In the final regulations, the limitation has been expanded to cover all vessels planned to be purchased within a reasonable period, the amount of a "reasonable" down payment has been increased from 25 to 28 percent, and the provision has been converted into a "safe harbor" provision. In addition, the final regulations also provide that in the case of an accumulation of assets which does not come within the safe harbor limitation, the determination as to whether such assets have accumulated beyond the reasonably anticipated needs of the business, will be made based on factors including but not limited to the availability of financing and the availability of a suitable vessel.

Section 1.955A-2(c) sets forth rules whereby an investment in stock or obligations of a related controlled foreign corporation are considered as qualified investments in foreign base company shipping operations. The regulations, as proposed, treated such an investment as a qualified investment only if each asset of the related controlled foreign corporation was an aircraft or vessel used in foreign commerce or a related shipping asset. Numerous commenters suggested that the "each asset" requirement was unduly restrictive and would work unfairly to disqualify investments where the related corporation's assets consisted substantially of shipping assets. Proposed § 1.955A-2(c)(1) has been changed in the final regulations to delete the "each asset" requirement. Under the new rule, the amount of the investment which will be treated as a qualified investment will depend upon the extent to which the assets of the related corporation are used in foreign base company shipping operations. Thus, a pro rata portion of an investment can qualify. A special rule is added, however, such that an investment in an obligation of a related corporation will not be a qualified investment if the obligation represents a liability which constitutes a specific charge against an asset of the second corporation which is not a shipping asset. A new "Example (3)" is added to § 1.955A-2(c)(3) to illustrate the new rule.

Section 1.955A-2(g) provides that the amount of an investment is its adjusted basis reduced by liabilities to which the property is subject. Section 1.955A-2(g)(2) ignores certain artificially created liabilities through related persons in making this determination. One public commenter suggested that the artificial

liability rule should be deleted. While the Service believes that the rule in the existing regulations is generally appropriate, the final regulations do provide that related party liabilities created before November 20, 1974 (the date the House of Representatives bill proposing the shipping rules was first introduced), will not be ignored.

Section 1.955A-3 establishes rules under which a U.S. shareholder may elect to combine the foreign base company shipping income and the change in qualified investments in foreign base company shipping operations of a related group of corporations. Section 1.955A-3(b)(1)(i) requires that in order to make a related group election, all the related corporations must use the same taxable year. A public commenter has suggested that the regulations should provide that, if a controlled foreign corporation wishes to change its taxable year in order to qualify for the election, such change would be permitted. The suggestion was not followed because the Service believes that the ordinary rules for changing a taxable year of a corporation should apply. In appropriate cases, the Service will approve the change of a taxable year in order to qualify for the election. One commenter has suggested that the final regulations should provide that if any member of a group is on a 52-53 week taxable year, and if the taxable year for all members of the group ends within the same seven-day period, then the same taxable year requirement should be satisfied. The final regulations adopt that suggestion.

Section 1.955A-3(b)(3) provides that if two or more corporations are treated as a related group for a taxable year, the U.S. shareholder may not also elect to treat two or more other corporations as a related group during that taxable year. A commenter has suggested that the rule should be deleted. The final regulations do not follow the suggestion because to do so would unduly complicate accounting by taxpayers and increase the audit burden of the Service.

Section 1.955A-3(c)(3) of the proposed regulations provided that qualified investments of each member of a related group shall not include stock or obligations of any other member of the group. A public commenter suggested that the combination of that rule and the rule in § 1.955A-2(g)(2) (that the amount of a qualified investment is determined by subtracting liabilities from adjusted basis) results in a double exclusion of the same liability from the amount of a qualified investment. As a result of the suggestion, the final regulations have

deleted the rule with respect to obligations of a related party.

A commenter has suggested that there should be a carryover of group excess deductions and group excess investments. The Service did not make the change because it believes that the pertinent statutory language is too specific to permit the change. However, as mentioned earlier, a rule with an effect similar to that suggested is adopted in § 1.954-1(b)(4)(ii)(b) in order to determine whether a significant purpose of substantial income tax reduction was present. The final regulations, in § 1.955A-3(c)(4)(vii), have been expanded significantly so as to provide a more detailed example of the computations required under the group excess investment provisions than that set forth in the proposed regulations.

A change has been made concerning the § 1.955A-1(b)(2)(ii)(B) limitation, in the related group setting, on the amount of a corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations. Under new § 1.955A-1(b)(2)(iii)(C), a related group member's limitation is increased by (1) the amount that its reinvestment in qualified shipping assets offsets a related group member's foreign base company shipping income (but only for a taxable year beginning after December 31, 1983) and (2) the amount that a deduction of a related group member reduces its foreign base company shipping income for the year (but only for a taxable year beginning after December 31, 1983).

Section 1.955A-4 prescribes regulations under section 955(b)(3) allowing the dates for determining the amount of increases in qualified investments to be postponed for an additional year or more. The regulations generally permit a one-year postponement of the election. Except for the first year that a controlled foreign corporation receives foreign base company shipping income, the regulations permit the postponement to a longer period of time only with consent of the Commissioner.

It is expected that later consideration may be given to the extent, if any, to which amounts of qualified investments in foreign base company shipping operations and other foreign base company shipping income tax characteristics should be carried over in corporate reorganizations.

The regulations also include technical changes to implement certain statutory amendments made by sections 602 (c) and (e) of the Tax Reduction Act of 1975. The Act generally repealed the investment in less developed country

provisions of prior law and the Act reduced the section 954(b)(3)(A) *de minimis* rule (excluding amounts from foreign base company income) from 30 percent to 10 percent of gross income.

Regulatory Flexibility Act and Executive Order 12291

This regulation was published as a proposed regulation before January 1, 1981, the effective date of the Regulatory Flexibility Act (5 U.S.C. Chapter 6). In addition, the Service has concluded that the regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has also determined that this regulation is not a major regulation as defined in Executive Order 12291 and therefore a regulatory impact analysis is not required.

Drafting Information

The principal author of these regulations is Kenneth Klein of the Legislation & Regulations Division, Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations both on matters of substance and style.

List of Subjects in 26 CFR 1.861-1 Through 1.997-1

Income taxes, Aliens, Exports, Domestic International Sales Corporation (DISC), Foreign investments in U.S., Foreign tax credit, Source of income, United States investment abroad.

Adoption of Amendments to the Regulations

The following amendments to 26 CFR Parts 1 and 9 are hereby adopted, as set forth below.

PART 1—[AMENDED]

Paragraph 1. Section 1.952-1 is amended by adding the following sentences at the end of paragraph (c)(2)(ii) thereof.

§ 1.952-1 Subpart F income defined.

(c) *Limitation on a controlled corporation's subpart F income.* * * *

(2) *Special rules.* * * *

(i) *Deficits in earnings and profits taken into account only once.* * * *
To the extent a controlled foreign corporation's (the "first corporation") excess foreign base company shipping deductions for any taxable year (determined under § 1.955A-3(c)(2)(i)) reduce the foreign base company

shipping income of another member of a related group (as defined in § 1.955A-2(b)), such deductions shall not be taken into account in determining the earnings and profits or deficits in earnings and profits of such first corporation for such taxable year for purposes of this paragraph (c) and paragraph (d) of this section. The rule of the preceding sentence shall not apply to the extent the excess foreign base company shipping deductions of the first corporation reduce the foreign base company shipping income of another member of a related group below zero.

Par. 2. § 1.952-2 is amended by revising paragraph (c)(2)(v) to read as follows:

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

(c) *Special rules for purposes of this section.* * * *

(2) *Application of principles of § 1.964-1.* * * *

(v) *Exchange gain or loss.* (a) Exchange gain or loss, determined in accordance with the principles of § 1.964-1(e), shall be taken into account for purposes of determining gross income and taxable income.

(b) Exchange gain or loss shall be treated as foreign base company shipping income (or as a deduction allocable thereto) to the extent that it is attributable to foreign base company shipping operations. The extent to which exchange gain or loss is attributable to foreign base company shipping operations may be determined under any reasonable method which is consistently applied from year to year. For example, the extent to which the exchange gain or loss is attributable to foreign base company shipping operations may be determined on the basis of the ratio which the foreign based company shipping income of the corporation for the taxable year bears to its total gross income for the taxable year, such ratio to be determined without regard to this subdivision (v).

(c) The remainder of the exchange gain or loss shall be allocated between subpart F income and non-subpart F income under any reasonable method which is consistently applied from year to year. For example, such remainder may be allocated to subpart F income in the same ratio that the gross subpart F income (exclusive of foreign base company shipping income) of the corporation for the taxable year bears to its total gross income (exclusive of foreign base company shipping income) for the taxable year, such ratio to be

determined without regard to this subdivision (v).

Par. 3. Immediately after § 1.952-2 new § 1.952-3 is added to read as follows:

§ 1.952-3 Order of foreign base company and subpart F income computations.

(a) *Scope.*—(1) *In general.* This section describes and illustrates the computations which a United States shareholder of a controlled foreign corporation is required to make in connection with the application of section 954 and the subsequent application of section 952. However, this section does not apply to any controlled foreign corporation to which section 953 (relating to income from insurance of United States risks) applies. For rules relating to the application of section 953 and the relationship between sections 953 and 954, see the regulations under section 953. This section also does not apply to any controlled foreign corporation to which section 952(a)(3) (relating to international boycotts) or section 952(a)(4) (relating to illegal payments to foreign officials) applies.

(2) *Effective date.* This section applies to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end.

(b) *General rule.* Except as provided in paragraph (c) of this section, a United States shareholder must determine the subpart F income of a controlled foreign corporation to which this section applies (and to which neither section 952(a)(3), 952(a)(4), nor 953 applies) in the following manner:

(1) *Step 1.* Determine gross income under § 1.952-2, and (if applicable) § 1.959-2 (relating to the exclusion of certain dividends from gross income).

(2) *Step 2.* Determine net foreign base company shipping income as follows:

(i) *First.* Determine foreign base company shipping income under § 1.954-6;

(ii) *Second.* Exclude from foreign base company shipping income the items thereof which are excluded from subpart F income under § 1.952-1(b)(2) (relating to the exclusion of United States income from subpart F income), or which are excluded from foreign base company income under § 1.954-1(b)(2) and (3) (relating, respectively, to chain rule and to corporation not availed of to reduce tax);

(iii) *Third.* Reduce the balance by the deductions allocable thereto under § 1.954-1(c); and

(iv) *Fourth.* Reduce the remaining balance by the increase in qualified investments in foreign base company shipping operations as determined under § 1.954-7 (see § 1.954-1(b)(1)).

(3) *Step 3.* Determine net foreign personal holding company income, net foreign base company sales income, and net foreign base company services income as follows:

(i) *First.* Determine foreign personal holding company income under § 1.954-2, foreign base company sales income under § 1.954-3, and foreign base company services income under § 1.954-4;

(ii) *Second.* Exclude from each such type of income the items thereof which are excluded from subpart F income under § 1.952-1(b)(2) or which are excluded from foreign base company income under § 1.954-1(b)(2) and (3); and

(iii) *Third.* Reduce the balance of each such type of income by the deductions allocable thereto under § 1.954-1(c).

(4) *Step 4.* The foreign base company income is the sum of the net amounts determined in subparagraphs (2) and (3) of this paragraph.

(5) *Step 5.* The subpart F income is the lesser of—

(i) The sum of (A) the foreign base company income as determined under subparagraph (4) of this paragraph and (B) the exchange gain (or loss) allocable (under § 1.952-2(c)(2)(v)(c)) to subpart F income; or

(ii) The earnings and profits limitation stated in section 952(c) (see § 1.952-1(c)).

(6) *Step 6.* The subpart F income of an export trade corporation (as defined in section 971(a)) must be reduced as provided in § 1.970-1(b).

(c) *Section 954(b)(3) ratio less than 10 percent or more than 70 percent.*—(1) *Less than 10 percent.* Under § 1.954-1(d)(1), if the foreign base company income (determined as provided in subparagraph (3) of this paragraph) of a controlled foreign corporation to which this section applies (and to which neither section 952(a)(3), 952(a)(4), nor 953 applies) is less than 10 percent of the gross income (determined as provided in paragraph (b)(1) of this section), the subpart F income of that controlled foreign corporation is zero.

(2) *More than 70 percent.* Under § 1.954-1(d)(2), if the foreign base company income (determined as provided in subparagraph (3) of this paragraph) of a controlled foreign corporation to which this section applies (and to which neither section 952(a)(3), 952(a)(4), nor 953 applies) is more than 70 percent of the gross income (determined as provided in paragraph

(b)(1) of this section), a United States shareholder must determine the subpart F income of that controlled foreign corporation in the following manner:

(i) *Step 1.* The foreign base company income is the gross income (determined as provided in paragraph (b)(1) of this section), reduced as follows:

(A) First, exclude the items thereof which are excluded from subpart F income under § 1.952-1(b)(2) or which are excluded from foreign base company income under § 1.954-1(b)(3);

(B) Second, reduce the balance by the deductions allocable thereto under § 1.954-1(c);

(C) Third, reduce the remaining balance by the amount of the reinvested shipping income determined as provided in subparagraph (4) of this paragraph.

(ii) *Step 2.* The subpart F income is the lesser of—

(A) The foreign base company income as determined under subdivision (i) of this subparagraph; or

(B) The limitation stated in section 952(c) (see § 1.952-1(c)).

(iii) *Step 3.* The subpart F income of an export trade corporation (as defined in section 971(a)) must be reduced as provided in § 1.970-1(b).

(3) *Foreign base company income.* Solely for purposes of subparagraphs (1) and (2) of this paragraph, the foreign base company income of a controlled foreign corporation shall be the sum of the balances determined after applying paragraph (b)(2)(ii) and (3)(ii) of this section.

(4) *Reinvested shipping income.* Solely for purposes of subparagraph (2)(i)(C) of this paragraph, the amount of reinvested shipping income of a controlled foreign corporation shall be determined as follows:

(i) *Step 1.* Determine foreign base company shipping income under § 1.954-6;

(ii) *Step 2.* Exclude from foreign base company shipping income the items thereof which are excluded from subpart F income under § 1.952-1(b)(2) or which are excluded from foreign base company income under § 1.954-1(b)(3);

(iii) *Step 3.* Reduce the balance by the deductions allocable thereto under § 1.954-1(c);

(iv) *Step 4.* The amount of reinvested shipping income is the lesser of—

(A) The remaining balance, or
(B) The increase in qualified investments in foreign base company shipping operations as determined under § 1.954-7.

(d) *Illustrations.* The application of this section may be illustrated by the following examples, in each of which it is assumed that A is a United States

shareholder who owns stock in a controlled foreign corporation on December 31, 1976, the corporation uses the calendar year as the taxable year, and for 1976, the corporation has no income derived from the insurance of United States risks (within the meaning of section 953(a)), neither section 952(a)(3) (relating to international boycotts) nor section 952(a)(4) (relating to illegal payments to foreign officials) applies to the corporation, and the corporation is not an export trade corporation (within the meaning of section 971(a)).

Example (1). (a) For 1976, P Corporation has no foreign base company sales income and no foreign base company shipping income.

(b) A must apply the test prescribed by section 954(b)(3) to P's taxable year 1976 as follows, based on the facts shown in the following table:

(1) Gross income	\$1,000
(2) (i) Foreign personal holding company income	\$200
(ii) Less: Items of foreign personal holding company income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	10
(iii) Balance	190
(3) (i) Foreign base company services income	450
(ii) Less: Items of foreign base company services income excluded under §§ 1.952-1(b)(2) and 1.954-1(b)(3)	100
(iii) Balance	350
(4) Tentative foreign base company income (line (2)(iii) plus line (3)(iii))	540
(5) Section 954(b)(3) ratio (line 4 - line (1)) (percent)	54
(c) Since the section 954(b)(3) ratio is not less than 10 percent nor more than 70 percent, A must determine P's subpart F income for 1976 as follows, based on the facts shown in the following table:	
(1) Gross income	\$1,000
(2) (i) Foreign personal holding company income	200
(ii) Less: Items of foreign personal holding company income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	10
(iii) Balance	190
(iv) Less: Deductions allocable to balance	170
(v) Net foreign personal holding company income	20
(3) (i) Foreign base company services income	450
(ii) Less: Items of foreign base company services income excluded under §§ 1.952-1(b)(2) and 1.954-1(b)(3)	100
(iii) Balance	350
(iv) Less: Deductible allocable to balance	250
(v) Net foreign base company services income	100
(4) Subpart F income: (i) Foreign base company income (line (2)(v) plus line (3)(v))	120
(ii) Exchange gain attributable to subpart F income	7
(iii) Tentative subpart F income (line (i) plus line (ii))	127
(iv) Earnings and profits limitation	225
(v) Subpart F income (lesser of lines (iii) and (iv))	127

Example (2). (a) For 1976, N Corporation has no foreign personal holding company income, no foreign base company sales income, and no foreign base company services income. However, N receives \$100 of dividends from another controlled foreign corporation which is excluded from foreign base company income under 1.954-1(b)(2) as attributable to foreign base company shipping income, but which is not excluded from gross income under section 959(b). A has not made an election as to qualified investments by related persons under section 955(b)(2) and § 1.955A-3.

