

Sunshine Act Meetings

Federal Register

Vol. 52, No. 165

Wednesday, August 26, 1987

This section of the FEDERAL REGISTER contains notices of meetings published under the "Government in the Sunshine Act" (Pub. L. 94-409) 5 U.S.C. 552b(e)(3).

FEDERAL HOME LOAN BANK BOARD

TIME AND DATE: At 8:00 a.m., Friday, August 28, 1987.

PLACE: In the Board Room, 6th Floor, 1700 G Street, NW., Washington, DC.

STATUS: Open Meeting.

CONTACT PERSON FOR MORE

INFORMATION: Ms. Gravlee (202-377-6679).

MATTERS TO BE CONSIDERED:

Amendments to FSLIC regulations concerning insurance premiums, new regulations for financing corporation assessments in addition to FSLIC assessments, and book-entry procedure for financing corporation securities.

No. 9, August 24, 1987.

John M. Buckley, Jr.,

Secretary.

[FR Doc. 87-19630 Filed 8-24-87; 12:12 pm]

BILLING CODE 6720-01-M

FEDERAL MINE SAFETY AND HEALTH REVIEW COMMISSION

August 19, 1987.

TIME AND DATE: 10:00 a.m., Thursday, August 27, 1987.

PLACE: Room 600, 1730 K Street, NW., Washington, DC.

STATUS: Closed [Pursuant to 5 U.S.C. 552b(c)(10)].

MATTERS TO BE CONSIDERED: In addition to the previously announced items, the Commission will consider and act upon the following:

3. *Austin Power, Inc.*, Docket No. CENT 86-40, 86-59-R, etc. (Issues include whether Austin Power violated 30 CFR 77.1607(g) and 30 CFR 77.1710(g) and, if so, whether the violations were significant and substantial, and the civil penalty assessments were proper.)

4. *Local Union 2274, District 28, UMW v. Clinchfield Coal Co.*, Docket No. VA 83-55-C. (Issues include the consideration of a petition for discretionary review.)

It was determined by a unanimous vote of Commissioners that these items be discussed in closed session.

CONTACT PERSON FOR MORE

INFORMATION: Jean H. Ellen, (202) 653-5629.

Jean H. Ellen,

Agenda Clerk.

[FR Doc. 87-19626 Filed 8-24-87; 11:18 am]

BILLING CODE 6735-01-M

MISSISSIPPI RIVER COMMISSION

TIME AND DATE: 9:00 a.m., September 14, 1987.

PLACE: On board MV MISSISSIPPI at foot of Eighth Street, Cairo, IL.

STATUS: Open to the public.

MATTERS TO BE CONSIDERED: (1) Report by president on general conditions of the Mississippi River and Tributaries Project and major accomplishments since the last meeting; (2) views and suggestions from members of the public on any matters pertaining to the Flood Control, Mississippi River and Tributaries Project; and (3) District Commander's report on the Mississippi River and Tributaries Project in Memphis District.

CONTACT PERSON FOR MORE

INFORMATION: Mr. Rodger D. Harris, telephone 601-634-5766.

Rodger D. Harris,

Executive Assistant, Mississippi River Commission.

[FR Doc. 87-19663 Filed 8-24-87; 1:39 pm]

BILLING CODE 3710-GX-M

MISSISSIPPI RIVER COMMISSION

TIME AND DATE: 9:00 a.m., September 15, 1987.

PLACE: On board MV MISSISSIPPI at City Front, vicinity of Beale Street, Memphis, TN.

STATUS: Open to the public.

MATTERS TO BE CONSIDERED: (1) Report by president on general conditions of the Mississippi River and Tributaries Project and major accomplishments since the last meeting; and (2) views and suggestions from members of the public on any matters pertaining to the Flood Control, Mississippi River and Tributaries Project.

CONTACT PERSON FOR MORE

INFORMATION: Mr. Rodger D. Harris, telephone 601-634-5766.

Rodger D. Harris,

Executive Assistant, Mississippi River Commission.

[FR Doc. 87-19664 Filed 8-24-87; 1:39 pm]

BILLING CODE 3710-GX-M

MISSISSIPPI RIVER COMMISSION

TIME AND DATE: 3:30 p.m., September 16, 1987.