(b) A must apply the test prescribed by section 954(b)(3) to N's taxable year 1976 as follows, based on the facts shown in the following table:

(1) Gross income	\$1,000
(2) (i) Foreign base company shipping income	1,000
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	100
(iii) Balance	900
(3) Section 954(b)(3) ratio (line (2)(iii) - line (1)) (percent)	90
(c) Since the section 954(b)(3) ratio exceeds 70 percent, A must determine the amount of N's reinvested shipping income for 1976 as follows, based on the facts shown in the following table:	
(1) Foreign base company shipping income	\$1,000
(2) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2) and 1.954-1(b)(3)	0
(3) Balance	1,000
(4) Less: Deductions allocable to balance	750
(5) Remaining balance	250
(6) Increase in qualified investments in foreign base company shipping operations	250
(7) Reinvested shipping income (lesser of lines (5) and (6))	250
(d) A must determine N's subpart F income for 1976 as follows, based on the facts shown in the following table:	
(1) (i) Gross income	\$1,000
(ii) Less: Items of gross income excluded under §§ 1.952-1(b)(2) and 1.954-1(b)(3)	0
(iii) Balance	1,000
(iv) Less: Deductions allocable to balance	750
(v) Remaining balance	250
(vi) Less: reinvested shipping income	250
(vii) Foreign base company income	0
(2) Earnings and profits limitation	1,200
(3) Subpart F income (lesser of lines (1)(vii) and (2))	0

Example (3). (a) For 1976, M Corporation has no foreign personal holding company income, no foreign base company sales income, and no foreign base company services income.

(b) A must apply the test prescribed by section 954(b)(3) to M's taxable year 1976 as follows, based on the facts shown in the following table:

(1) Gross income	\$1,000
(2) (i) Foreign base company shipping income	650
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	0
(iii) Balance	650
(3) Section 954(b)(3) ratio (line (2)(iii) - line (1)) (percent)	65
(c) Since the section 954(b)(3) ratio is not less than 10 percent nor more than 70 percent, A must determine M's subpart F income for 1976 as follows, based on the facts shown in the following table:	
(1) Gross income	\$1,000
(2) Net foreign base company shipping income: (i) Foreign base company shipping income	650
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	0
(iii) Balance	650
(iv) Less: Deductions allocable to balance	550
(v) Remaining balance	100
(vi) Less: Increase in qualified investments in foreign base company shipping operations	80

(vii) Net foreign base company shipping income	20
(3) Subpart F income: (i) Foreign base company income (line (2)(vii))	20
(ii) Exchange gain attributable to subpart F income	0
(iii) Tentative subpart F income (line (i) plus line (ii))	20
(iv) Earnings and profits limitation	15
(v) Subpart F income (lesser of lines (iii) and (iv))	15

Example (4). (a) For 1976, Q Corporation has no foreign base company sales income and no foreign base company services income.

(b) A must apply the test prescribed by section 954(b)(3) to Q's taxable year 1976 as follows, based on the facts shown in the following table:

(1) Gross income	\$1,000
(2) (i) Foreign base company shipping income	\$450
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	100
(iii) Balance	350
(3) (i) Foreign personal holding company income	200
(ii) Less: Items of foreign personal holding company income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	10
(iii) Balance	190
(4) Tentative foreign base company income (line (2)(iii) plus line (3)(iii))	540
(5) Section 954(b)(3) ratio (line (4) - line (1)) (percent)	54
(c) Since the section 954(b)(3) ratio is not less than 10 percent nor more than 70 percent, A must determine Q's subpart F income for 1976 as follows, based on the facts shown in the following table:	
(1) Gross income	\$1,000
(2) (i) Foreign base company shipping income	450
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	100
(iii) Balance	350
(iv) Less: Deductions allocable to balance	250
(v) Remaining balance	100
(vi) Less: Increase in qualified investments in foreign base company shipping operations	135
(vii) Net foreign base company shipping income (not less than zero)	0
(3) (i) Foreign personal holding company income	200
(ii) Less: Items of foreign personal holding company income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3)	10
(iii) Balance	190
(iv) Less: Deductions allocable to balance	70
(v) Net foreign personal holding company income	120
(4) Subpart F income: (i) Foreign base company income (line (2)(vii) plus line (3)(v))	120
(ii) Exchange gain attributable to subpart F income	7
(iii) Tentative subpart F income (line (i) plus line (ii))	127
(iv) Earnings and profits limitation	225
(v) Subpart F income (lesser of lines (iii) and (iv))	127

Example (5). (a) For 1976, corporation R's only income is comprised of interest and dividends which are treated as foreign base company shipping income under § 1.954-6(f)(1)(i). Consequently, R has no foreign personal holding company income, foreign base company sales income of foreign base company services income for 1976 (see section 954(b)(6)(A) and § 1.954-1(f)(3)).

(b) A must apply the test prescribed by section 954(b)(3) to R's taxable year 1976 as follows, based on the facts shown in the following table:

(1) Gross income.....	\$1,000
(2) (i) Foreign base company shipping income.....	1,000
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3).....	400
(iii) Balance.....	600

(3) Section 954(b)(3) ratio (line (2)(iii) ÷ line (1)) (percent).....

60

(c) Since the section 954(b)(3) ratio is not less than 10 percent nor more than 70 percent, A must determine R's subpart F income for 1976 as follows, based on the facts shown in the following table:

(1) Gross income.....	\$1,000
(2) Net foreign base company shipping income:	
(i) Foreign base company shipping income.....	1,000
(ii) Less: Items of foreign base company shipping income excluded under §§ 1.952-1(b)(2), 1.954-1(b)(2), and 1.954-1(b)(3).....	400
(iii) Balance.....	600
(iv) Less: Deductions allocable to balance.....	50
(v) Remaining balance.....	550
(vi) Less: Increase in qualified investments in foreign base company shipping operations.....	530
(vii) Net foreign base company shipping income.....	20

(3) Subpart F income: (i) Foreign base company income (line (2)(vii)).....	20
(ii) Exchange gain attributable to subpart F income.....	0
(iii) Tentative subpart F income (line (i) plus line (ii)).....	20
(iv) Earnings and profits limitation.....	25
(v) Subpart F income (lesser of lines (iii) and (iv)).....	20

Par. 4. Section 1.954-1 is amended as follows:

1. The heading and paragraphs (a), (b)(1), and (b)(2) are revised.
2. Paragraph (b)(3) is redesignated as paragraph (b)(4), and paragraph (b)(4) is redesignated as paragraph (b)(3).

3. Paragraph (b)(3) (as redesignated) is amended as follows:

- a. The heading is revised.
- b. Subdivision (i) is amended by deleting "ending After October 9, 1969", and inserting in lieu thereof "beginning after December 31, 1975".
- c. Subdivision (ii) is amended by revising (a), in (b) by deleting "subparagraph (3)" and inserting in lieu thereof "subparagraph (4)", and by deleting "subparagraph (3)(viii)" in the last sentence and inserting in lieu thereof "subparagraph (4)(vii)".

d. Subdivision (iv) is amended by adding a new sentence at the end thereof.

e. Subdivision (v) is amended by deleting the phrase "(d)(6)", inserting the phrase "(d)(7)" in its place, deleting "Income Tax Division" and inserting in lieu thereof "Corporation Tax Division".

f. Subdivision (vi) is amended by deleting "subparagraph (3)(vi)" and inserting in lieu thereof "subparagraph (4)(v)", and by deleting "subparagraph

(3)(vii)" and inserting in lieu thereof "subparagraph (4)(vi)".

g. Subdivision (vii) is amended by revising the heading, by deleting "example" in the first sentence and inserting in lieu thereof "examples", by redesignating the example as "Example (1)", by deleting "1969" in the seventh sentence of example (1) (as redesignated) and inserting in lieu thereof "1977", and by adding new examples (2) and (3) at the end thereof.

4. Paragraph (b)(4) (as redesignated) is amended as follows:

- a. The heading, subdivisions (i) and (ii), and the text of subdivision (iii) as precedes (a) thereof are revised.
- b. Subdivisions (iii)(a) (1) and (2), (iii) (b), and (iv) are each amended by deleting "in respect to" and inserting in lieu thereof "in respect of".
- c. Subdivision (v) is deleted.
- d. Subdivisions (vi), (vii), and (viii) are redesignated as subdivisions (v), (vi), and (vii), respectively.

e. Subdivision (v) (as redesignated) is amended by deleting "the creation or organization of a controlled foreign corporation results in" and inserting in lieu thereof "there has been", by deleting "29 percent" and inserting in lieu thereof "9 percent", and by deleting "71 percent" and inserting in lieu thereof "91 percent".

f. Subdivision (vi) (as redesignated) is amended by deleting "subdivisions (i) to (vi)" and inserting in lieu thereof "subdivisions (i) to (v)".

g. Example (1) of subdivision (vii) as (redesignated) is amended by deleting "1963" and inserting "1976" in lieu thereof, and by deleting "organization of B Corporation in country Y did not have the effect of substantially reducing" and inserting in lieu thereof "there has been no substantial reduction of".

h. Example (2) of subdivision (vii) (as redesignated) is amended by deleting "organization of B Corporation in country Y did have the effect of substantially reducing" and inserting in lieu thereof "there has been a substantial reduction of".

i. Example (3) of subdivision (vii) (as redesignated) is amended, and example (4) of subdivision (vii) (as redesignated) is deleted.

5. Paragraph (c) is amended by revising the first and last sentences thereof.

6. Paragraph (d) is amended as follows:

- a. The heading is revised.
- b. Subparagraph (1) is amended by deleting "30" in both places where it

appears and inserting in lieu thereof "10".

c. Subparagraph (2) is amended by deleting "(1)", immediately after "except as provided in paragraph" and by inserting "(1), (b)(3)", immediately after "and paragraphs (b)". In addition, a new sentence is added at the end of subparagraph (2).

d. Subparagraph (3) is revised.

e. The text of subparagraph (4) as precedes the example is revised.

f. The example in subparagraph (4) is amended by deleting "30" in all three places where it appears and by inserting in lieu thereof "10".

7. Paragraph (e) is amended by deleting "1.954-5" and inserting in lieu thereof "1.954-7".

8. Paragraph (f) is amended by deleting "1.954-5" and inserting in lieu thereof "1.954-7", and by adding a new subparagraph (3) at the end thereof.

The added and amended provisions read as follows:

§ 1.954-1 Foreign base company income; taxable years beginning after December 31, 1975.

(a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year includes its foreign base company income for such taxable year. See section 952(a). For taxable years beginning after December 31, 1975, the foreign base company income of a controlled foreign corporation consists of the sum of its foreign personal holding company income, as defined in § 1.954-2, its foreign base company sales income, as defined in § 1.954-3, its foreign base company services income, as defined in § 1.954-4, and its foreign base company shipping income, as defined in § 1.954-6, modified and adjusted in accordance with this section. For corresponding rules applicable to taxable years beginning before January 1, 1976, see 26 CFR § 1.954-1 (Rev. as of April 1, 1975). For additional rules relating to the computation of foreign base company income, see § 1.952-3.

(b) *Exclusions from foreign base company income.* Foreign base company income does not include the following items:

(1) *Reinvested shipping income.* Foreign base company income does not include foreign base company shipping income to the extent that the amount of such income does not exceed the controlled foreign corporation's increase for the taxable year in qualified investments in foreign base company shipping operations. See section

954(b)(2). For definition of the term "qualified investments in foreign base company shipping operations," see section 955(b) and § 1.955A-2. For rules relating to the determination of the increase for a taxable year in qualified investments in foreign base company shipping operations, see section 954(g) and § 1.954-7. For rules relating to the computation of the amount excluded from foreign base company income under this subparagraph, see § 1.952-3.

(2) *Chain rule for shipping income.* Except as provided in section 954(b)(3) (and notwithstanding any provision of § 1.954-8), distributions by dividend, redemption of stock, or complete or partial liquidation by a controlled foreign corporation through a chain of ownership described in section 958(a) to another controlled foreign corporation shall not be included in the foreign base company income of such other controlled foreign corporation to the extent that such distributions are attributable (under § 1.954-6(f) (4), (5), or (6)) to foreign base company shipping income. Thus, a distribution which is not excluded from gross income under section 959(b) and § 1.959-2 may be excluded from foreign base company income under section 954(b)(6)(B) and this subparagraph. However, this chain rule does not apply to the characterization of income for purposes of the foreign personal holding company rules of sections 551 through 558.

(3) *Income of controlled foreign corporations not availed of to substantially reduce income or similar taxes.* * * *

(i) *Substantial reduction of income taxes.* * * *

(a) Item of foreign personal holding company income described in § 1.954-2 or an item of foreign base company shipping income described in § 1.954-8 shall be made by applying the principles of subparagraph (4)(ii) of this paragraph, or

(iv) *Application of significant purpose test.* * * * The fact that an aircraft or vessel is registered in any particular foreign country does not mean that the income-producing activity in connection with which the aircraft or vessel is used is carried on in that country.

(vii) *Illustrations.* * * *

Example (2). Controlled foreign corporation X is incorporated under the laws of foreign country A, and uses the calendar year as the taxable year. Corporation X has conducted business for a substantial period of years prior to 1977. Before 1977, X Corporation was subject, under the laws of country A, to an effective tax rate of 48.6 percent on the income (after allocable deductions other than

income or similar taxes) derived from purchasing and selling activities conducted throughout the world. A substantial part of its income for 1976 was derived from transactions in which it purchased from an unrelated person in foreign country C raw materials produced in country C and sold them to Z Corporation, a related person organized under the laws of foreign country B for use in country B. If X Corporation had been incorporated under the laws of country B, it would have paid income and similar taxes to country B for 1976 in an amount effectively equal to 51.2 percent of the income (after allocable deductions other than income or similar taxes) derived from the sales to Z Corporation. If X Corporation had been incorporated under the laws of country C, it would have paid income and similar taxes to country C for years before 1977 in an amount effectively equal to 52 percent of the income (after allocable deductions other than income or similar taxes) derived from the sales to Z Corporation. In 1977 X Corporation also derives a substantial part of its income from transactions, in which it purchases from an unrelated person in country C raw materials produced in country C and sells them to Z Corporation for use in country B. Effective January 1, 1977, there is a general reduction in income tax rates in country A, so that X Corporation pays an income tax to country A for 1977 in an amount effectively equal to 45 percent of the income (after allocable deductions other than income or similar taxes) from the sales to Z Corporation. The income tax laws of countries B and C applicable for 1976 remain applicable to 1977 without change. During years both before and after the reduction in country A tax, X Corporation actively conducts a trade or business of purchasing personal property from unrelated persons and selling such property to unrelated persons as well as to Z Corporation. For 1977, the percentage of total income of X Corporation derived from sales of the raw materials to Z Corporation and the nature of the raw materials so sold to Z Corporation remain substantially unchanged from that for 1976. Although the rate of income and similar taxes paid by X Corporation to country A for 1977 on the income from the sales to Z Corporation is less than 90 percent of, and as much as 5 percentage points less than, the rate (51.2 percent) of the income and similar taxes which X Corporation would have paid to country B on the income from the sales to Z Corporation, under subdivision (iv) of this subparagraph the other facts and circumstances in this example will establish to the satisfaction of the district director that (a) the organization of X Corporation in country A, and (b) the effecting through X Corporation of the sales to Z Corporation during 1977, did not have as a significant purpose a substantial reduction of income or similar taxes. Foreign base company income of X Corporation for 1977 does not include income derived from such sales. However, if the percentage of the total income of X Corporation derived from sales of raw materials to Z Corporation were substantially increased, or if the nature of the raw materials so sold to Z Corporation were significantly changed, the facts and

circumstances of this example would not establish to the satisfaction of the district director that the effecting through X Corporation of the additional or unusual sales to Z Corporation during 1977 did not have as a significant purpose a substantial reduction of income or similar taxes.

Example (3). (i) Controlled foreign corporation Y, which owns and operates a fleet of foreign flag tankers, is incorporated under the laws of foreign country L. L imposes an effective rate of tax of 10 percent on the income (after allocable deductions other than income or similar taxes) from shipping operations. The highest rate prescribed by section 11 for all relevant taxable years is 48 percent, the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption). It is assumed that had Y been incorporated in the United States and owned and operated a fleet of United States flag tankers, it could have avoided payment of any taxes on its income from shipping operations because of its ability to reduce taxable income by means of deposits of amounts equal to such income into a capital construction fund. It is further assumed that had Y been incorporated in the United States and owned and operated a fleet of foreign flag tankers, it would have paid income taxes to the United States on its income from shipping operations at the highest rate prescribed by section 11.

(ii) Since the effective rate of tax on income from such shipping operations paid to country L (10 percent) does not equal or exceed 90 percent of the 48 percent rate prescribed by section 11 (43.2 percent), such income cannot be excluded from foreign base company income under paragraph (b)(3)(i) of this section by reason of the application of paragraph (b)(3)(ii) (a) of this section and paragraph (b)(4)(ii) of this section.

(iii) Also, the fact that Y could have avoided paying any taxes in the United States on its shipping income will not establish to the satisfaction of the district director that the incorporation of Y in foreign country L did not have as a significant purpose a substantial reduction of income or similar taxes, since such avoidance of United States tax would have been possible only upon the occurrence of additional events other than incorporation in the United States (i.e., the use of United States flag tankers and the depositing of amounts into the capital construction fund), which events did not actually occur.

(4) *No substantial reduction of income or similar taxes—(i) Scope.* This subparagraph prescribes rules for the application of subparagraph (3) of this paragraph.

(ii) *Foreign personal holding company income and foreign base company shipping income.—(a) General rule.* For purposes of paragraph (b)(3)(ii)(a) of this section, there will be considered to have been no substantial reduction of income, war profits, excess profits, or similar taxes with respect to an item of foreign personal holding company income

described in § 1.954-2 or an item of foreign base company shipping income described in § 1.954-6 if the effective rate of such taxes (after allocable deductions other than such taxes) paid by a controlled foreign corporation to a foreign country for the taxable year in respect of such item of income equals or exceeds 90 percent of the highest rate prescribed by section 11 (or section 1201 if that is the applicable section) for the taxable year of the United States shareholder within which or with which ends such taxable year of such controlled foreign corporation. For taxable years in which section 11 prescribes both a normal tax rate and a surtax rate, the highest rate is the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption).

(b) *Carryover rule for foreign base company shipping income.* If the rule in the immediately preceding subdivision (a) does not operate to exclude all of a controlled foreign corporation's foreign base company shipping income from foreign base company income for a taxable year, the carryover rule of this subdivision (b) shall be applied. Under this subdivision (b), if for a taxable year, the amount of a controlled foreign corporation's increase in qualified investments in foreign base company shipping operations (determined under § 1.954-7), plus any carryover amount (or any portion thereof) to that year, equals or exceeds (thus, is not less than) the corporation's foreign base company shipping income for that taxable year, then there will be considered to have been no substantial reduction for that taxable year of income, war profits, excess profits, or similar taxes with respect to foreign base company shipping income. A carryover amount is an amount which equals, for the taxable year in which it arises, the excess of a controlled foreign corporation's increase in qualified investments in foreign base company shipping operations over the corporation's foreign base company shipping income. A carryover amount (or any portion thereof) may be carried back or forward only one taxable year and may be carried over and utilized only once. A carryover amount (or any portion thereof) must always be carried back until exhausted before it is carried forward unless—(1) the rule in the immediately preceding subdivision (a) operates to exclude all of a controlled foreign corporation's foreign base company shipping income from foreign base company income for the preceding taxable year, or (2) the corporation's increase in qualified investments in foreign base company shipping

operations for the preceding taxable year, plus any other carryover amount being carried forward to such preceding taxable year, equals or exceeds the corporation's foreign base company shipping income for the preceding taxable year. This subdivision (b) shall not be applied to a corporation with respect to which a related group election under § 1.955A-3 is in effect for the taxable year in which the carryover arose or to which the amount might otherwise be carried. The benefit of a carryover amount which is carried back may be obtained for a taxable year only by filing an amended income tax return (if the income tax return for the taxable year already has been filed). For purposes of § 1.955A-1(b)(2)(i)(C), relating to withdrawal of investment in foreign base company shipping operations, an amount shall be treated as previously excluded from foreign base company income if not treated as foreign base company shipping income by reason of the application of this carryover rule. The rules of this subdivision (b) are illustrated by the following examples. In each example controlled foreign corporation K's taxable year is the calendar year, no related group election under § 1.955A-3 is in effect with respect to K for any year, and K has no other income in any year.

Example (1). Controlled foreign corporation K has foreign base company shipping income and an increase in qualified investments in foreign base company shipping operations as set forth in the following table.

	1981	1982	1983
(1) Foreign base company shipping income	\$100	\$100	\$100
(2) Increase in qualified investments in foreign base company shipping operations	80	150	90
(3) Excess (or shortfall) of line (2) over line (1)	(20)	50	(10)

K has a 1982 carryover amount of \$50. Twenty dollars of the carryover amount is carried back to 1981 and \$10 is carried forward to 1983. The remaining \$20 cannot be carried back or forward to any other year. For 1981 and 1983, by virtue of the rule of this subdivision (b), there will be considered to have been no substantial reduction of income taxes (and all of the foreign base company shipping income for 1981 and 1983 is excluded from foreign base company income). The benefit of the operation of the rule for 1981 may be claimed by the U.S. shareholder of K by the filing of an amended income tax return.

Example (2). Controlled foreign corporation K has foreign base company shipping income and an increase in qualified investments in foreign base company shipping operations as set forth in the following table.

	1981	1982	1983
(1) Foreign base company shipping income	\$100	\$100	\$100
(2) Increase in qualified investments in foreign base company shipping operations	40	150	90
(3) Excess (or shortfall) of line (2) over line (1)	(60)	50	(10)

K has a 1982 carryover amount of \$50. All \$50 must be carried back to 1981, where it is exhausted, and may not be carried forward to 1983. Because K's increase in qualified investments in foreign base company shipping operations for 1981 (\$40), plus the carryover amount from 1982 (\$50), does not equal or exceed K's foreign base company shipping income for 1981 (\$100), the rule of this subdivision (b) does not operate to exclude from foreign base company income any of K's income for 1981. The same is true for 1983, as K has exhausted the entire \$50 carryover amount in 1981. If K had had a 1982 carryover amount of \$60 (rather than \$50), then the rule of this subdivision (b) would operate to exclude all of the 1981 foreign base company shipping income. If the 1982 carryover amount had been \$70, then all of the 1981 and 1983 income would have been excluded.

Example (3). Controlled foreign corporation K has foreign base company shipping income and an increase in qualified investments in foreign base company shipping operations as set forth in the following table.

	1980	1981	1982	1983	1984
(1) Foreign base company shipping income	\$100	\$100	\$100	\$100	\$100
(2) Increase in qualified investments in foreign base company shipping operations	100	120	70	120	90
(3) Excess (or shortfall) of line (2) over line (1)	0	20	(30)	20	(10)

K has a 1981 carryover amount of \$20. The \$20 must be carried forward to 1982. It is not carried back to 1980 because K's 1980 increase in qualified investments in foreign base company shipping operations equaled its 1980 foreign base company shipping income. K's 1983 carryover amount is \$20. Ten dollars of it is carried back to 1982 where, in combination with the \$20 carried forward from 1981, it operates, by virtue of the rule of this subdivision (b), to exclude all of K's 1982 foreign base company shipping income from foreign base company income. The benefit of the operation of the rule for 1982 may be claimed by the U.S. shareholder of K by filing an amended income tax return after 1983. The remaining \$10 carryover amount from 1983 is carried forward to 1984 where, by virtue of the rule of this subdivision (b), all of K's foreign base company shipping income for 1984 is excluded from foreign base company income.

Example (4). Controlled foreign corporation K has foreign base company shipping income and an increase in qualified investments in

foreign base company shipping operations as set forth in the following table.

	1981	1982	1983
(1) Foreign base company shipping income	\$100	\$100	\$100
(2) Increase in qualified investments in foreign base company shipping operations	80	120	80
(3) Excess (or shortfall) of line (2) over line (1)	(20)	20	(20)

K has a 1982 carryover amount of \$20. All of the \$20 must be carried back to 1981 and exhausted. By virtue of the operation of the rule of this subdivision (b), K's 1981 foreign base company shipping income is excluded from foreign base company income. No 1982 carryover amount is carried forward to 1983 (as it was exhausted in 1981). If, however, the rule in the immediately preceding subdivision (a) had operated to exclude all \$100 of K's 1981 foreign base company shipping income from foreign base company income for 1981, then the 1982 carryover amount would not have been carried back to 1981 and the entire amount would have been carried forward to 1983. In the latter case, the rule of this subdivision (b) would have operated to exclude all of K's 1983 foreign base company shipping income from foreign base company income. If in 1981 the rule in the immediately preceding subdivision (a) had operated to exclude only \$90 of the \$100 foreign base company shipping income, then the entire 1982 carryover amount would have to be carried back and exhausted, as set forth earlier in example (2), and no amount may be carried forward to 1983.

(iii) *Foreign base company sales and services income.* For purposes of this paragraph, there will be considered to have been no substantial reduction of income, war profits, excess profits, or similar taxes with respect to an item of foreign base company sales income described in § 1.954-3 or an item of foreign base company services income described in § 1.954-4 if the effective rate of such taxes paid to a country or countries for the taxable year in respect of such item of income by the controlled foreign corporation equals or exceeds 90 percent of, or is not as much as 5 percentage points less than—

(vii) *Illustrations.*

Example (3). Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. In 1976, A Corporation derived interest and rent not excluded under section 954(c) (3) or (4). With respect to the item of interest, A Corporation paid an income tax to country X in an amount effectively equal to 44 percent of such item (after allocable deductions other than income or similar taxes) and, with respect to the item of rent, paid an income tax to country Y in an amount effectively equal to 40 percent of such item (after allocable deductions other than income or similar taxes). No other income or similar tax

was paid by A Corporation with respect to such items. In 1976, the highest rate prescribed by section 11 for the taxable year of M Corporation is 48 percent, the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption). Therefore, with respect to the item of interest, there will be considered to have been no substantial reduction of income or similar taxes (44 percent being more than 90 percent of 48 percent), and such interest is not included in foreign base company income of A Corporation. With respect to the item of rent, however, there will be considered to have been a substantial reduction of income or similar taxes (40 percent being less than 90 percent of 48 percent), and the exclusion from foreign base company income provided by section 954(b)(4) will not apply to such item unless it is established in accordance with subparagraph (b)(3)(i) of this paragraph that both the creation or organization of A Corporation under the laws of foreign country X and the effecting through A Corporation of the transaction which gave rise to such rental income did not have as a significant purpose a substantial reduction of such taxes.

(c) *Gross income and deductions to be taken into account.* For purposes of section 954 and this section, foreign personal holding company income as defined in § 1.954-2, foreign base company sales income as defined in § 1.954-3, foreign base company services income as defined in § 1.954-4, and foreign base company shipping income as defined in § 1.954-6 shall be taken into account in determining foreign base company income after allowance for deductions properly allocable to such categories of income.

However, if the foreign base company income of a controlled foreign corporation exceeds 70 percent (as determined under paragraph (d) of this section) of gross income, the entire expenses, taxes, and other deductions shall be taken into account, except expenses, taxes, and other deductions properly allocable to amounts excluded from foreign base company income under the provisions of paragraph (4) of section 954(b) and paragraph (b)(3) of this section and expenses, taxes, and other deductions properly allocable to amounts excluded from subpart F income under section 952(b) and the regulations thereunder.

(d) *Special rules where foreign base company income is less than 10 percent or more than 70 percent of gross income.*

(2) *More than 70 percent of gross income.* Any amount included in foreign base company by reason of section 954(b)(3)(B) and this subparagraph (2) shall be treated as foreign base company shipping income to the extent allowed by the following formula:

FBCI amount under sec. 954(b)(3)(B) (to be allocated)	Other FBC shipping income	All FBCI amount not under sec. 954(b)(3)(B)

(3) *Method of computation.* See § 1.952-3 for rules relating to the method of determining the percentage which foreign base company income is of gross income under subparagraphs (1) and (2) of this paragraph.

(4) *Branches of controlled foreign corporations treated as separate corporations.* (i) *In general.* The 10-percent and 70-percent tests described in subparagraphs (1) and (2) of this paragraph apply to the foreign base company income of each controlled foreign corporation. In addition, if a branch or similar establishment of a controlled foreign corporation is treated as a separate wholly owned subsidiary corporation of such corporation under section 954(d)(2) and paragraph (b) of § 1.954-3, the 10-percent and 70-percent tests apply separately to the income allocated under such paragraph to such branch or similar establishment, to other branches and similar establishments similarly treated, and to the remainder of the controlled foreign corporation.

(ii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

(f) *Classification of an item of income.*

(3) *Shipping classification applies first.* Foreign base company shipping income (as determined under § 1.954-6) of a controlled foreign corporation shall not also be considered foreign personal holding company income, foreign base company sales income, or foreign base company services income. See section 954(b)(6)(A). However, foreign base company shipping income may be treated as foreign personal holding company income under sections 551 through 558, rather than as foreign base company shipping income. See section 951(d).

Par. 5. Section 1.954-2 is amended as follows:

1. The first sentence of paragraph (a) is amended by inserting "section 954(b)(6)(A)," immediately before "section 954(c) (3) and (4)", and by striking out "(e)" and inserting "(f)" in lieu thereof.

2. A new paragraph (f) is added at the end thereof to read as follows:

§ 1.954-2 *Foreign personal holding company income.*

(f) *Shipping income for taxable years beginning after December 31, 1975.* For taxable years beginning after December

31, 1975, foreign base company shipping income of a controlled foreign corporation (as determined under § 1.954-6) shall not also be considered foreign personal holding company income of that controlled foreign corporation.

Par. 6. Section 1.954-3 is amended by inserting "or foreign base company shipping income under § 1.954-6" immediately after "§ 1.954-2" in the fourth sentence of paragraph (a)(1) and by adding a new paragraph (c) to read as follows:

§ 1.954-3 Foreign base company sales income.

(c) *Shipping income for taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under § 1.954-6) of a controlled foreign corporation shall not also be considered foreign base company sales income of that controlled foreign corporation.

Par. 7. Section 1.954-4(d) is amended by deleting "or" at the end of subparagraph (1), by deleting the period at the end of subparagraph (2) and inserting in lieu thereof "; or", and by adding a new subparagraph (3) at the end thereof to read as follows:

§ 1.954-4 Foreign base company services income.

(d) *Items excluded.* . . .

(3) For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under § 1.954-6).

Par. 8. Immediately after § 1.954-5 new §§ 1.954-6 and 1.954-7 are added to read as follows:

§ 1.954-6 Foreign base company shipping income.

(a) *Scope—(1) In general.* This section prescribes rules for determining foreign base company shipping income under the provisions of section 954(f), as amended by the Tax Reduction Act of 1975.

(2) *Effective date.* (i) The rules prescribed in this section apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end.

(ii) Except as described in paragraph (b)(1)(viii) of this section, foreign base company shipping income does not include amounts earned by a foreign corporation in a taxable year of such corporation beginning before January 1,

1976. See example (1) of paragraph (g)(2) of this section for an illustration of the effect of this subparagraph on partnership income. See example (3) of paragraph (f)(4)(ii) of this section for an illustration of the effect of this subparagraph on certain dividend income. See paragraph (f)(5)(iii) of this section for the effect of this subparagraph on certain interest and gains.

(b) *Definitions—(1) Foreign base company shipping income.* The term "foreign base company shipping income" means—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce (see paragraph (c) of this section).

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce (see paragraph (d) of this section).

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as provided in paragraph (e) of this section.

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used or held for use (by the seller or by a person related to the seller) in foreign commerce.

(v) In the case of a controlled foreign corporation, dividends, interest, and gains described in paragraph (f) of this section.

(vi) Income described in paragraph (g) of this section (relating to partnerships, trusts, etc.).

(vii) Exchange gain, to the extent allocable to foreign base company shipping income (see § 1.952-2(c)(2)(v)(b)), and

(viii) In the case of a controlled foreign corporation and at its option, dividends, interest, and gains attributable to income derived from aircraft and vessels (as defined in 26 CFR § 1.954-1(b)(2) (Rev. as of April 1, 1975)) by a less developed country shipping company (described in § 1.955-5(b)) in taxable years beginning after December 31, 1962, and before January 1, 1976. The portion of a dividend, interest, or gain attributable to such income shall be determined by the same method as that for determining the portion of a dividend, interest, or gain attributable to foreign base company shipping income under paragraphs (f) (4), (5), and (6) of this section, but without regard to paragraphs (f)(6) (ii) and (iv)(B).

(2) *Foreign base company shipping operations.* For purposes of sections 951 through 964, the term "foreign base

company shipping operations" means the trade or business from which gross income described in subparagraph (1) (i) and (ii) of this paragraph is derived.

(3) *Foreign commerce.* For purposes of sections 951 through 964—

(i) An aircraft or vessel is used in foreign commerce to the extent it is used in transportation of property or passengers—

(A) Between a port (or airport) in the United States or possession of the United States and a port (or airport) in a foreign country, or

(B) Between a port (or airport) in a foreign country and another in the same country or between a port (or airport) in a foreign country and one in another foreign country.

Thus, for example, a trawler, a factory ship, and an oil drilling ship are not considered to be used in foreign commerce. On the other hand, a cruise ship which visits one or more foreign ports is considered to be so used. Notwithstanding subdivision (i)(B) of this paragraph (b)(3), foreign base company income does not include income derived from, or in connection with, the use of an aircraft or vessel in transportation of property or passengers between a port (or airport) in a foreign country and another port (or airport) in the same country if both the foreign corporation is created or organized and the aircraft or vessel is registered in that country.

(ii) The term "vessel" includes all water craft and other artificial contrivances of whatever description and at whatever stage of construction, whether on the stocks or launched, which are used or are capable of being used or are intended to be used as a means of transportation on water. This definition does not apply for purposes of section 956(b)(2)(G) and § 1.956-2(b)(1)(ix).

(iii) The term "port" means any place (whether on or off shore) where aircraft or vessels are accustomed to load or unload goods or to take on or let off passengers.

(iv) Any vessel (such as a lighter or beacon lightship) which serves other vessels used in foreign commerce (within the meaning of subdivision (i) of this subparagraph) shall, to the extent so used, also be considered to be used in foreign commerce.

(v) For the meaning of the term "foreign country", see section 638(2).

(4) *Use in foreign commerce.* For purposes of sections 951 through 964, the use of an aircraft or vessel in foreign commerce includes the hiring or leasing (or subleasing) of an aircraft or vessel to another for use in foreign commerce.

Thus, for example, an aircraft or vessel is "used in foreign commerce" within the meaning of section 955(b)(1)(A) if such aircraft or vessel is chartered (whether pursuant to a bareboat charter, time charter, or otherwise) to another for use in foreign commerce.