PLACE: On board MV MISSISSIPPI at City Front, foot of Crawford Street, Vicksburg, MS.

STATUS: Open to the public.

MATTERS TO BE CONSIDERED: (1) Report by president on general conditions of the Mississippi River and Tributaries Project and major accomplishments since the last meeting; (2) views and suggestions from members of the public on any matters pertaining to the Flood Control, Mississippi River and Tributaries Project; and (3) District Commander's report on the Mississippi River and Tributaries Project in Vicksburg District.

CONTACT PERSON FOR MORE

INFORMATION: Mr. Rodger D. Harris, telephone 601-634-5766.

Rodger D. Harris,

Executive Assistant, Mississippi River Commission.

[FR Doc. 87-19665 Filed 8-24-87; 1:39 am]

BILLING CODE 3710-GX-M

MISSISSIPPI RIVER COMMISSION

TIME AND DATE: 9:00 a.m., September 18, 1987.

PLACE: On board MV MISSISSIPPI at City Front, Morgan City, LA.

STATUS: Open to the public.

MATTERS TO BE CONSIDERED: (1) Report by president on general conditions of the Mississippi River and Tributaries Project and major accomplishments since the last meeting; (2) views and suggestions from members of the public on any matters pertaining to the Flood Control, Mississippi River and Tributaries Project; and (3) District Commander's report on the Mississippi River and Tributaries Project in New Orleans District.

CONTACT PERSON FOR MORE

INFORMATION: Mr. Rodger D. Harris, telephone 601-634-5766.

Rodger D. Harris,

Executive Assistant, Mississippi River Commission.

[FR Doc. 87-19666 Filed 8-24-87; 1:39 pm]

BILLING CODE 3710-GX-M

NATIONAL TRANSPORTATION SAFETY BOARD

TIME AND DATE: 9:00 a.m., Tuesday, September 1, 1987.

PLACE: Board Room (Room 812A), Eighth Floor, 800 Independence Avenue, SW., Washington, DC 20594.

STATUS: Open.

MATTERS TO BE CONSIDERED:

1. *Aircraft Accident Report:* Piedmont Airlines, Flight 467, Boeing 737-222, N752N, Charlotte Douglas International Airport, Charlotte, North Carolina, October 25, 1986.
2. *Railroad Accident Report:* Collision and Derailment of Southern Pennsylvania Transportation Authority Train, Upper Darby, Pennsylvania, August 23, 1986.
3. *Safety Study—Uninspected Fishing Vessel Safety.*

FOR MORE INFORMATION, CONTACT: Bea Hardesty, *Federal Register Liaison Officer.*

Bea Hardesty,
Federal Register Liaison Officer.
August 21, 1987.

[FR Doc. 87-19597 Filed 8-21-87; 4:38 pm]

BILLING CODE 7533-01-M

Corrections

Federal Register

Vol. 52, No. 165

Wednesday, August 26, 1987

This section of the FEDERAL REGISTER contains editorial corrections of previously published Presidential, Rule, Proposed Rule, and Notice documents and volumes of the Code of Federal Regulations. These corrections are prepared by the Office of the Federal Register. Agency prepared corrections are issued as signed documents and appear in the appropriate document categories elsewhere in the issue.

DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

7 CFR Part 994

[Docket No. EMO-1]

Egg Marketing Order; Establishment of Programs Relating to Research, Consumer Education, and Advertising

Correction-

In proposed rule document 87-18124 appearing on page 29531 in the issue of Monday, August 10, 1987, make the following corrections on that page:

1. In the first column, under **SUPPLEMENTARY INFORMATION**, in the eighth line insert "member to administer programs and projects relating to" after the word "public".

2. In the second column, in the first complete paragraph, in the ninth line, the date should read "December 16, 1985".

BILLING CODE 1505-01-D

DEPARTMENT OF COMMERCE

Patent and Trademark Office

[Docket No. 70470-7070]

Electronic Data Dissemination Policies and Guidelines

Correction

In notice document 87-19056 beginning on page 31442 in the issue of Thursday, August 20, 1987, make the following corrections:

1. On page 31443, in the first column, under **SUPPLEMENTARY INFORMATION**, in the second paragraph, in the sixth line, "not will" should read "not nor will".

2. On the same page, in the second column, under **Background**, in the fourth paragraph, in the fifth line, "relected" should read "selected".

3. On the same page, in the third column, in the fourth line, "patent" should read "patents".

BILLING CODE 1505-01-D

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 799

[OPTS-42065B; FRL-3223-9]

2-Ethylhexanoic Acid; Technical Modification

Correction

In rule document 87-14673 beginning on page 24157 in the issue of Monday, June 29, 1987, make the following correction:

\$ 799.1650 [Corrected]

On page 24158, in the first column, in § 799.1650(c)(3), in the fifth line, "§ 795.233(c)(2)(ii)(C)" should read "§ 795.223(c)(2)(ii)(C)".

BILLING CODE 1505-01-D

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Social Security Administration

20 CFR Part 416

[Regs. No. 16]

Pension Funds for Deeming Purposes and Grandfathering Provisions

Correction

In rule document 87-18310 beginning on page 29840 in the issue of Wednesday, August 12, 1987, make the following correction:

§ 416.1202 [Corrected]

On page 29841, in the second column, in § 416.1202(a), in the 14th line, insert "also" after "are".

BILLING CODE 1505-01-D

DEPARTMENT OF THE INTERIOR

Bureau of Land Management

[OR-39468; OR-943-07-4220-11; GP-07-247]

Realty Actions; Conveyance of Public Land; Order Providing for Opening of Land; Oregon

Correction

In notice document 87-18459 appearing on page 30259 in the issue of Thursday, August 13, 1987, make the following correction:

In the third column, in the 16th line, "20° 19' 14'" should read "28° 19' 14'".

BILLING CODE 1505-01-D

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

[Summary Notice No. PE-87-19]

Petition for Exemption; Summary of Petitions Received, Dispositions of Petitions Issued

Correction

In notice document 87-18770 beginning on page 30989 in the issue of Tuesday, August 18, 1987, make the following correction:

On page 30990, in the second column, under **DATE**, in the last line, the date should read "September 7, 1987".

BILLING CODE 1505-01-D

IRS First Look

Wednesday
August 26, 1987

Part II

Department of the Treasury

Internal Revenue Service

26 CFR Part 1

**Foreign Tax Credit; Application of
Section 904 to Income Subject to
Separate Limitations; Notice of Proposed
Rulemaking and Public Hearing**

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[INTL-931-86]

Foreign Tax Credit; Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service, Treasury.

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

SUMMARY: This document contains proposed regulations and a notice of a public hearing relating to the application of section 904 with respect to income received or accrued by a taxpayer consisting of income described in section 904 (d). These proposed regulations are necessary because of the changes made to the applicable law by the Tax Reform Act of 1986. The regulations would provide the public with guidance needed to comply with that act and would affect individuals and entities claiming the foreign tax credit.

DATES: Written comments and/or requests to appear at a public hearing scheduled for November 12, 1987 must be delivered or mailed by October 26, 1987. The amendments are proposed generally to be effective for taxable years beginning after December 31, 1986. Paragraph (c)(2) of § 1.904-6 applies to taxable years beginning after December 31, 1987.

ADDRESS: Send comments and requests to appear at the public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (INTL-931-86), Washington, DC 20224. The public hearing will be held in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Marnie J. Carro or Carolyn M. DuPuy of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T) (202-566-3499).

SUPPLEMENTARY INFORMATION:**Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 904 of the Internal Revenue Code of 1954. These amendments are proposed to provide regulations under

section 904 (d) which was amended by section 1201 of the Tax Reform Act of 1986 (Pub. L. 99-514).

Prior Law

Prior to 1987, the foreign tax credit limitation was generally determined in the following manner: The taxpayer totaled its net income and net losses from all sources outside the United States and calculated one aggregate limitation based on the total. Separate foreign tax credit limitations were calculated, however, for certain categories of income that bore high or low rates of foreign tax or that could easily be earned in low-tax countries rather than in the United States. For example, section 904 (d)(3) provided that dividends, interest, or subpart F income earned or accrued by a United States person that was attributable to certain types of passive interest income earned by the payor would be subject to a separate foreign tax credit limitation. This separate limitation prevented taxpayers from inflating their foreign tax credit limitation by averaging low-taxed interest income with high-taxed active business income and thereby distorting the foreign tax credit.