(5) *Related person.* With respect to a controlled foreign corporation, the term "related person" means a related person as defined in § 1.954-1(e)(1), and the term "unrelated person" means an unrelated person as defined in § 1.954-1(e)(2).

(c) *Aircraft or vessel income.* (1) *In general.* The term "income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce" as used in paragraph (b)(1)(i) of this section means—

(i) Income derived from transporting passengers or property by aircraft or vessel in foreign commerce and

(ii) Income derived from hiring or leasing an aircraft or vessel to another for use in foreign commerce.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation C owns a foreign flag vessel which it charters under a long-term charter to foreign corporation D. The vessel is used by D as a tramp which has no fixed or regular schedule. The vessel carries bulk and packaged cargoes, as well as occasional passengers, under charter parties, contracts of affreightment, or other contracts of carriage. The carriage of cargoes and passengers is between a port in the United States and a port in a foreign country or between a port in one foreign country and another port in the same or a different foreign country. The charter hire paid to C by D constitutes income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire is allocable to income derived from the use of the vessel between ports in the same foreign country in which both C is incorporated and the vessel is registered. The charter hire and freight and passenger revenue (including demurrage and dead freight) derived by D also constitute income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire and freight and passenger revenue are allocable to the use of the vessel between ports in the same foreign country in which both D is incorporated and the vessel is registered.

Example (2). (a) Foreign corporation E owns a foreign flag tanker which it charters under a long-term bareboat charter to foreign corporation F for use in foreign commerce. F produces oil in a foreign country and ships the oil to other foreign countries and to the United States. The vessel, when not engaged in carrying F's oil, is used to carry bulk cargoes for unrelated persons in foreign commerce as opportunity offers. The charter hire received by E constitutes income derived

from the use of the vessel in foreign commerce. The income derived by F from carrying bulk cargoes for unrelated persons also constitutes income derived from the use of the vessel in foreign commerce.

(b) F is forced to lay up the vessel as a result of adverse market developments. Pursuant to the terms of the charter, F continues to pay charter hire to E during the period of lay-up. The charter hire received by E during the period of lay-up constitutes income derived from the use of the vessel in foreign commerce.

Example (3). (a) A shipment of cheese is loaded into a container owned by controlled foreign corporation S at the consignor's place of business in Hamar, Norway. The cheese is transported to Milan, Italy, by the following routings:

(1) Overland by road from Hamar, Norway, to Gothenburg, Sweden, by unrelated motor carriers via Oslo, Norway.

(2) By sea from Gothenburg to Rotterdam, Netherlands, by feeder vessel under foreign flag, time chartered to S by unrelated owner.

(3) By sea from Rotterdam to Algeiras, Spain, by feeder vessel under foreign flag, time chartered to S by unrelated owner.

(4) By sea from Algeiras to Genoa, Italy, by line-haul vessel under U.S. flag, chartered by S from related company, and

(5) Overland from Genoa to Milan, Italy, by unrelated motor carrier.

(b) The consignor pays S total charges of \$1,710, and S pays \$676 to unrelated third parties, which amounts may be broken down as follows:

Description of charges	Amount billed to customer and collected by S	Revenue collected by S on behalf of an unrelated party	Costs paid to unrelated 3d party and absorbed by S
Ocean freight	\$1,420		
Trucking charge of empty equipment to shipper's facility	50	\$50	
Trucking charges Hamar to Oslo	60	60	
Trucking charges Oslo to Gothenburg			\$315
Trucking charges Genoa to Milan	180	180	
Brokerage Commission in Europe			71
Total	1,710	290	386

(c) Of the \$1,710 amount billed to the consignor and collected by S, \$290 is collected by S on behalf of unrelated third parties. This \$290 amount is not includable in S's gross income, and is therefore not includable in S's foreign base company shipping income. The remaining \$1,420 amount (i.e., \$1,710 - \$290) is includable in S's foreign base company shipping income. The \$386 amount paid by S to unrelated third parties and absorbed by S is deductible from foreign base company shipping income under § 1.954-1(c).

(d) *Services directly related.*—(1) *In general.* The term "income derived from,

or in connection with, the performance of services directly related to the use of an aircraft or vessel in foreign commerce", as used in paragraph (b)(1)(ii) of this section, means—

(i) Income derived from, or in connection with, the performance of services described in subparagraph (2) or (3) of this paragraph, and

(ii) Income treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(2) *Intragroup services.* The services described in this subparagraph are services performed for a person who is the owner, lessor, lessee or operator of an aircraft or vessel used in foreign commerce, by such person or by a person related to such person, and which fall into one or more of the following categories:

(i) Terminal services, such as dockage, wharfage, storage, lights, water, refrigeration, and similar services;

(ii) Stevedoring and other cargo handling services;

(iii) Container related services (including the rental of containers and related equipment) performed either in connection with the local drayage or inland haulage of cargo or in the course of transportation in foreign commerce;

(iv) Services performed by tugs, lighters, barges, scows, launches, floating cranes, and other similar equipment;

(v) Maintenance and repairs;

(vi) Training of pilots and crews;

(vii) Licensing of patents, know-how, and similar intangible property developed and used in the course of foreign base company shipping operations;

(viii) Services performed by a booking, operating, or managing agent; and

(ix) Any service performed in the course of the actual transportation of passengers or property.

(3) *Services for passenger, consignor, or consignee.* The services described in this subparagraph are services provided by the operator (or person related to the operator) of an aircraft or vessel in foreign commerce for the passenger, consignor, or consignee, such as—

(i) Services described in one or more of the categories set out in subparagraph (2)(i) through (iv) and (ix) of this paragraph,

(ii) The rental of staterooms, berths, or living accommodations and the furnishing of meals,

(iii) Barber shop and other services to passengers aboard vessels,

(iv) Excess baggage, and

(v) Demurrage, dispatch, and dead freight.

(4) *The 70-percent test.* At the option of the foreign corporation all the gross income for a taxable year derived by a foreign corporation from any facility used in connection with the performance of services described in one or more of the categories set out in subparagraph (2)(i) through (ix) of this paragraph is foreign base company shipping income if more than 70 percent of such gross income for either—

- (i) Such taxable year, or
 - (ii) Such taxable year and the two preceding taxable years,
- is foreign base company shipping income (determined without regard to this subparagraph). Thus, for example, if 80 percent of the gross income derived by a controlled foreign corporation at a stevedoring facility is treated as foreign base company shipping income under subparagraph (2) of this paragraph, then the remaining 20 percent is treated as foreign base company shipping income under this subparagraph.

(5) *Rules for applying subparagraph (4).* (i) Solely for purposes of applying subparagraphs (4) of this paragraph, foreign base company shipping income and gross income shall be deemed to include an arm's length charge (see paragraph (h)(5) of this section) for services performed by the foreign corporation for itself.

(ii) In determining whether services performed by a foreign corporation are performed at a single facility or at two or more different facilities, all of the facts and circumstances involved will be taken into account. Ordinarily, all services performed by a foreign corporation within a single port area will be considered performed at a single facility.

(iii) The application of this subparagraph and subparagraph (4) of this paragraph may be illustrated by the following example in which it is assumed that the foreign corporation has chosen to apply the 70-percent test of subparagraph (4):

Example. (a) Controlled foreign corporation X uses the calendar year as the taxable year. For 1976, X is divided into two operating divisions, A and B. Division A operates a number of vessels in foreign commerce. Division B operates a terminal facility at which it performs services described in subparagraph (2)(i) of this paragraph for vessels some of which are operated by division A, some of which are operated by persons unrelated to X. For 1976, X includes under subparagraph (5) as foreign base company shipping income and gross income, for purposes of subparagraph (4), an arm's length charge for services performed for itself. For 1976, the gross income derived

by division B is reconstructed for purposes of subparagraph (4) of this paragraph as follows, based on the facts shown in the following table:

(1) Gross income derived from persons unrelated to X.....	\$20
(2) Gross income derived from persons related to X.....	10
(3) Actual gross income (line (1) plus line (2)).....	30
(4) Hypothetical gross income derived from division A (determined by the application of subdivision (i) of this subparagraph).....	70
(5) Total reconstructed gross income (line (3) plus line (4)).....	100

(b) Since 80 percent of the reconstructed gross income derived by division B would be treated as foreign base company shipping income under subparagraph (2) of this paragraph, the entire \$30 amount of the gross income actually derived by division B is treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(6) *Arm's length charge.* For purposes of this section, the arm's length charge for services performed by a foreign corporation for itself shall be determined by applying the principles of section 482 and the regulations thereunder as if the party for whom the services are performed and the party by whom the services are performed were not the same person, but were controlled taxpayers within the meaning of § 1.482-1(a)(4).

(7) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A acts as a managing agent for foreign corporation B, a related person which contracts to construct and charter a foreign flag vessel for use in foreign commerce. As managing agent for B, A performs a broad range of services relating to the use of the vessel, including arranging for, and supervising of, construction and chartering of the vessel, and handling of operating services after construction is completed. The income derived by A from its management and operating services constitutes income derived in connection with the performance of services directly related to the use of the vessel in foreign commerce.

Example (2). Controlled foreign corporation C uses the calendar year as the taxable year. During 1976, C is engaged in the trade or business of acting as a steamship agent solely for unrelated persons. C's activities as steamship agent range from "husbanding" (i.e., arranging for fuel, supplies and port services, and attending to crew and customs matters) to the solicitation and booking of cargo at a number of foreign ports. None of C's other gross income for 1976 is foreign base company shipping income. Under these circumstances, C's gross income derived from

its steamship agency does not constitute foreign base company shipping income.

(e) *Incidental income.*—(1) *In general.* Foreign base company shipping income includes all incidental income derived by a foreign corporation in the course of its active conduct of foreign base company shipping operations.

(2) *Examples.* Examples of incidental income derived in the course of the active conduct of foreign base company shipping operations include—

(i) Gain from the sale, exchange or other disposition of assets which are related shipping assets within the meaning of § 1.955A-2(b),

(ii) Income derived from temporary investments described in § 1.955A-2(b)(2) (i) and (iii),

(iii) Interest on accounts receivable and evidences of indebtedness described in § 1.955A-2(b)(2)(ii),

(iv) Income derived from granting concessions to others aboard aircraft or vessels used in foreign commerce,

(v) Income derived from stock and currency futures described in § 1.955A-2(b)(2) (vii) and (viii),

(vi) Income derived by the lessor of an aircraft or vessel used in foreign commerce from additional rentals for the use of related equipment (such as a complement of containers), and

(vii) Interest derived by the seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel described in § 1.955A-2(a)(1)(i).

(f) *Certain dividends, interest, and gain.*—(1) *In general.* (i) The foreign base company shipping income of a controlled foreign corporation (referred to in subdivision (ii)(A) of this paragraph (f)(1) as "first corporation") includes—

(A) Dividends and interest received from foreign corporations listed in subdivision (ii) of this paragraph (f)(1), and

(B) Gain recognized from the sale, exchange, or other disposition of stock or obligations of foreign corporations listed in subdivision (ii) of this paragraph (f)(1),

but only to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income of the foreign corporations listed in subdivision (ii) of this paragraph (f)(1).

(ii) The foreign corporations referred to in subdivision (i) of this paragraph (f)(1) are—

(A) Foreign corporations with respect to which the first corporation (see subdivision (i) of this paragraph (f)(1)) would be deemed under section 902(b) to pay taxes,

(B) Controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)), and

(C) Less developed country shipping companies described in § 1.955-5(b).

(2) *Corporation deemed to pay taxes.* (i) For purposes of this paragraph, a controlled foreign corporation would be deemed under section 902(b) to pay taxes in respect of any other foreign corporation if such controlled foreign corporation would be deemed, for purposes of applying section 902(a) to any United States shareholder of such controlled foreign corporation, to pay taxes in respect of dividends which were received from such other foreign corporation (whether or not such other foreign corporation actually pays any taxes or dividends). Solely for purposes of this subdivision, each United States shareholder (within the meaning of section 951(b)) shall be deemed to be a domestic corporation.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y is not a controlled foreign corporation. For purposes of subdivision (1) of this subparagraph, X is deemed to pay taxes in respect of Y.

Example (2). The facts are the same as in example (1), except that United States shareholder A, an individual, owns 80 percent of the stock of corporation X, and United States shareholders B and C, parent and child, own the other 20 percent in equal shares. For purposes of applying this paragraph to all three United States shareholders (A, B, and C), X is deemed to pay taxes in respect of Y.

(3) *Obligation defined.* For purposes of this section, the term "obligation" means any bond, note, debenture, certificate, or other evidence of indebtedness, and a debt recorded in the books of account of both the creditor and the debtor. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Dividends.* (i) For purposes of this paragraph and § 1.954-1(b)(2), the portion of a dividend which is attributable to foreign base company shipping income is that amount which bears the same ratio to the total dividend received as the earnings and profits out of which such dividend is paid that are attributable to foreign base company shipping income bears to the total earnings and profits out of which such dividend is paid. For purposes of this subdivision, the source of the earnings and profits out of which a distribution is made shall be determined

under section 316(a), except that the source of the earnings and profits out of which a distribution is made by a controlled foreign corporation with respect to stock owned (within the meaning of section 958(a)) by a United States shareholder of such controlled foreign corporation shall be determined under § 1.959-3.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y, which is not (and has not been) either a controlled foreign corporation or a less developed country shipping company, makes a distribution of \$100 to X. Under section 316(a), such distribution is made out of Y's earnings and profits for 1978. Sixty percent of Y's earnings and profits for 1978 are attributable to foreign base company shipping income. As a result, \$60 of the \$100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example (2). The facts are the same as in example (1), except that under section 316(a) \$20 of the \$100 dividend is paid out of Y's earnings and profits for 1979, and the other \$80 is paid out of Y's earnings and profits for 1978. Thirty percent of Y's earnings and profits for 1979 are attributable to foreign base company shipping income. Since 60 percent of Y's earnings and profits for 1978 are also attributable to foreign base company shipping income, \$54, i.e., $(.60 \times \$80) + (.30 \times \$20)$, of the \$100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example (3). The facts are the same as in example (1) except that under section 316(a) the \$100 dividend is made out of Y's earnings and profits for 1972. Since under paragraph (a)(2)(ii) of this section foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping company) in a taxable year beginning before January 1, 1978, no amount of such \$100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example (4). Domestic corporation N owns 100 percent of the one class of stock of controlled foreign corporation S, which in turn owns 100 percent of the one class of stock of controlled foreign corporation T. T makes a distribution of \$100 to S, of which \$80 is allocable under § 1.959-3 to earnings and profits for 1977 which are described in § 1.959-3(b)(2), and \$20 is allocable to earnings and profits for 1978 which are described in § 1.959-3(b)(3). The \$80 amount is excluded from S's gross income under section 959(b) and therefore is not included in S's foreign base company shipping income. One hundred percent of T's earnings and profits for 1978 described in § 1.959-3(b)(3) were attributable to reinvested foreign base company shipping income. As a result, the

entire \$20 amount is included in S's foreign base company shipping income under this paragraph. See § 1.954-1(b)(2) for the rule that such \$20 amount may be excluded from the foreign base company income of S.

(5) *Interest and gain.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph, the portion of any interest paid by a foreign corporation, or gain recognized from the sale, exchange, or other disposition of stock or obligations of a foreign corporation, which is attributable to the foreign base company shipping income of such foreign corporation is that amount which bears the same ratio to such interest or gain as the foreign base company shipping income of such corporation for the period described in subparagraph (6) of this paragraph bears to its gross income for such period.

(ii) Interest which is paid by a controlled foreign corporation is attributable to such corporation's foreign base company shipping income to the same extent that such interest is allocable (under the principles of § 1.954-1(c)) to its foreign base company shipping income.

(iii) If interest is paid by a foreign corporation, or if stock obligations of a foreign corporation are sold, exchanged, or otherwise disposed of, during a taxable year of such foreign corporation beginning before January 1, 1976, then no portion of such interest or gain is attributable to foreign base company shipping income.

(iv) Solely for purposes of subdivision (i) of this subparagraph, if a controlled foreign corporation (the "first corporation") owns more than 10 percent of the stock of another controlled foreign corporation (the "second corporation"), then

(A) The gross income of the first corporation for any taxable year shall be—

(1) Increased by its pro rata share of the gross income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(2) Decreased by the amount of any dividends received from the second corporation; and

(B) The foreign base company shipping income of the first corporation for any taxable year shall be—

(1) Increased by its pro rata share of the foreign base company shipping income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(2) Decreased by the amount of any dividends received from the second

corporation which constitute foreign base company income.

(v) Solely for purposes of applying subdivision (i) of this subparagraph, the district director shall make such other adjustments to the gross income and the foreign base company shipping income of any foreign corporation as are necessary to properly determine the extent to which any interest or gain is attributable to foreign base company shipping income, including proper adjustments to reflect any transaction during the test period described in subparagraph (6) of this paragraph to which section 332, 351, 354, 355, 356, or 361 applies.

(6) *Test period.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph the period described in this subparagraph with respect to any foreign corporation is the 3-year period ending with the close of such corporation's taxable year preceeding the year during which interest was paid or stock or obligations were sold, exchanged, or otherwise disposed of, or such part of such period as such corporation was in existence.

(ii) The period described in this paragraph shall not include any part of a taxable year beginning before January 1, 1976.

(iii) If interest is paid by a foreign corporation, or if stock or obligations of a foreign corporation are sold, exchanged, or otherwise disposed of during its first taxable year, then the period described in this paragraph shall be such first taxable year.

(iv) For purposes of subdivision (iii) of this subparagraph, the first taxable year of a foreign corporation is the later of—

(A) The first taxable year of its existence, or

(B) Its first taxable year beginning after December 31, 1975.

(g) *Income from partnerships, trusts, etc.—(1) In general.* The foreign base company shipping income of any foreign corporation includes—

(i) Its distributive share of the gross income of any partnership, and

(ii) Any amounts includible in its gross income under section 652(a), 662(a), 671, or 691(a),

to the extent that such items would have been includible in its foreign base company shipping income had they been realized by it directly.

(2) *Illustrations.* The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Controlled foreign corporations X and Y are equal partners in partnership P. The taxable years end on December 31 for X, June 30 for Y, and March 31 for P. In the fiscal year ending March 31, 1976, P's sole business activity is the use of a

vessel in foreign commerce. P derives gross income of \$200 from the use of the vessel, and incurs expenses, taxes, and other deductions of \$160. Assume X's distributive share of such \$200 of P's gross income is \$100, all of which is includible in X's gross income. If X had realized its distributive share of \$100 directly, then the amount which would have been includible in X's foreign base company shipping income under this paragraph is the portion allocable to the months of January, February, and March of 1976. Such amount, \$25 (i.e., $\frac{1}{4} \times \$200 \times 3 \text{ months}/12 \text{ months}$), is included in X's foreign base company shipping income for its taxable year ending December 31, 1976. Similarly, Y is entitled under this paragraph to a deduction from foreign base company shipping income of \$20 (i.e., $\frac{1}{4} \times \$160 \times 3 \text{ months}/12 \text{ months}$). Since foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping corporation) in a taxable year beginning before January 1, 1976, Y has no foreign base company shipping income (under this paragraph or otherwise) for its taxable year beginning on July 1, 1975.

Example (2). The facts are the same as in example (1), except that P incurs expenses, taxes, and deductions of \$240 in its taxable year ending on March 31, 1976. Accordingly, \$25 is includible in X's foreign base company shipping income, and the amount deductible therefrom under this paragraph is \$30 (i.e., $\frac{1}{4} \times \$240 \times 3 \text{ months}/12 \text{ months}$).

(3) *Other income.* Except as expressly provided in subparagraph (1) of this paragraph, foreign base company shipping income does not include any amount includible in the gross income of a controlled foreign corporation under part I of subchapter J (section 641 and following, relating to estates, trusts, and beneficiaries), and gains from the sale or other disposition of any interest in an estate or trust.

(h) *Additional rules.—(1) Gross income.* For purposes of this section and § 1.955A-2, the gross income of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 952 and § 1.952-2. Thus, for example, section 883 (relating to exclusions from gross income of foreign corporations) is inapplicable under § 1.952-2 (a)(1) and (c)(1). In addition, the gross income of a controlled foreign corporation shall be determined, with respect to a United States shareholder of such controlled foreign corporation, by excluding distributions received by such corporation which are excluded from gross income under section 959(b) with respect to such shareholder.

(2) *Earnings and profits.* For purposes of this section, the earnings and profits of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 964 and the regulations thereunder.

(3) *No double counting.* No item of gross income shall be counted as foreign base company shipping income under more than one provision of this section. For example, if \$200 of gross income derived from the use of a lighter is treated as foreign base company shipping income under both paragraph (b)(1)(i) and paragraph (b)(1)(ii) of this section, then such \$200 is counted only once as foreign base company shipping income. A taxpayer may choose under which provision to include an item of income.

(4) *Losses.* (i) Generally, if a controlled foreign corporation has losses which are properly allocable to foreign base company shipping income, the extent to which such losses are deductible from such income shall be determined by treating such foreign corporation as a domestic corporation and applying the principles of section 63. See §§ 1.954-1(c) and 1.952-2(b). Thus for example, losses from sales or exchanges of capital assets are allowable only to the extent of gains from such sales or exchanges.

(ii) If gain from the sale, exchange, or other disposition of any stock or obligation would be treated (to any extent) as foreign base company shipping income, then loss from such sale, exchange, or other disposition is properly allocable to foreign base company shipping income (to the same extent).

(iii) In determining the extent to which any loss on the disposition of a qualified investment in foreign base company shipping operations is deductible from foreign base company shipping income, it is immaterial that such loss is taken into account under § 1.955A-1(b)(1)(ii) as a reduction in the amount of the decrease in (withdrawal from) qualified investments in foreign base company shipping operations.

(5) *Hypothetical charges.* Under paragraph (d)(5)(i) of this section and § 1.955A-2(a)(4)(ii)(A), gross income may be deemed to include hypothetical arm's length charges for services performed by a controlled foreign corporation for itself. Under paragraph (d)(2) of this section, certain of these hypothetical charges may be treated as foreign based company shipping income. Such hypothetical charges are deemed to be income solely for purposes of applying the "extent of use" tests prescribed by paragraph (d)(4) of this section and § 1.955A-2(a)(4). Charges for services performed by a controlled foreign corporation for itself shall in no event be included in income for any other purposes.

§ 1.954-7 Increase in qualified investments in foreign base company shipping operations.

(a) *Determination of investments at close of taxable year.*—(1) *In general.* Under section 954(g), the increase in qualified investments in foreign base company shipping operations, for purposes of section 954(b)(2) and paragraph (b)(1) of § 1.954-1, of any controlled foreign corporation for any taxable year is, except as provided in paragraph (b) of this section, the amount by which—

(i) The controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the preceding taxable year.

(2) *Preceding taxable year.* For purposes of this section, a taxable year which begins before January 1, 1976, may be a preceding taxable year.

(3) *Cross-reference.* See section 955(b) and § 1.955A-2 for the definition of the term "qualified investments in foreign base company shipping operations".

(b) *Election to determine investments at close of following taxable year.*—(1)

General rule. In lieu of determining an increase in qualified investments in foreign base company shipping operations for a taxable year in the manner provided in paragraph (a) of this section, a United States shareholder of a controlled foreign corporation may make an election under section 955(b)(3) to determine the increase for the corporation's taxable year by ascertaining the amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such following taxable year.

(2) *Election with respect to first taxable year.* Notwithstanding subparagraph (1) of this paragraph, if an election is made without consent by a United States shareholder under § 1.955A-4 (b)(1) with respect to a controlled foreign corporation, the increase in such controlled foreign corporation's qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be the

amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such first taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such first taxable year.

(3) *Manner of making election.* For the manner of making an election under section 955(b)(3), and for rules pertaining to the revocation of such an election, see § 1.955A-4.

(4) *Coordination with prior law.* If a United States shareholder makes an election without consent under § 1.955A-4(b)(1) with respect to a controlled foreign corporation, then such corporation's increase in qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be determined by disregarding any change which occurs during such taxable year in the amount of such corporation's investments in stock or obligations of a less developed country shipping company described in § 1.955-5 (b) if both of the following conditions exist:

(i) Such taxable year is the first taxable year of such corporation which begins after December 31, 1975, and

(ii) Such United States shareholder has elected to determine the change in such corporation's qualified investments in less developed countries for its last taxable year beginning before January 1, 1976, under § 1.954-5(b) or § 1.955-3.

(5) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) Controlled foreign corporation X is a wholly owned subsidiary of domestic corporation M. X uses the calendar year as the taxable year. The amounts of X's qualified investments in foreign base company shipping operations at the close of 1975 through 1979 are as follows:

Qualified investments at Dec. 31, 1975.....	\$16,000
Qualified investments at Dec. 31, 1976.....	17,000
Qualified investments at Dec. 31, 1977.....	23,000
Qualified investments at Dec. 31, 1978.....	28,000
Qualified investments at Dec. 31, 1979.....	30,000

(b) Assume that M properly files without consent a timely election under § 1.955A-4(b)(1) to determine X's increase for 1976 in

qualified investments in foreign base company shipping operations pursuant to this paragraph, and that the election remains in force through 1978. Then X's increases for 1976 through 1978 in qualified investments in foreign base company shipping operations are as follows:

Increase for 1976 (\$23,000 minus \$16,000).....	\$7,000
Increase for 1977 (\$28,000 minus \$23,000).....	5,000
Increase for 1978 (\$30,000 minus \$28,000).....	2,000

Example (2). Assume the same facts as in example (1), except that M never files an election under § 1.955A-4(b)(1). X's increases for 1976 through 1978 in qualified investments in foreign base company shipping operations are as follows:

Increase for 1976 (\$17,000 minus \$16,000).....	\$1,000
Increase for 1977 (\$23,000 minus \$17,000).....	6,000
Increase for 1978 (\$28,000 minus \$23,000).....	5,000

Example (3). The facts are the same as in example (1), except that X's qualified investments in foreign base company shipping operations include an investment in less developed country shipping companies described in § 1.955-5(b) of \$500 on December 31, 1975, and \$750 on December 31, 1976. Assume further that M has made an election under section 955(b)(3) (as in effect before the enactment of the Tax Reduction Act of 1975) with respect to X's taxable year 1975. Then X's increase in qualified investments in foreign base company shipping operations for 1976 is \$6,750 (i.e., \$7,000 - \$250).

(c) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) Controlled foreign corporation X uses the calendar year as the taxable year. On December 31, 1975, X's qualified investments in foreign base company shipping operations (determined as provided in § 1.955A-2(g)) consist of the following amounts:

Cash.....	\$6,000
Readily marketable securities.....	1,000
Stock of related controlled foreign corporations.....	4,000
Traffic and other receivables.....	14,000
Marine insurance claims receivables.....	1,000
Foreign income tax refunds receivable.....	1,000
Prepaid shipping expenses and shipping inventories ashore.....	1,000

Vessel construction funds.....	0
Vessels.....	123,000
Vessel plans and construction in progress.....	3,000
Containers and chassis.....	0
Terminal property and equipment.....	2,000
Shipping office (land and building).....	1,000
Vessel spare parts ashore.....	1,000
Performance deposits.....	2,000
Deferred charges.....	2,000
Stock of less developed country shipping company described in § 1.955-5(b).....	10,000
	<u>172,000</u>

(b) On December 31, 1976, X's qualified investments in foreign base company shipping operations (determined as provided in § 1.955A-2(g)) consists of the following amounts:

Cash.....	\$5,000
Readily marketable securities.....	2,000
Stock of related controlled foreign corporations.....	4,000
Traffic and other receivables.....	16,000
Foreign income tax refunds receivable.....	3,000
Prepaid shipping expenses and shipping inventories ashore.....	2,000
Vessel construction funds.....	1,000
Vessels.....	117,000
Vessel plans and construction in progress.....	12,000
Containers and chassis.....	4,000
Terminal property and equipment.....	2,000
Shipping office (land and building).....	1,000
Vessel spare parts ashore.....	1,000
Performance deposits.....	2,000
Deferred charges.....	2,000
Stock of less developed country shipping company described in § 1.955-5(b).....	0
	<u>174,000</u>

(c) For 1976, X's increase in qualified investments in foreign base company shipping operations is \$2,000, which amount is determined as follows:

Qualified investments at Dec. 31, 1976.....	\$174,000
Qualified investments at Dec. 31, 1975.....	172,000
Increase for 1976.....	2,000

Par. 9. A new paragraph (b) is added to § 1.955-0 to read as follows:

§ 1.955-0 Effective dates.

(b) Section 955 as amended by the Tax Reduction Act of 1975. Except as otherwise provided therein, §§ 1.955A-1 through 1.955A-4 are applicable to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such

taxable years of such foreign corporations end.

Par. 10. Section 1.955-1(b) is amended as follows:

1. Subparagraph (2)(i)(a) is amended by inserting "(including prior taxable years beginning after December 31, 1975)" immediately after "1962".

2. Subparagraph (2)(ii)(a) is revised.

3. A new subparagraph (3) is added. The added and amended provisions read as follows:

§ 1.955-1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.

* * *

(b) Amount withdrawn by controlled foreign corporation. * * *

(2) Limitations applicable in determining decreases. * * *

(ii) Treatment of earnings and profits. * * *

(a)(1) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A) (i) or (iii), or

(2) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(3) Taxable years beginning after December 31, 1975. (i) In the case of a taxable year of a controlled foreign corporation beginning after December 31, 1975, § 1.955-2(b)(5) must be applied in determining the amount of its qualified investments in less developed countries on both of the determination dates applicable to such taxable year.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). (a) Controlled foreign corporation M uses the calendar year as the taxable year. Throughout 1974 through 1976, M owns 100 percent of the only class of stock of foreign corporation N, a less developed country shipping company described in § 1.955-5(b), and M owns no other stock or obligations. The amount taken into account under § 1.955-2(d) with respect to the stock of N is \$10,000 at the close of 1974, 1975, and 1976. The amount of M's previously excluded subpart F income which is withdrawn for 1975 (a year to which § 1.955-2(b)(5) does not apply) from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1974.....	\$10,000
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(2) Less: qualified investments in less developed countries at the close of 1975.....	10,000
(3) Balance.....	0

(Further computations similar to those set out in lines (iv) through (ix) of example (1) of paragraph (d) of this section are unnecessary because the balance in line (3) of this example is zero.)

(b) As a result of § 1.955-2(b)(5) (ii), the amount of M's previously excluded subpart F income which is withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1975.....	\$0
(2) Less: qualified investments in less developed countries at the close of 1976.....	0
(3) Balance.....	0

Example (2). The facts are the same as in example (1), except that foreign corporation N is a less developed country corporation described in § 1.955-5(a). The amount of M's previously excluded subpart F income withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1975.....	\$10,000
(2) Less: qualified investments in less developed countries at the close of 1976.....	10,000
(3) Balance.....	0

Par. 11. Section 1.955-2 is amended by revising paragraph (b)(4) and adding new paragraphs (b)(5), (b)(6), and (d)(4) thereto to read as follows:

§ 1.955-2 Amount of a controlled foreign corporation's qualified investments in less developed countries.

* * *

(b) Special rules. * * *

(4) Date of acquisition. For purposes of paragraphs (a)(2) and (b)(5)(i) of this section, stock or an obligation shall be considered acquired by a foreign corporation as of the date such corporation acquires an adjusted basis in the stock or obligation. For this purpose, in a case in which a foreign corporation acquires stock or an obligation in a transaction (other than a reorganization of the type described in section 368(a)(1) (E) or (F)) in which no gain or loss would be recognized had the transaction been between two domestic corporations, such corporation will be considered to have acquired an adjusted

basis in such stock or obligation as of the date such transaction occurs.

(5) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, qualified investments in less developed countries do not include—

(i) Any property acquired after the latest determination date applicable to a taxable year beginning before December 31, 1975.

(ii) Stock or obligations of a less developed country shipping company described in § 1.955-5(b), and

(iii) Stock or obligations which were not treated as qualified investments in less developed countries on the later of the two determination dates applicable to the preceding taxable year.

See § 1.955-1(b)(3) for rules relating to the application of this subparagraph.

See § 1.955A-2(h) for rules relating to the treatment of investments in stock or obligations described in subdivision (ii) of this subparagraph as qualified investments in foreign base company shipping operations.

(6) *Determination dates.* For purposes of subparagraph (5) of this paragraph and § 1.955-1(b)(3), the determination dates applicable to a taxable year of a controlled foreign corporation are—

(i) Except as provided in subdivision (ii) of this subparagraph, the close of such taxable year and the close of the preceding taxable year, and

(ii) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in less developed countries at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

(d) *Amount attributable to property.* . . .

(4) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, the amount taken into account under subparagraph (1) of this paragraph with respect to any property which constitutes a qualified investment in less developed countries shall not exceed the amount taken into account with respect to such property at the close of the preceding taxable year.

Par. 12. Section 1.955-3 is amended as follows:

1. Paragraph (b)(2) is amended by adding a new sentence after the second sentence thereof.

2. Paragraph (c)(3) is amended by adding a new sentence after the fifth sentence thereof.

3. Paragraph (c)(3)(i) is amended by inserting "name, address, and taxpayer identification number" in lieu of "name and address".

The added provisions read as follows:

§ 1.955-3 Election as to date of determining qualified investments in less developed countries.

(b) *Time and manner of making elections.* . . .

(2) *With consent.* . . . Consent will not be granted if the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section begins after December 31, 1975.

(c) *Effect of election.* . . .

(3) *Revocation.* . . . The application may also be filed in a taxable year beginning after December 31, 1975.

Par. 13. The following new sections are added immediately after § 1.955-6:

§ 1.955A-1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations.

(a) *In general.* Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year beginning after December 31, 1975, from investment in foreign base company shipping operations. Pursuant to section 951(a)(1)(A)(iii) and the regulations thereunder, a United States shareholder of such controlled foreign corporation must include in his gross income his pro rata share of such amount as determined in accordance with paragraph (c) of this section.

(b) *Amount withdrawn by controlled foreign corporation.*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in foreign base company shipping operations is an amount equal to the decrease for such year in such corporation's qualified investments in foreign base company shipping operations. Such decrease is, except as provided in § 1.955A-4—

(i) An amount equal to the excess of the amount of its qualified investments in foreign base company shipping operations at the close of the preceding taxable year over the amount of its qualified investments in foreign base company shipping operations at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in foreign base company shipping operations exceed its recognized gains on sales or exchanges during such year of qualified investments in foreign base company shipping operations.

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See § 1.955A-2 for determining the amount of qualified investments in foreign base company shipping operations.