Statutory Provision

Section 1201 of the Tax Reform Act of 1986 (the Act) amends section 904 (d) by replacing the separate limitation for interest income with a separate limitation for passive income generally. In addition, the Act requires that a taxpayer calculate a separate foreign tax credit limitation for financial services income, high withholding tax interest, shipping income, and dividends from each noncontrolled section 902 corporation. This discussion incorporates changes to the Act proposed in the Technical Corrections Act of 1987.

Section 904 (d)(2)(A) defines passive income as any income received or accrued by any person that is of a kind that would be foreign personal holding company income, as defined in section 954 (c). Passive income also includes any amount includible in gross income under section 551 or section 1293. Passive income does not include any income that is defined under section 904 (d) as high withholding tax interest, financial services income, shipping income, or dividends from a noncontrolled section 902 corporation. In addition, passive income does not include any high-taxed income, any export financing interest, or any foreign oil and gas extraction income.

Section 904 (d)(2)(B) defines income as high withholding tax interest if the interest is subject to a foreign

withholding tax and the rate of the tax applicable to such income is at least 5 percent. High withholding tax interest, like passive income, does not include export financing interest.

Section 904 (d)(2)(C) defines financial services income as certain income that is derived by a person that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Financial services income also includes income that would otherwise be passive income or shipping income. Section 904 (d)(2)(C)(iii) excludes export financing interest, high withholding tax interest, and dividends from a noncontrolled section 902 corporation from the definition of financial services income.

Section 904 (d)(2)(D) defines shipping income as any income of a kind that would be foreign base company shipping income, as defined in section 954 (f). Shipping income does not include dividends from a noncontrolled section 902 corporation of financial services income.

Section 904(d)(2)(E) defines a noncontrolled section 902 corporation as any foreign corporation in which the taxpayer meets the stock ownership requirements of section 902(a) or section 902(b). However, a controlled foreign corporation (CFC) will not be treated as a noncontrolled section 902 corporation with respect to periods when it was a CFC. A special rule is provided that limits the amount of foreign taxes available for credit under section 902 if the tax is attributable to high withholding interest received or accrued by a noncontrolled section 902 corporation.

Section 902(d)(2)(F) defines high-taxed income. As stated above, high-taxed income is specifically excluded from the definition of passive income. Under section 904(d)(2)(F), passive income will be considered to be high-taxed income (and, therefore, not passive income) if the sum of the foreign taxes paid and deemed paid by the taxpayer with respect to that income exceeds the highest rate of United States tax multiplied by the amount of such income. The high-tax "kick-out" applies after allocation of expenses at the taxpayer level.

Section 904(d)(2)(G) defines export financing interest. As stated above, export financing interest is specifically excluded from the definitions of passive income, high withholding tax interest, and financial services income. Export financing interest is defined as interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any

property that is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States.

Section 904(d)(3) (A), (B), (C), and (D) provides that dividends, interest, rents, or royalties received or accrued by a United States shareholder from a CFC will be treated as income subject to a separate limitation to the extent that the income of the payor is itself subject to one or more of the separate limitations. Subpart F inclusions are also subject to this look-through rule. A special look-through rule is provided with respect to interest payments made by a CFC to a United States shareholder or to a CFC related to a United States shareholder. Section 954(b)(5) is amended to provide that any interest paid or accrued by a CFC to any United States shareholder (or to any CFC related to such shareholder) shall be allocated first to foreign personal holding company income which is passive income. Therefore, these interest payments will be considered to be attributable to passive income of the CFC for purposes of the look-through rule on interest.

Section 904(d)(3)(E) provides that, if a CFC is considered to have no subpart F income for the taxable year pursuant to the de minimis rule provided in section 954(b)(3)(A), none of its income for such taxable year shall be treated as income in a separate category. For purposes of applying the dividend look-through rule, passive income of a CFC that meets the requirements of section 954(b)(4) (the taxpayer establishes that the income was subject to a high rate of foreign tax) will not be considered to be income subject to a separate category.

Section 904(d)(3)(H) provides that the look-through rules will not apply to an interest payment that is subject to a high withholding tax if the payment would be allocable under the look-through rules to financial services income of a controlled foreign corporation.

Explanation of Proposed Regulations

The proposed regulations incorporate changes proposed to be made to the Tax Reform Act of 1986 by the Technical Corrections Act of 1987.

Section 1.904-6 (a) provides that a taxpayer must compute a separate foreign tax credit limitation for income within each of the following separate limitations: (1) Passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) dividends from each noncontrolled section 902 corporation, (6) DISC dividend income, (7) foreign trade

income, (8) FSC income, and (9) general limitation income.

Section 1.904-6(b)(1) defines the term "passive income." Paragraph (b)(2)(i) provides rules for determining whether rents or royalties are derived in the active conduct of a trade or business. A special rule is provided for certain affiliated corporations. Paragraph (b)(2)(ii) provides rules for determining whether certain types of royalties derived by a CFC will be treated as general limitation income for purposes of the look-through rules.

Section 1.904-6(c)(1) provides rules for determining whether an item of income that is otherwise passive income is high-taxed income and, therefore, should be treated as general limitation income. Paragraph (c)(2) provides grouping rules for purposes of determining whether an item of passive income is high-taxed income. The grouping rules are proposed to be effective for taxable years beginning after December 31, 1987. See Notice 87-6, 1987-3 I.R.B. 8, for the grouping rules for taxable years beginning after December 31, 1986 and before January 1, 1987. Paragraph (c)(3) provides rules relating to the determination of whether an amount included in gross income under section 951(a) is high-taxed income if additional taxes are paid or deemed paid in the year of receipt of this income. Taxpayers are invited to comment on the appropriate treatment of a change in the effective tax rate on an inclusion due to a difference between the amount of tax accrued and the amount actually paid.

The proposed regulations do not address the application of the rules in paragraph (c) to gains and losses resulting from a change in the effective rate of tax because of exchange rate fluctuations between the time an amount is included in the gross income of a United States shareholder of a controlled foreign corporation under section 951 and the distribution to the United States shareholder of earnings attributable to that amount. For example, if passive income is treated as general limitation income in the year of inclusion because it is high-taxed income, a currency gain in the year of distribution arguably affects the effective rate of tax on the inclusion amount and therefore would require a redetermination of the character of the inclusion. As another example, if passive income is not treated as general limitation income in the year of inclusion because it is not high-taxed income, a currency loss in the year of distribution arguably affects the effective rate of tax on the inclusion amount and therefore would require a

redetermination of the character of the inclusion. Paragraph (c) also does not address the appropriate treatment of exchange gain or loss with respect to remittances from branches and from other entities subject to the look-through rules. Taxpayers are invited to comment on the appropriate treatment in these cases and other related cases.

Paragraph (c)(4) provides special rules for determining whether income that has been taxed under an integrated tax system is high-taxed income. Taxpayers are invited to comment on the application of this rule to cases in which the foreign tax system does not provide a mechanism for tracing distributions out of a particular year's earnings.

Section 1.904-6(d) defines the term "high withholding tax interest." High withholding tax interest does not include any interest described as export financing interest.

Section 1.904-6(e)(1) defines the term "financial services income." Paragraph (e)(2) describes income derived in the active conduct of a banking, insurance, financing, or similar business which relates to the definition of financial services income and the definition of a financial services entity. Paragraph (e)(3)(i) provides a definition of a financial services entity. Paragraph (e)(3)(ii) provides a special rule for affiliated groups. Paragraph (e)(3)(iii) provides a rule for treatment of partnerships and other pass-through entities. Paragraph (e)(4) describes incidental income that will be considered to be financial services income if earned by a financial services entity. Paragraph (e)(5) describes income that is excluded from the definition of financial services income.

Section 1.904-6(f) defines the term "shipping income." Shipping income does not include dividends received from a noncontrolled section 902 corporation or financial services income.