(2) *Limitation applicable in determining decreases.*—(1) *In general.* The limitation referred to in subparagraph (i) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(A) The sum of (1) the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year, (2) the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1975, and (3) the amount described in subparagraph (3) of this paragraph; or

(B) The sum of the amounts excluded under section 954(b)(2) (see subparagraph (4) of this paragraph) from the foreign base company income of such corporation for all prior taxable years beginning after December 31, 1975, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all such prior taxable years.

(C) For purposes of the immediately preceding subparagraph (B), the amount excluded under section 954(b)(2) for a taxable year of a controlled foreign corporation (the "first corporation") includes (1) an amount excluded under section 954(b)(2) by another corporation which is a member of a related group (as defined in § 1.955A-3(b)(1)) attributable to the first corporation's excess investment (see § 1.955A-3(c)(4)) for a taxable year beginning after December 31, 1983, (2) an amount excluded by a corporation under § 1.954-1(b)(4)(ii)(b) by reason of the application of the carryover rule there set forth, and (3) an amount equal to the first corporation's pro rata share of a group excess deduction (see § 1.955A-3(c)(2)) of a related group for a taxable year

beginning after December 31, 1983 (but not in excess of that portion of such pro rata share which would reduce the first corporation's foreign base company shipping income to zero). Such amounts will not be treated as excluded under section 954(b)(2) by any other corporation.

(ii) *Certain exclusions from earnings and profits.* For purposes of determining the earnings and profits of a controlled foreign corporation under subdivision (i)(A) (1) and (2) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(A)(1) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A)(i), or

(2) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(B)(1) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(2) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed. The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in foreign base company shipping operations. See section 959 and the regulations thereunder for rules relating to the exclusion from gross income of previously taxed earnings and profits.

(3) *Carryover of amounts relating to investments in less developed country shipping companies.*—(i) *In general.* The amount described in this subparagraph for any taxable year of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The excess of the amount described in subdivision (ii) of this subparagraph, over the amount described in subdivision (iii) of this subparagraph, or

(B) The limitation determined under subdivision (iv) of this subparagraph.

(ii) *Previously excluded subpart F income invested in less developed*

country shipping companies. The amount described in this subdivision for all taxable years of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The amount of such corporation's qualified investments (determined under § 1.955-2 other than paragraph (b)(5) thereof) in less developed country shipping companies described in § 1.955-5(b) at the close of the last taxable year of such corporation beginning before January 1, 1976, or

(B) The limitation determined under § 1.955-1(b)(2)(i)(b) (relating to previously excluded subpart F income) for the first taxable year of such corporation beginning after January 1, 1976.

(iii) *Amounts previously carried over.* The amount described in this subdivision for any taxable year of a controlled foreign corporation shall be the sum of the excesses determined for each prior taxable year beginning after December 31, 1976, of—

(A) The amount (determined under this paragraph) of such corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, over

(B) The sum of the earnings and profits determined under subparagraph (2)(1)(A) (1) and (2) of this paragraph.

(iv) *Extent attributable to accumulated earnings and profits.* The limitation determined under this subdivision for any taxable year of a controlled foreign corporation is the sum of such controlled foreign corporation's earnings and profits (or deficits in earnings and profits) accumulated for taxable years beginning after December 31, 1962, and before January 1, 1976. For purposes of the preceding sentence, earnings and profits shall be determined by excluding the amounts described in subparagraph (2)(ii) (A) and (B) of this paragraph.

(v) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Throughout the period here involved, A is a United States shareholder of controlled foreign corporation M. M is not a foreign personal holding company, and M uses the calendar year as the taxable year.

(b) The amount described in this subparagraph for M's taxable year 1978 with respect to A is determined as follows, based on the facts shown in the following table:

(1) Investment in less developed country shipping companies on December 31, 1975 (subdivision (i)(A) amount)	\$10,000
(2) § 1.955-1(b)(2)(i)(b) limitation for 1976 (previously excluded subpart F income not withdrawn	

from investment in less developed countries) (subdivision (i)(B) amount)	50,000
(3) Subdivision (i) amount (lesser of lines (1) and (2))	10,000
(4) Subdivision (ii) amount. Excess for 1977 of M's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, \$3,000, over the sum of the amounts determined under subparagraphs (2)(i)(A) (1) and (2) of this paragraph, \$1,000	2,000
(5) Excess of line (3) over line (4)	8,000
(6) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1978	26,000
(7) Amount described in this subparagraph for 1978 (lesser of line (5) and line (6))	8,000

(c) For 1978, M's earnings and profits (reduced as provided in § 1.955-1(b)(2)(ii)(a)(1)) are \$19,000, and the amount of M's previously excluded subpart F income withdrawn from investment in less developed countries determined under § 1.955-1(b) is \$42,000. Consequently, \$23,000 of M's earnings and profits accumulated for 1962 through 1975 are attributable to such \$42,000 amount, and will therefore be excluded under subparagraph (2)(ii)(A)(2) of this paragraph from M's earnings and profits accumulated for 1962 through 1975, determined as of December 31, 1979. No other portion of M's earnings and profits accumulated for 1962 through 1975 is distributed or included in the gross income of a United States shareholder in 1978.

(d) The amount described in this subparagraph for M's taxable year 1979 with respect to A is determined as follows, based on the additional facts shown in the following table:

(1) Subdivision (i) amount (line (3) from paragraph (b) of this example)	\$10,000
(2) Subdivision (ii) amount: (i) Excess for 1977 from line (4) of paragraph (b) of this example	2,000
(ii) Plus: excess for 1978 of M's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, \$6,000, over the sum of the amounts determined under subparagraphs (2)(i)(A) (1) and (2) of this paragraph, \$25,000	0
(iii) Subdivision (ii) amount	2,000
(3) Excess of line (1) over line (2)(iii)	8,000
(4) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1979 (\$26,000 minus \$23,000)	3,000
(5) Amount described in this subparagraph for 1979 (lesser of line (3) and line (4))	3,000

(4) *Amount excluded.* For purposes of subparagraph (2)(i)(B) of this paragraph, the amount excluded under section 954(b)(2) from the foreign base company income of a controlled foreign corporation for any taxable year beginning after December 31, 1975, is the excess of—

(i) The amount which would have been equal to the subpart F income of such corporation for such taxable year if such corporation had had no increase in qualified investments in foreign base company shipping operations for such taxable year, over

(ii) The subpart F income of such corporation for such taxable year.

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation.*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in foreign base company shipping operations is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this section. See section 995(a)(3). Such pro rata share shall be determined in accordance with the principles of § 1.195-1(e).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)(B) of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1) A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign corporation throughout the entire period here involved. Both A and M use the calendar year as a taxable year. The amount of M's previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is \$40,000, and A's pro rata share of such amount is \$24,000 determined as follows based on the facts shown in the following table:

(a) Qualified investments in foreign base company shipping operations at the close of 1977.....	\$125,000
(b) Less: qualified investments in foreign base company shipping operations at the close of 1978.....	75,000
(c) Balance.....	50,000
(d) Less: excess of recognized losses (\$15,000) over recognized gains (\$5,000) on sales during 1978 of qualified investments in foreign base company shipping operations.....	10,000
(e) Tentative decrease in qualified investment in foreign base company shipping operations for 1978.....	40,000
(f) Earnings and profits for 1976, 1977, and 1978.....	45,000
(g) Plus: amount determined under paragraph (b)(3) of this section....	0
(h) Earnings and profits limitation....	45,000

(i) Excess of amount excluded under section 954(b)(2) from foreign base company income for 1975 (\$75,000) over amount of previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations (\$25,000).....	50,000
(j) M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations (item (e), but not to exceed the lesser of item (h) or item (i).....	40,000
(k) A's pro rata share of M Corporation's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations (60 percent of \$40,000).....	24,000

Example (2). The facts are the same as in example (1), except that M's earnings and profits (determined under paragraph (b)(2) of this section) for 1976, 1977, and 1978 (item (f)) are \$30,000 instead of \$45,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is \$30,000. A's pro rata share of such amount is \$18,000 (60 percent of \$30,000).

Example (3). The facts are the same as in example (1), except that the excess of the amount excluded under section 954(b)(2) for 1976 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations (item (i)) is \$20,000 instead of \$50,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is \$20,000. A's pro rata share of such amount is \$12,000 (60 percent of \$20,000).

§ 1.955A-2 Amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations.

(a) *Qualified investments.*—(1) *In general.* Under section 955(b), for purposes of sections 951 through 964, a controlled foreign corporation's "qualified investments in foreign base company shipping operations" are investments in—

(i) Any aircraft or vessel, to the extent that such aircraft or vessel is used (or hired or leased for use) in foreign commerce,

(ii) Related shipping assets (within the meaning of paragraph (b) of this section),

(iii) Stock or obligations of a related controlled foreign corporation, to the extent provided in paragraph (c) of this section,

(iv) A partnership, to the extent provided in paragraph (d) of this section, and

(v) Stock or obligations of a less developed country shipping company described in § 1.955-5(b), as provided in paragraph (h) of this section.

(2) *Coordination of provisions.* No amount shall be counted as a qualified investment in foreign base company shipping operations under more than one provision of this section. Thus, for example, if a \$10,000 investment in stock of a controlled foreign corporation is treated as a qualified investment in foreign base company shipping operations under both subparagraph (1) (iii) and (v) of this paragraph, then such \$10,000 is counted only once as a qualified investment in foreign base company shipping operations.

(3) *Definitions.* If the meaning of any term is defined or explained in § 1.954-6, then such term shall have the same meaning when used in this section.

(4) *Extent of use.* (i) For purposes of subparagraph (1)(i) of this paragraph and paragraph (b)(i) of this section, the extent to which an asset of a controlled foreign corporation is used during a taxable year in foreign base company shipping operations shall be determined on the basis of the proportion for such year which the foreign base company shipping income derived from the use of such asset bears to the total gross income derived from the use of such asset.

(ii) For purposes of determining under subdivision (i) of this subparagraph the amounts of foreign base company shipping income and gross income of a controlled foreign corporation—

(A) Such amounts shall be deemed to include an arm's length charge (see § 1.954-6(h)(5)) for services performed by such corporation for itself.

(B) Such amounts shall be deemed to include an arm's length charge for the use of an asset (such as a vessel under construction or laid up for repairs) which is held for use in foreign base company shipping operations, but is not actually so used.

(C) Foreign base company shipping income shall be deemed to include amounts earned in taxable years beginning before January 1, 1976, and

(D) The district director shall make such other adjustments to such amounts as are necessary to properly determine the extent to which any asset is used in foreign base company shipping operations.

(b) *Related shipping assets.*—(1) *In general.* For purposes of this section, the term "related shipping asset" means any asset which is used (or held for use) for

or in connection with the production of income described in § 1.954-6(b)(1) (i) or (ii), but only to the extent that such asset is so used (or is so held for use).

(2) *Examples.* Examples of assets of a controlled foreign corporation which are used (or held for use) for or in connection with the production of income described in subparagraph (1) of this paragraph include—

(i) Money, bank deposits, and other temporary investments which are reasonably necessary to meet the working capital requirements of such corporation in its conduct of foreign base company shipping operations,

(ii) Accounts receivable and evidences of indebtedness which arise from the conduct of foreign base company shipping operations by such corporation or by a related person,

(iii) Amounts (other than amounts described in subdivision (i) of this subparagraph) deposited in bank accounts or invested in readily marketable securities pursuant to a specific, definite, and feasible plan to purchase any tangible asset for use in foreign base company shipping operations,

(iv) Amounts paid into escrow to secure the payment of (A) charter hire for an aircraft, vessel, or other asset used in foreign base company shipping operations or (B) a debt which constitutes a specific charge against such an asset,

(v) Capitalized expenditures (such as progress payments) made under a contract to purchase any asset for use in foreign base company shipping operations,

(vi) Prepaid expense and deferred charges incurred in the course of foreign base company shipping operations,

(vii) Stock acquired and retained to insure a source of supplies or services used in the conduct of foreign base company shipping operations, and

(viii) Currency futures acquired and retained as a hedge against international currency fluctuations in connection with foreign base company shipping operations.

(3) *Limitations.*—(i) *Vessels generally.* Notwithstanding any other provision of this paragraph, the term "related shipping assets" does not include any money or other intangible assets of a controlled foreign corporation, to the extent that such assets are permitted to accumulate in excess of the reasonably anticipated needs of the business.

(ii) *Safe harbor.* If a controlled foreign corporation accumulates money or other intangible assets pursuant to a plan to purchase one or more vessels for use in foreign commerce, and if—

(A) The amount so accumulated, plus

(B) The sum of the amounts accumulated by other controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)) pursuant to similar plans, does not exceed 110 percent of a reasonable down payment on each vessel planned to be purchased within a reasonable period, then such plan will be considered to be feasible. For purposes of the preceding sentence, a reasonable down payment shall not exceed 28 percent of the total cost of acquisition. The determination dates applicable to the taxable year of a controlled foreign corporation are those set forth in paragraph (c)(2)(ii) of this section. In the case of accumulation of assets which do not come within the safe harbor limitation of this subdivision (ii), in determining whether such assets have accumulated beyond the reasonably anticipated needs of the business, factors to be taken into account include, but are not limited to, the availability of financing to purchase a vessel and the availability of a vessel suitable for the purposes to which the vessel is to be put.

(iii) *Other assets.* In determining whether a plan to purchase any asset other than a vessel for use in foreign base company shipping operations is feasible, principles similar to those stated in subdivision (ii) of this subparagraph shall be applied.

(4) *Cross-reference.* See § 1.954-7(c) for additional illustrations bearing on the application of this paragraph.

(c) *Stock and obligations.*—(1) *In general.* Investments by a controlled foreign corporation (the "first corporation") in stock or obligations of a second controlled foreign corporation which is a related person (within the meaning of section 954(d)(3)) are considered to be qualified investments in foreign base company shipping operations to the extent that the assets of such second corporation are used (or held for use) in foreign base company shipping operations. See subparagraph (2) of this paragraph. However, an investment in an obligation of the second corporation will not be considered a qualified investment in foreign base company shipping operations if the obligation represents a liability which constitutes a specific charge (nonrecourse or otherwise) against an asset of the second corporation which is not either—

(i) An aircraft or vessel used (or held for use) to some extent in foreign commerce, or

(ii) An asset described in paragraph (a)(1) (ii) through (v) of this section.

(2) *Extent of use.* On any determination date applicable to a

taxable year of the first corporation, the extent to which the assets of the second corporation are used in foreign base company shipping operations shall be determined on the basis of the proportion which the amount of such second corporation's qualified investments in foreign base company shipping operations bears to its net worth, such proportion to be determined at the close of the second corporation's last taxable year which ends on or before such determination date. For purposes of the preceding sentence—

(i) A controlled foreign corporation's net worth is the total adjusted basis of the corporate assets reduced by the total outstanding principal amount of the corporate liabilities, and

(ii) The determination dates applicable to a taxable year of a controlled foreign corporation are—

(A) Except as provided in (B) of this subdivision, the close of such taxable year and the close of the preceding taxable year, and

(B) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in foreign base company shipping operations at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). On December 31, 1976, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y. X and Y both use the calendar year as the taxable year. On December 31, 1976, Y's assets consist of a vessel used in foreign commerce, related shipping assets, and other assets unrelated to its foreign base company shipping operations. On such date Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) of \$60,000, and a net worth of \$100,000. If X's investment in the stock of Y is \$50,000, then \$30,000 of such amount, i.e.,

$$\frac{\$60,000}{\$100,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

Example (2). The facts are the same as in example (1), except that on December 31, 1976, Y's assets consist entirely of a vessel used in foreign commerce and related shipping assets. Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this

section) of \$16,000 and (therefore) a net worth of \$16,000. If X's investment in the stock of Y is \$50,000, then the entire \$50,000, i.e.,

$$\frac{\$16,000}{\$16,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

Example (3). On December 31, 1980, controlled foreign corporation J owns two notes of controlled foreign corporation K, which is a related person (within the meaning of section 954(d)(3)). Both J and K use the calendar year as the taxable year. J's adjusted basis in each of the two notes is \$100,000. The first note is secured only by the general credit of K. The second note is secured by (and, therefore, constitutes a specific charge on) a hotel owned by K in a foreign country. On December 31, 1980, K has qualified investments in foreign base company shipping operations with an adjusted basis of \$500,000. The adjusted basis of all of K's corporate assets is \$1,000,000. K's only liabilities are the two notes. The amount of K's qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) is \$450,000. K's net worth is \$800,000. The amount of J's qualified investment in foreign base company shipping operations in respect of the first note is \$56,250, i.e.,

$$\frac{\$450,000}{\$800,000} \times \$100,000$$

The amount of J's qualified investment in respect of the second note is zero (see the last sentence of paragraph (c)(1) of this section).

(d) Partnerships.—(1) *In general.* A controlled foreign corporation's investment in a partnership at the close of any taxable year of such corporation shall be considered a qualified investment in foreign base company shipping operations to the extent of the proportion which such corporation's foreign base company shipping income for such taxable year would bear to its gross income for such taxable year if—

(i) Such corporation had realized no income other than its distributive share of the partnership gross income, and

(ii) Such corporation's income were adjusted in accordance with the rules stated in paragraph (a)(4)(ii) (B) and (D) of this section.