Section 1.904-6(g)(1) defines the term "noncontrolled section 902 corporation." Paragraph (g)(2)(i) provides a rule for the treatment of dividends from noncontrolled section 902 corporations. Paragraph (g)(2)(ii) provides a special rule for determining whether a controlled foreign corporation owns stock in a noncontrolled section 902 corporation. Paragraph (g)(2)(iii) provides rules relating to dividends from a noncontrolled section 902 corporation that are attributable to high withholding tax interest earned by the corporation. Paragraph (g)(3) provides a rule for the treatment of dividends from a CFC attributable to a period when the CFC was neither a CFC nor a noncontrolled section 902 corporation.

Section 1.904-6(h)(1) defines the term "export financing interest." Paragraph (h)(4)(i) provides that export financing interest that is also related person factoring income (within the meaning of section 864(d)(1)) shall be subject to a taxpayer's passive limitation unless the taxpayer is a financial services entity. If the taxpayer is a financial services entity, such income will be subject to the separate limitation for financial services income. Paragraph (h)(4)(iii) provides that income derived from factoring receivables that is not considered to be related person factoring income under section 864(d)(1) because it is income described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) will be treated in the same manner as interest income that is excepted from related person factoring treatment because of the same country exception. This income shall be treated as general limitation income unless the income is earned by a financial services entity. If the income is earned by a financial services entity, it will be subject to the separate limitation for financial services income.

Section 1.904-6(i) provides rules relating to the interaction of section 907 (c) (oil and gas income) and income described in the separate limitations.

Section 1.904-6(j) provides priority rules in the case of income that meets the definitions of more than one category of separate limitation income.

Section 1.904-7 provides look-through rules for CFCs and other entities. Paragraph (a)(1) defines the term "separate category" of income. Paragraph (a)(2) defines the term "controlled foreign corporation." Paragraph (a)(3) defines the term "United States shareholder."

Section 1.904-7(b) provides that dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled corporation will be general limitation income unless under the look-through rules they are allocated or attributable to another separate category of income.

Section 1.904-7(c)(1) provides for look-through treatment of section 951 (a)(1)(A) inclusions. Paragraph (c)(2)(i) provides that interest that is received or accrued from a CFC in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent it is allocable to income of the CFC in that category. Paragraph (c)(2)(ii) provides rules for allocating expenses of a CFC to the income of the CFC in separate categories if interest is paid to a U.S. shareholder of the CFC. Pursuant to

section 954(b)(5), this paragraph provides that such related person interest is allocated to passive income of the CFC to the extent of such passive income (the "netting rule"). Any excess of related person interest over passive income ("excess related person interest") is allocated among the CFC's separate categories (other than passive) on the basis of the assets in each such category. Other interest expense of the CFC is allocated among the CFC's separate income categories, including passive income, on the basis of the assets in each such category (reduced by related person debt allocable to that category), including assets in the passive category.

The Internal Revenue Service will reassess this rule in the process of adopting final regulations. For example, the following alternative will be considered in that process. Excess related person interest would be allocated in the same manner as interest expense other than definitely related interest and related person interest. Under this rule, related person interest would be allocated among a CFC's separate categories on the basis of assets in each separate category, including passive assets, with passive assets reduced by related person debt attributable to the passive category under the netting rule. The amount of excess related person interest that could be allocated to passive income under this rule would be limited to an amount that, when combined with related person interest allocated to the passive category under the netting rule, would not exceed the related person interest that would have been allocated to the passive category under § 1.861-8 without regard to the netting rule. Taxpayers are invited to comment on the relative merits of the rule as proposed, the suggested alternative, and any other alternatives.

Paragraph (c)(3) provides that rents or royalties received or accrued from a CFC shall be treated as income in a separate category to the extent allocable to the income of the CFC in that category. Paragraph (c)(4)(i) provides that dividends shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the CFC. Paragraph (c)(4)(ii) provides a special rule for dividends attributable to loans made to the CFC payor by a related person.

Section 1.904-7(d) provides that, if a CFC satisfies the de minimis rule of section 904(b)(5), all of the CFC's gross foreign base company income and gross

insurance income shall be treated as general limitation income. Paragraph (d)(2) provides that, for purposes of the dividend look-through rule, an item of net income that would otherwise be passive income will be treated as general limitation income if the taxpayer elects to establish that such income was subject to a high effective rate of foreign income tax.

Section 1.904-7(e) provides that if all of a CFC's income is treated as Subpart F income because the CFC's foreign base company income and gross insurance income exceeds 70 percent of the CFC's gross income, the look-through shall apply to all of the CFC's income, including the amount of income that would not otherwise have been considered to be Subpart F income without the application of the 70 percent full inclusion rule.

Section 1.904-7(f)(1) provides that if a taxpayer receives interest that is allocable to financial services income of a CFC that would be treated as high withholding tax interest if the look-through rules did not apply, such interest shall be treated as high withholding tax interest.

Section 1.904-7(g) provides rules for the application of the look-through rules to related CFCs. Section 1.904-7(h) provides rules for the application of the look-through rules to certain domestic corporations. Section 1.904-7(i)(1) provides rules for the application of the look-through rules to partnerships. Paragraph (i)(2) provides an exception to the look-through rules for certain general and limited partnership interests.

Section 1.904-7(j) provides ordering rules for purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases.

Section 1.904-7(l) provides rules for the application of section 904(g) to income of a CFC. The application of section 904(g) to income of United States-owned foreign corporations other than CFCs is not addressed in these rules. Paragraph (l)(2) provides rules for determining the portion of an interest payment that is allocable to income earned by a CFC from sources within the United States. Paragraph (l)(4) provides rules for determining the portion of a dividend paid by a CFC from sources within the United States. Paragraph (l)(5) provides rules for determining the portion of an amount included in gross income under section 951(a) from sources within the United

States. Paragraph (l)(6) provides that the section 78 amount shall be treated as United States source income to the extent that it is attributable to taxes paid with respect to United States source income. Paragraph (l)(7) provides a special rule for income that is United States source income under the Code but is treated as foreign source income pursuant to an income tax convention with the United States.

Section 1.904-7(m) provides an ordering rule for the application of sections 904(d), (f), and (g).

Section 1.904-7(n) provides the effective date of the look-through rules.

Section 1.904-8 provides rules for the allocation of taxes to a separate category of income. Paragraph (a)(1) provides the general rule for allocating taxes to separate categories of income. Paragraph (a)(2) provides a special rule for the treatment of foreign taxes allocable to certain dividends from noncontrolled section 902 corporations.

Section 1.904-8(b)(1) provides rules for the determination of the deemed paid credit under sections 902 and 960 for taxes allocated to different categories of income. Paragraph (b)(2) provides a special allocation rule for taxes on income excluded from subpart F under section 954(b)(4). Paragraph (b)(3) provides rules for distributions received from foreign corporations if the distributions are excluded from gross income under section 959(b). Paragraph (b)(4) provides that the section 78 amount shall be treated as income in a separate category to the extent that it is attributable to taxes paid with respect to income in that category. Paragraph (b)(5) provides that the increase in foreign tax credit limitation under section 960(b) shall be determined with regard to the applicable category of income under section 904(d).

Section 1.904-9 provides transition rules for the application of section 904(d). Paragraph (a) provides rules for the characterization of distributions and section 951(a)(1)(B) inclusions of earnings of a foreign corporation accumulated in taxable years beginning before January 1, 1987 during taxable years for both the payor foreign corporation and the recipient which begin after December 31, 1986. Paragraph (b) provides rules for the application of the look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986. Paragraph (c) provides a transitional rule for income received after the effective date of the Act attributable to an installment sale

that occurred prior to the effective date of the Act. Paragraph (d) provides a special effective date for high withholding tax interest earned with respect to qualified loans described in section 1201(e)(2) of the Act. Paragraph (e) provides a rule for the characterization of amounts subject to recapture under section 585(c).

Section 701 of the Act (relating to the limitation on the use of foreign tax credits against minimum tax liability) shall apply notwithstanding any treaty provisions in effect on the date of enactment of the Act.

Comments and Requests To Appear at the Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held on November 12, 1987 in the I.R.S. Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

Special Analysis

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Drafting Information

The principal authors of this regulation are Marnie J. Carro and Carolyn M. DuPuy of the Office of Associate Chief Counsel (International), Internal Revenue Service. However, other personnel from offices of the Internal Revenue Service and Treasury Department participated in developing the regulations on matters of substance and style.

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

Income taxes, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, FSC, Sources of income, United States investments abroad.