(2) Transitional rule. For purposes of subparagraph (1)(i) of this paragraph, the controlled foreign corporation's distributive share of the partnership gross income shall not include any amount attributable to income earned by the partnership before the first day of

such corporation's first taxable year beginning after December 31, 1975.

(3) Cross-reference. See paragraph (g) (4) of this section for rules relating to the determination of the amount of a controlled foreign corporation's investment in a partnership.

(e) Trusts.—(1) *In general.* An investment in a trust is not a qualified investment in a foreign base company shipping operations.

(2) Grantor trusts. Notwithstanding subparagraph (1) of this paragraph, if a controlled foreign corporation is treated as the owner of any portion of a trust under Subpart E of Part I of Subchapter J (relating to grantors and others treated as substantial owners), then for purposes of this section such controlled foreign corporation is deemed to be the actual owner of such portion of the assets of the trust. Accordingly, its investments in such assets (as determined under paragraph (g)(5) of this section) may be treated as a qualified investment in foreign base company shipping operations.

(3) Definitions. For purposes of this section, the term "trust" means a trust as defined in § 301.7701-4.

(f) Excluded property. For purposes of paragraph (a) of this section, property acquired principally for the purpose of artificially increasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized; whether an item of property is acquired principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to an item of property is whether the item is disposed of within 6 months after the date of its acquisition.

(g) Amount attributable to property.—

(1) General rule. For purposes of this section, the amount taken into account under section 955(b)(4) with respect to any property which constitutes a qualified investment in foreign base company shipping operations shall be its adjusted basis as of the applicable determination date, reduced by the outstanding principal amount of any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date including a liability secured only by the general credit of the controlled foreign corporation. Liabilities shall be taken into account in the following order:

(i) The adjusted basis of each and every item of corporate property shall be reduced by any specific charge (non-recourse or otherwise) to which such item is subject. For this purpose, if a

liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the specific charge shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. The excess against property over the adjusted basis of such property shall be taken into account as a liability secured only by the general credit of the corporation.

(ii) A liability which is evidenced by an open account or which is secured only by the general credit of the controlled foreign corporation shall be apportioned against each and every item of corporate property in that ratio which the adjusted basis of such item on the applicable determination date (reduced as provided in subdivision (i) of this subparagraph) bears to the adjusted basis of all the corporate property on such date (reduced as provided in subdivision (i) of this subparagraph); provided that no liability shall be apportioned under this subdivision against any stock or obligations described in paragraph (h)(1) of this section.

(2) Excluded charges. For purposes of subparagraph (1) of this paragraph, a liability created principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized. Whether a liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan was both created after November 20, 1974, and is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954-1. Another such factor is whether the liability was created after March 29, 1975, in a taxable year beginning before January 1, 1976. For purposes of this paragraph (g) (2), payments on liabilities which are represented by an open account are credited against the account transactions arising earliest in time.

(3) Statement required. If for purposes of this section the adjusted basis of property which constitutes a qualified investment in foreign base company shipping operations by a controlled foreign corporation is reduced on the ground that such property is subject to a liability, each United States shareholder shall attach to his return a statement

setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(4) *Partnership interest.* If a controlled foreign corporation is a partner in a partnership, its investment in the partnership taken into account under section 955(b)(4) shall be its adjusted basis in the partnership determined under section 722 or 742, adjusted as provided in section 705, and reduced as provided in subparagraph (1) of this paragraph. (However, if the partnership is not engaged solely in the conduct of foreign base company shipping operations, such amount shall be taken into account only to the extent provided in paragraph (d)(1) of this section.)

(5) *Grantor trust.* If a controlled foreign corporation is deemed to own a portion of the assets of a trust under paragraph (e)(2) of this section then the amount taken into account under section 955(b)(4) with respect to such assets shall be determined as provided in subparagraph (1) of this paragraph by the application of the following rules:

(i) Such controlled foreign corporation's adjusted basis in such assets shall be deemed to be a proportionate share of the trust's adjusted basis in such assets, and

(ii) A proportionate share of the liabilities of the trust shall be deemed to be liabilities of such controlled foreign corporation and to constitute specific charges against such assets.

(6) *Translation into United States dollars.* The amounts determined in accordance with this paragraph shall be translated into United States dollars in accordance with the principles of § 1.964-1(e)(4).

(h) *Investments in shipping companies under prior law.*—(1) *In general.* If an amount invested in stock or obligations of a less developed country shipping company described in § 1.955-5(b) is treated as a qualified investment in less developed countries under § 1.955-2 (applied without regard to paragraph (b)(5)(ii) thereof) on the applicable determination date for purposes of section 954(g) or section 955(a)(2) with respect to a taxable year beginning after December 31, 1975, then such amount shall be treated as a qualified investment in foreign base company shipping operations on such determination date. See section 955(b)(5).

(2) *Effect on prior law.* See § 1.955-2(b)(5)(ii) for the rule that investments which are treated as qualified investments in foreign base company shipping operations under subparagraph (1) of this paragraph shall not be treated as qualified investments in less

developed countries for purposes of section 951(a)(1)(A)(ii).

(3) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. (a) Throughout the period here involved, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y. X and Y each use the calendar years as the taxable year. At the close of 1975, X's \$50,000 investment in the stock of Y is treated as a qualified investment in less developed countries under § 1.955-2 (applied without regard to § 1.955-2(b)(5)(ii)), and Y is a less developed country shipping company described in § 1.955-5(b).

(b) On December 31, 1976, Y is still a less developed country shipping company and X's \$50,000 investment in the stock of Y is still treated as a qualified investment in less developed countries under § 1.955-2 (applied without regard to § 1.955-2(b)(5)(ii)). Under subparagraph (1) of this paragraph X's entire \$50,000 investment in the stock of Y is treated as a qualified investment in foreign base company shipping operations.

(c) For 1977, Y's gross income is \$10,000 and Y's foreign base company shipping income is \$7,500. Since Y fails to meet the 80-percent income test of § 1.955-5(b)(1), Y is no longer a less developed country shipping company described in § 1.955-5(b), and X's investment in the stock of Y is no longer treated as a qualified investment in less developed countries under § 1.955-2 (applied without regard to § 1.955-2(b)(5)(ii)). However, assume that on December 31, 1977, Y's net worth (as defined in paragraph (c)(2)(1) of this section) is \$100,000, that Y's qualified investments in foreign base company shipping operations (determined under this section) on December 31, 1977, are \$75,000, and that X's investment in the stock of Y (as determined under paragraph (g) of this section) continues to be \$50,000. Then \$67,500, i.e.,

$$\frac{\$75,000}{\$100,000} \times \$50,000$$

of X's \$50,000 investment in the stock of Y is treated as a qualified investment in foreign base company shipping operations under paragraph (c) of this section.

(d) For 1978, all of Y's gross income is foreign base company shipping income. Although Y is again a less developed country shipping company described in § 1.955-5(b), X's investment in the stock of Y is no longer treated as a qualified investment in less developed countries under § 1.955-2(b)(5)(iii). Thus, X's investment in the stock of Y is not treated as a qualified investment in foreign base company shipping operations under subparagraph (1) of this paragraph. However, X's investment in the stock of Y may be so treated under another provision of this section, as was the case in item (c) of this example.

§ 1.955A-3 Election as to qualified investments by related persons.

(a) *In general.* If a United States shareholder elects the benefits of section 955(b)(2) with respect to a related group (as defined in paragraph (b)(1) of this section) of controlled foreign corporations, then an investment in foreign base company shipping operations made by one member of such group will be treated as having been made by another member to the extent provided in paragraph (c)(4) of this section, and each member will be subject to the other provisions of paragraph (c) of this section. For the manner of making an election under section 955(b)(2), and for rules relating to the revocation of such an election, see paragraph (d) of this section. For rules relating to the coordination of sections 955(b)(2) and 955(b)(3), see paragraph (e) of this section.

(b) *Related group.*—(1) *Related group defined.* The term "related group" means two or more controlled foreign corporations, but only if all of the following requirements are met:

(i) All such corporations use the same taxable year.

(ii) The same United States shareholder controls each such corporation within the meaning of section 954(d)(3) at the end of such taxable year, and

(iii) Such United States shareholder elects to treat such corporations as a related group for such taxable year.

(iv) If any of the corporations is on a 52-53 week taxable year and if all of the taxable years of the corporations end within the same 7-day period, the rule of paragraph (b)(1)(i) of this section shall be deemed satisfied.

(v) An election under paragraph (b)(1)(iii) of this section will not be valid in the case of an election by a U.S. shareholder (the "first U.S. shareholder") if—

(A) The first U.S. shareholder controls a second U.S. shareholder,

(B) The second U.S. shareholder controls one or more controlled foreign corporations, and

(C) Any of the controlled foreign corporations are the subject of the election by the first U.S. shareholder, unless the second U.S. shareholder consents to the election by the first U.S. shareholder.

(2) *Group taxable years defined.* The "group taxable year" is the common taxable year of a related group.

(3) *Limitation.* If a United States shareholder elects to treat two or more corporations as a related group for a group taxable year (the "first group taxable year"), then such United States

shareholder (and any other United States shareholder which is controlled by such shareholder) may not also elect to treat two or more other corporations as a related group for a group taxable year any day of which falls within the first group taxable year.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporations A, B, C, D, and E. A, B, and C use the calendar year as the taxable year. D and E use the fiscal year ending on June 30 as the taxable year. M may elect to treat A, B and C as a related group. However, M may not elect to treat C, D, and E as a related group.

Example (2). The facts are the same as in example (1). In addition, M elects to treat A, B, and C as a related group for the group taxable year which ends on December 31, 1976. M may not also elect to treat D and E as a related group for the group taxable year ending on June 30, 1977.

Example (3). United States shareholder A owns 60 percent of the only class of stock of controlled foreign corporation X and 40 percent of the only class of stock of controlled foreign corporation Y. United States shareholder B owns the other 40 percent of the stock of X and the other 60 percent of the stock of Y. Neither A nor B (nor both together) may elect to treat X and Y as a related group.

(c) *Effect of election.* If a United States shareholder elects to treat two or more controlled foreign corporations as a related group for any group taxable year then, for purposes of determining the foreign base company income (see § 1.954-1) and the increase or decrease in qualified investments in foreign base company shipping operations (see §§ 1.954-7, 1.955A-1, and 1.955A-4) of each member of such group for such year, the following rules shall apply:

(1) *Intragroup dividends.* The gross income of each member of the related group shall be deemed not to include dividends received from any other member of such group, to the extent that such dividends are attributable (within the meaning of § 1.954-6(f)(4)) to foreign base company shipping income. In determining net foreign base company shipping income, deductions allocable to intragroup dividends attributable to foreign base company shipping income shall not be allowed.

(2) *Group excess deduction.* (i) The deductions allocable under § 1.954-1(c) to the foreign base company shipping income of each member of the related group shall be deemed to include such member's pro rata share of the group excess deduction.

(ii) The group excess deduction for the group taxable year is the sum of the

excesses for each member of the related group (having an excess) of—

(A) The member's deductions (determined without regard to this subparagraph) allocable to foreign base company shipping income for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess deduction is the amount which bears the same ratio to such group excess deduction as—

(A) The excess of such member's foreign base company shipping income over the deductions (so determined) allocable thereto, bears to

(B) The sum of such excesses for each member of the related group having an excess.

(iv) For purposes of this subparagraph, "foreign base company shipping income" means foreign base company shipping income (as defined in § 1.954-6), reduced by excluding therefrom all amounts which are—

(A) Excluded from subpart F income under section 952(b) (relating to exclusion of United States income) or

(B) Excluded from foreign base company income under section 954(b)(4) (relating to exception for foreign corporation not availed of to reduce taxes).

(v) The application of this subparagraph may be illustrated by the following example:

Example. Controlled foreign corporations X, Y, and Z are a related group for calendar year 1976. The excess group deduction for 1976 is \$9. X's pro rata share of the group excess deduction is \$6, and Y's pro rata share is \$3, determined as follows on the basis of the facts shown in the following table:

	X	Y	Z	Group
(1) Gross shipping income	\$100	\$90	\$90	
(2) Shipping deductions	80	70	80	
(3) Net shipping income	40	20	(9)	
(4) Group excess deduction				80
(5) X's pro rata share of group excess deduction (\$9 x \$40/\$60)	6			
(6) Y's pro rata share of group excess deduction (\$9 x \$20/\$60)		3		

(3) *Intragroup investments.* On both of the determination dates applicable to the group taxable year for purposes of section 954(g) or section 955(a)(2), the qualified investments in foreign base company shipping operations of each member of the related group shall be deemed not to include stock of any other member of the related group. In addition, neither the gains nor the losses on dispositions of such stock during the group taxable year shall be taken into account under § 1.955A-1(b)(1)(ii) in determining the decrease in qualified

investments in foreign base company shipping operations of any member of such related group.

(4) *Group excess investment.* (i) On the later (and only the later) of the two determination dates applicable to the group taxable year for purposes of section 954(g) or section 955(a)(2), the qualified investments in foreign base company shipping operations of each member of the related group shall be deemed to include such member's pro rata share of the group excess investment.

(ii) The group excess investment for the group taxable year is the sum of the excess for each member of the related group (having an excess) of—

(A) The member's increase in qualified investments in foreign base company shipping operations (determined under § 1.954-7 after the application of subparagraph (3) of this paragraph) for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess investment is the amount which bears the same ratio to such group excess investment as—

(A) Such member's shortfall, in qualified investments bears to

(B) the sum of the shortfalls in qualified investments of each member of such related group having a shortfall.

(iv) If a member has an increase in qualified investments in foreign base company shipping operations (determined as provided in § 1.954-7 after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's "shortfall in qualified investments" is the excess of—

(A) Such member's foreign base company shipping income for such year, over

(B) Such increase.

(v) If a member has a decrease in qualified investments in foreign base company shipping operations (determined under § 1.955A-1(b)(1) or § 1.955A-4(a), whichever is applicable, after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's "shortfall in qualified investments" is the sum of—

(A) Such member's foreign base company shipping income for such year and

(B) Such decrease.

(vi) For purposes of this subparagraph, "foreign base company shipping income" means foreign base company shipping income (as defined in subparagraph (2)(iv) of this paragraph), reduced by the deductions allocable thereto under § 1.954-1(c) (including the

additional deductions described in subparagraph (2) of this paragraph).

(vii) The application of paragraphs (c) (1), (3), and (4) of this section may be illustrated by the following example:

Example. (a) Controlled foreign corporations R, S, and T are a related group for calendar year 1977. R and S do not own the stock of any member of the related group.

(b) On December 31, 1977, T has qualified investments in foreign base company shipping operations (determined without regard to paragraphs (c) (3) and (4)) of \$105, of which \$15 consists of stock of S. After application of paragraph (c)(3) (but before application of paragraph (c)(4)), on December 31, 1977, T has qualified investments in foreign base company shipping operations of \$90, determined as follows:

(1) Qualified investments (determined without regard to paragraph (c)(3)) on December 31, 1977	\$105
(2) Less: Qualified investments in stock of another member of a related group (as required by paragraph (c)(3))	15
(3) Balance	90

(c) During 1977, T's foreign base company shipping income is \$180, determined without regard to paragraph (c)(1). Included in the \$180 is \$5 in dividends in respect of T's stock in S. During 1977, T has shipping deductions of \$91. Of T's shipping deductions, \$1 is allocable to the dividends from S. After application of paragraph (c)(1), T's net shipping income during 1977 is \$85, determined as follows:

(1) Foreign base company shipping income	\$180
(2) Less: Intragroup dividends (as required by paragraph (c)(1))	5
(3) Balance	175
(4) Shipping deductions	\$91
(5) Less: Deductions allocable to intragroup dividends (as required by paragraph (c)(1))	1
(6) Balance	90
(7) Net shipping income (line (3) minus line (6))	85

(d) During 1977 (without regard to paragraph (c) (4)), R's increase in qualified investments in foreign base company shipping operations is \$120; S's decrease is \$55; and T's increase is \$35, determined on the basis of the facts shown in the following table. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see §§ 1.955A-3 (c)(3) and (4)(i)).

	R	S	T
(1) Qualified investments on December 31, 1977 (in the case of T, taken from line (3) of part (b) of this example)	\$220	\$150	\$90
(2) Qualified investments on December 31, 1976	100	205	55
(3) Increase (decrease) (line (1) minus line (2))	120	(55)	35

(e) In 1977, R's net shipping income is \$100; S's is \$95; and T's is \$85, determined as follows:

	R	S	T
(1) Gross foreign base company shipping income (in the case of T, taken from line (3) of part (c) of this example)	\$200	\$180	\$175
(2) Shipping deductions (in the case of T, taken from line (6) of part (c) of this example)	100	85	90
(3) Net shipping income (line (1) minus line (2))	100	95	85

(f) By application of paragraph (c)(4) for 1977, S's pro rata share of the group excess investment is \$15, and T's pro rata share is \$5, determined as follows:

	R	S	T	Group
(1) Net shipping income (taken from line (3) of part (e) of this example)	\$100	\$95	\$85	
(2) Increase (decrease) in qualified investments (taken from line (3) of part (d) of this example)	120	(55)	35	
(3) Excess investment		20		\$20
(4) Shortfall		150	50	200
(5) S's pro rata share of group excess investment (\$20 × \$150/\$200)		15		
(6) T's pro rata share of group excess investment (\$20 × \$50/\$200)			5	

(g) After application of paragraph (c)(4), for purposes of determining their increase or decrease in qualified investments in foreign base company shipping operations for 1977, on December 31, 1977, the amount of R's qualified investments is \$200; the amount of S's is \$165; and the amount of T's is \$95, determined as follows:

	R	S	T
(1) Qualified investments on December 31, 1977 (taken from line (1) of part (d) of this example)	\$220	\$150	\$90
(2) Plus: pro rata share of group excess investment (as required by paragraph (c)(4)) (taken from lines (5) and (6) of part (f) of this example)		15	5
(3) Minus: Excess investment treated as investments of related group members (taken from line (3) of part (f) of this example)		20	
(4) Total qualified investments	200	165	95

(h) After application of paragraph (c) (1), (3), and (4), during 1977, R's increase in qualified investments in foreign base company shipping operations is \$100; S's decrease is \$40; and T's increase is \$40, determined as set forth in the table below. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any similar adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see §§ 1.955A-3(c)(3) and (4)(i)).

	R	S	T
(1) Qualified investments on December 31, 1977 (taken from line (4) of part (g) of this example)	\$200	\$165	\$95

	R	S	T
(2) Qualified investments on December 31, 1976 (see line (2) of part (d) of this example)	100	205	55
(3) Increase (decrease) (line (1) minus line (2))	100	(40)	40

(5) **Collateral effect.** (i) An election under this section by a United States shareholder to treat two or more controlled foreign corporations as a related group for a group taxable year shall have no effect on—

(A) Any other United States shareholder (including a minority shareholder of a member of such related group),

(B) Any other controlled foreign corporation,

(C) The foreign personal holding company, foreign base company sales income, and foreign base company services income, and the deductions allocable under § 1.954-1(c) thereto, of any member of such related group, and

(D) Any other taxable year. See § 1.952-1(c)(2)(ii) for the effect of an election under this section on the computation of earnings and profits and deficits in earnings and profits under section 952 (c) and (d).

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). United States shareholder A owns 80 percent of the only class of stock of controlled foreign corporations X and Y. United States shareholder B owns the other 20 percent of the stock of X and Y. X and Y both use the calendar year as the taxable year. A elects to treat X and Y as a related group for 1977. For purposes of determining the amounts includible in B's gross income under section 951(a) in respect of X and Y, the election made by A shall be disregarded and all of B's computations shall be made without regard to this section, as illustrated in § 1.952-3(d).

Example (2). The facts are the same as in example (1). In addition, the amount of X's qualified investments in foreign base company shipping operations on December 31, 1977, determined as provided in § 1.955A-2 and modified as provided in paragraph (c) (3) and (4) of this section, is \$1,000. A does not elect to treat X and Y as a related group for 1978. The amount of X's qualified investments in foreign base company shipping operations on December 31, 1978, determined without regard to paragraph (c) (3) and (4) of this section, is \$1,200. The amount of X's qualified investments in foreign base company shipping operations on December 31, 1977, determined without regard to paragraph (c) (3) and (4) of this section, is \$900. X's increase in qualified investments in foreign base company shipping operations for 1978 is \$300.

(d) **Procedure.**—(1) **Time and manner of making election.** A United States

shareholder shall make an election under this section to treat two or more controlled foreign corporations as a related group for a group taxable year by filing a statement to such effect with the return for the taxable year within which or with which such group taxable year ends. The statement shall include the following information:

(i) The name, address, taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of each controlled foreign corporation which is to be a member of the related group; and

(iii) A schedule showing the calculations by which the amounts described in this section have been determined.

A consent to an election required by paragraph (b)(1)(v) of this section shall include the same information required for the election statement.

(2) *Revocation.* (i) Except as provided in subdivision (ii) of this subparagraph, an election under this section by a United States shareholder shall be binding for the group taxable year for which it is made.

(ii) Upon application by the United States shareholder (and any other United States shareholder controlled by such shareholder which consented under paragraph (b)(1)(v) of this section to the election), an election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:C:C, Washington, D.C. 20224, containing a statement of the facts which justify such consent.

(c) *Coordination with section 955(b)(3).* If a United States shareholder elects under this section to treat two or more controlled foreign corporations as a related group for any taxable year, and if such United States shareholder is required under § 1.955A-4(c)(2) for purposes of filing any return to estimate the qualified investments in foreign base company shipping operations of any member of such group, then such United States shareholder shall, for purposes of filing such return, determine the amount includible in his gross income in respect of each member of such related group on the basis of such estimate. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall

immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder. If a United States shareholder elects under this section and if the United States shareholder has made an election under section 955(b)(3) as to at least one member of the related group, then the qualified investment amounts necessary for the calculations of paragraphs (c) (3) and (4) of this section shall be obtained, for each member of the related group, as of the determination dates applicable to each of the members.

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). (a) Controlled foreign corporations X and Y are wholly owned subsidiaries of domestic corporation M. X and Y use the calendar year as the taxable year. For 1977, X and Y are not export trade corporations (as defined in section 971(a)), nor have they any income derived from the insurance of United States risks (within the meaning of section 963(a)). M does not elect to treat X and Y as a related group for 1977.

(b) For 1977, X and Y each have gross income (determined as provided in § 1.951-6(h)(1)) of \$1,000. X's foreign base company income is \$20 and Y's foreign base company income is \$0, determined as follows, based on the facts shown in the following table:

	X	Y
(1) Foreign base company shipping income	\$1,000	\$1,000
(2) Less: amounts excluded from subpart F income under section 952(b) (relating to U.S. income) and amounts excluded from foreign base company income under section 945(b)(4) (relating to corporation not availed of to reduce taxes)	0	0
(3) Balance	1,000	1,000
(4) Less: deductions allocable under § 1.954-1(c) to balance	800	1,040
(5) Remaining balance	200	0
(6) Less: Increase in qualified investments in foreign base company shipping operations	180	
(7) Foreign base company income	20	

(c) For 1977, Y has a withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations of \$20, determined as follows, on

the basis of the facts shown in the following table:

(1) Qualified investments in foreign base company shipping operations at Dec. 31, 1976	\$1,210
(2) Less: qualified investments in foreign base company shipping operations at Dec. 31, 1977	1,170
(3) Balance	40
(4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations	20
(5) Tentative decrease in qualified investments in foreign base company shipping operations for 1977	20
(6) Limitation described in § 1.955A-1(b)(2)	100
(7) Y's amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations (lesser of lines (5) and (6))	20

Example (2). (a) The facts are the same as in example (1), except that M does elect to treat X and Y as a related group for 1977.

(b) The group excess deduction, which is solely attributable to Y's net shipping loss, is \$40 (i.e., \$1,040 - \$1,000). Since X is the only member of the related group with net shipping income, X's pro rata share of the group excess deduction is the entire \$40 amount.

(c) X's foreign base company income for 1977 is zero, determined as follows:

(1) Preliminary net foreign base company shipping income (line (b) (5) of example (1))	\$200
(2) Less: X's pro rata share of group excess deduction	40
(3) Remaining balance	160
(4) Less: increase in qualified investments in foreign base company shipping operations	180
(5) Foreign base company income	0

(d) The group excess investment, which is solely attributable to X's excess investment, is \$20 (i.e., \$180 minus \$160). Since Y is the only member of the related group with a shortfall in qualified investments, Y's share of the group excess investment is the entire \$20 amount.

(e) During 1976 and 1977, Y owns no stock of X. Y's withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations for 1977 is zero, determined as follows:

(1) Qualified investments at Dec. 31, 1976	\$1,210
(2) (i) Qualified investments at Dec. 31, 1977 (determined without regard to paragraph (c) (4) of this section)	1,170
(ii) Y's pro rata share of group excess investment	20
(iii) Total qualified investments at Dec. 31, 1977 (line (i) plus line (ii))	1,190
(3) Balance (line (1) minus line (2) (iii))	20
(4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations	20
(5) Decrease in qualified investments for 1977	0

§ 1.955A-4 Election as to date of determining qualified investment in foreign base company shipping operations.

(a) *Nature of election.* In lieu of determining the increase under the provisions of section 954(g) and § 1.954-7(a) or the decrease under the provisions of section 955(a)(2) and § 1.955A-1(b) in a controlled foreign corporation's qualified investments in foreign base company shipping operations for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of § 1.954-7(b) and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of such taxable year exceed its qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under § 1.955A-1(b)(1)(ii) for such taxable year subject to the limitation provided in § 1.955A-1(b)(2) for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of § 1.954-7(b), subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with § 1.955A-1(b).

(b) *Time and manner of making election.*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder is a United States shareholder, and

(ii) Such controlled foreign corporation realizes foreign base

company shipping income, as defined in § 1.954-8.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(2) in accordance with the election provided in this section. The application shall include the following information.

(i) The name, address, and taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(2) and § 1.954-1(b)(1) from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election.*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and shall apply to all qualified investments in foreign base

company shipping operations acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in foreign base company shipping operations for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed

before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(2) or 955(a) without regard to the election provided in this section. The application shall include the following information:

(i) The name, address, and taxpayer identification number of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be computed;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(2) and § 1.954-1(b)(1) from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition, then, with respect to the stock so sold, exchanged, or disposed of, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in foreign base company shipping operations for the taxable year in which he acquires such

stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of § 1.954-7(b)(1). If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(2) and § 1.954-1(b)(1) for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such subsequent taxable year shall be determined in accordance with the provisions of § 1.954-7(b)(2).

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1977, M makes an election under section 955(b)(3) and the election remains in force for the taxable year 1978. At December 31, 1978, A's qualified investments in foreign base company shipping operations amount to \$100,000; and, at December 31, 1979, to \$80,000. For purposes of paragraph (a)(1) of this section, A Corporation's decrease in qualified investments in foreign base company shipping operations for the taxable year 1978 is \$20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in foreign base company shipping operations at December 31, 1978 (\$100,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 (\$80,000).

Example (2). The facts are the same as in example (1) except that A experiences no changes in qualified investments in foreign base company shipping operations during its taxable years 1980 and 1981. If M's election were to remain in force, A's acquisitions and dispositions of qualified investments in foreign base company shipping operations during A's taxable year 1982 would be taken into account in determining whether A has experienced an increase or a decrease in qualified investments in foreign base company shipping operations for its taxable year 1981. However, M duly files before the close of A's taxable year 1981 an application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A's change in qualified investments in foreign base company shipping operations for its taxable year 1981 is zero because the effect of the

revocation of the election is to treat acquisitions and dispositions of qualified investments in foreign base company shipping operations actually occurring in 1982 as having occurred in such year rather than in 1981.

Example (3). The facts are the same as in example (2) except that A's qualified investments in foreign base company shipping operations at December 31, 1982, amount to \$70,000. For purposes of paragraph (b)(1)(i) of § 1.955A-1, the decrease in A's qualified investments in foreign base company shipping operations for the taxable year 1982 is \$10,000 and is determined by ascertaining the amount by which A's qualified investments in foreign base company shipping operations at December 31, 1981 (\$80,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1982 (\$70,000).

Example (4). The facts are the same as in example (1). Assume further that on September 30, 1979, M sells 40 percent of the only class of stock of A to N Corporation, a domestic corporation. N uses the calendar year as a taxable year. A remains a controlled foreign corporation immediately after such sale of its stock. A's qualified investments in foreign base company shipping operations at December 31, 1980, amount to \$90,000. The changes in A Corporation's qualified investments in foreign base company shipping operations occurring in its taxable year 1979 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire \$20,000 reduction in A Corporation's qualified investments in foreign base company shipping operations which occurs during the taxable year 1979 is taken into account by M for purposes of paragraph (c)(1) of this section in determining its tax liability for the taxable year 1978. A's increase in qualified investments in foreign base company shipping operations for the taxable year 1979 with respect to the 60-percent stock interest retained by M is \$6,000 and is determined by ascertaining M's pro rata share (60 percent) of the amount by which A's qualified investments in foreign base company shipping operations at December 31, 1980 (\$90,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 (\$80,000). N does not make an election under section 955(b)(3) in its return for its taxable year 1980. Corporation A's increase in qualified investments in foreign base company shipping operations for the taxable year 1980 with respect to the 40-percent stock interest acquired by N is \$4,000.

PART 9—[AMENDED]

§ 9.2 [Removed]

Par. 14. Section 9.2 of the Temporary

Regulations under the Tax Reduction Act of 1975 is removed.

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Approved: April 26, 1983.

John E. Chapoton,

Assistant Secretary of the Treasury.

[FR Doc. 83-12815 Filed 5-11-83; 2:03 pm]

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DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 942

Tennessee Permanent Regulatory Program; Informal Conference on Status

AGENCY: Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

ACTION: Notice of informal conference.

SUMMARY: On August 10, 1982, the Secretary of the Interior approved Tennessee's program under the Surface Mining Control and Reclamation Act of 1977 (SMCRA) [See 47 FR 34724]. On April 8, 1983, the Director, OSM, notified Tennessee's Governor that OSM had reason to believe that serious problems exist which are adversely affecting the effective implementation, administration, maintenance and enforcement of Tennessee's approved regulatory program (See "Supplemental Information" below).

Under the provisions of OSM's regulations at 30 CFR 733.12(c), the Director may hold an informal conference to discuss the facts surrounding the Director's notification if such an informal conference is requested by the State. By letter dated April 18, 1983, the Governor of Tennessee requested that the Director hold an informal conference. Accordingly, the Director hereby notifies Tennessee and the public that OSM will hold an informal conference on May 24, 1983, at the address shown below under "ADDRESSES." All interested persons may attend the informal conference.

DATE: OSM has scheduled an informal conference on May 24, 1983, to be held at the address below.

ADDRESSES: The informal conference will be held on May 24, 1983, beginning at 1:00 p.m. at the Knoxville Hilton, 501 W. Church Street, Knoxville, Tennessee 37902, Meeting Rooms 1 and 2.

Copies of Administrative Record documents referenced in this notice are available for public inspection and copying during normal business hours

at: Office of Surface Mining, 530 Gay Street, S.W., Suite 400, Knoxville, Tennessee 37902; Telephone: (615) 524-7648.

FOR FURTHER INFORMATION CONTACT:

Mr. James Curry, Knoxville Field Office Director, Office of Surface Mining Reclamation and Enforcement, 530 Gay Street, S.W., Suite 400, Knoxville, Tennessee 37902; Telephone: (615) 524-7648.

SUPPLEMENTARY INFORMATION: On February 3, 1982, the State of Tennessee resubmitted to the Department of the Interior its proposed permanent regulatory program under SMCRA. This followed an initial approval in part and disapproval in part of the proposed program which was published in the Federal Register on October 10, 1980 (45 FR 67372-67395).

The Secretary reviewed the State's submission, provided the public an opportunity to review it, and conditionally approved the program on August 10, 1982 (47 FR 34724).

On April 8, 1983, the Director, OSM, notified the Governor of Tennessee that OSM had reason to believe that serious problems exist which are adversely affecting the effective implementation, administration, maintenance, and enforcement of Tennessee's approved permanent regulatory program under SMCRA.

Since the approval of Tennessee's program, and in keeping with its policy of working closely with the State, OSM has had numerous discussions with officials from the Tennessee Division of Surface Mining (DSM) about the State's performance. Recent discussions and investigations have centered on inadequacies of DSM's implementation of the approved program in the area of permitting.

A review of all permitting information provided by DSM to OSM's Knoxville Field Office indicates that DSM issued at least 164 permanent program permits between August 10, 1982 and March 30, 1983. Only four of the 164 permits appear to have been issued in accordance with the permitting procedures of Tennessee's approved program. The remaining 160 appear to have been issued with one or more of the following deficiencies:

- (1) Without public notice and agency coordination.
- (2) Without written findings of permit adequacy.
- (3) Without complete information from the applicant.
- (4) Prior to technical review and approval.
- (5) Prior to expiration of the public comment period.

- (6) Without pre-mine inspection.
- (7) With existing violations on the site.

- (8) Without review of the bond adequacy.

OSM's review focused on the above problem areas. Other problems, such as deficiencies in the technical adequacy of the permit applications may exist. The 164 permits issued fall into the following three categories:

- (1) Eighty administrative updates of permanent program permits were issued which DSM indicated to Tennessee coal mine operators were permanent program permits. These permits were issued without requiring the operators to submit complete applications. Each permit in this category was deficient for some or all the eight reasons listed above, and none of them appears to have been properly issued.

- (2) Forty-six renewals of interim program permits were issued which the State indicated to the operators were permanent program permits. The State issued these permits after receiving applications from the operators. Only three of these permits appear to have been issued without most or all of the eight deficiencies listed above. It appears that none of these 43 permits was properly issued.

- (3) Thirty-eight permanent program permits were issued for new mining areas. Only one of these permits appears to have been issued without any of the deficiencies listed above. None of the other 37 permits appears to have been properly issued.

In addition to these 164 permits, OSM has concerns relating to the permitting of 78 tipples and processing plants. Under the 1980 Tennessee Coal Surface Mining Law (TCSML), tipples, coal storage and processing plants were required to have a coal surface mining permit in order to operate. However, the State made no attempt to permit or regulate the majority of these operations. Shortly after primacy the State issued a letter to tippel operators advising them that their (NPDES) permit would be temporarily recognized as meeting the permit requirements of DSM and that these operators had until May 15, 1983, to submit complete applications. These permitting instructions given by DSM to tippel operators, which later may have been revoked, were in violation of the State program requirement that operators who expect to continue operations after the eighth month following primacy, submit a complete program application within two months after primacy. Apparently there are no current instructions from DSM to the tippel operators.