Proposed Amendments to the Regulations

Accordingly, the proposed amendments to 26 CFR Part 1 are as follows:

Income Tax Regulations

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

PART 1—[AMENDED]

Authority: 26 U.S.C. 7805. * * * Section 1.904-6 also issued under 26 U.S.C. 904 (d) (5). * * *

Par. 2. New § 1.904-6 through § 1.904-9 are added immediately after § 1.904-5. The added sections read as follows:

§ 1.904-6 Separate application of section 904 with respect to certain categories of income.

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904 (d) (1) (A) (passive income), (B) (high withholding tax interest), (C) (financial services income), (D) (shipping income), (E) (dividends from each noncontrolled section 902 corporation), (F) (dividends from a DISC or former DISC), (G) (foreign trade income), (H) (distributions from a FSC or former FSC), or (I) (general limitation income).

(b) *Passive income*—(1) *In general.* The term "passive income" means any—

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

(ii) Amount includible in gross income under section 551 or section 1293.

Passive income does not include any income that is described in another subparagraph of section 904 (d) (1), any export financing interest (as defined in section 904 (d) (2) (G) and paragraph (h) of this section), any high-taxed income (as defined in section 904 (d) (2) (F) and paragraph (c) of this section), or any foreign oil and gas extraction income (as defined in section 907 (c)). In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864 (d) (6) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957).

(2) *Active rents or royalties*—(i) *In general.* Passive income does not include any rents or royalties that are derived in the active conduct of a trade

or business and received from a person who is an unrelated person. Except as provided in paragraph (b) (2) (ii) of this section, the principles of § 1.954-2 (d) (1) shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term "taxpayer" shall be substituted for the term "controlled foreign corporation" if the recipient of the rents or royalties is not a controlled foreign corporation. If rents or royalties are received or accrued by a United States corporation from an unrelated person, the active trade or business requirement may be satisfied by the recipient or by—

(A) A corporation that is a member of an affiliated group of corporations (within the meaning of section 1504 (a)) of which the recipient is a member if the group files a return on a consolidated basis; or

(B) A controlled foreign corporation of which the recipient of the income is a United States shareholder (as defined in section 951 (b)).

(ii) *Royalties earned by a controlled foreign corporation.* Royalties are considered derived in the active conduct of a trade or business by a controlled foreign corporation for purposes of section 904 (but not for purposes of section 954 unless, without regard to this paragraph (b) (2) (ii), the requirements of section 954 (c) (2) (A) and the regulations thereunder are satisfied) if:

(A) The property which the controlled foreign corporation licenses is property which the United States shareholder of the controlled foreign corporation (or any other member of the affiliated group (as defined in section 1504(a)) of which the United States shareholder is a member) has developed, created, or produced, or has acquired or added substantial value to, but only if the United States shareholder (or a member of the United States shareholder's affiliated group) is regularly engaged in the development, creation, or production of, or the acquisition and addition of substantial value to, and licensing of such property, and

(B) The controlled foreign corporation's activities are an essential economic element in the realization of the royalties.

A controlled foreign corporation's activities are an essential economic element in the realization of royalty income only if the controlled foreign corporation performs significant services, sales, or manufacturing activities incident to the production of such income.

(iii) *Unrelated person.* For purposes of this paragraph (b)(2), a person is

considered to be an unrelated person if the person is not a related person within the meaning of section 954(d)(3), without regard to whether the relationship described in section 954(d)(3) is between a controlled foreign corporation and another person or between two persons neither one of which is a controlled foreign corporation.

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

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of § 1.904-7 to the royalties S receives from the franchisees. All of the franchisees are unrelated to S or P and operate in S's country of incorporation. S employs a substantial staff in its country of incorporation that regularly engages in selecting franchisees, training employees of franchisees, marketing of products, developing an independent supplier network, providing quality control, selecting restaurant sites, and providing other services to franchisees. S does not satisfy the active trade or business requirements of § 1.954-2(d)(1) but its activities are an essential economic element in the realization of the royalty income. Therefore, the royalty income earned by S with regard to its franchisees is foreign personal holding company income that is general limitation income, and the royalties paid to P are general limitation income to P.

Example (2). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. P is a soft drink manufacturer and S manufactures the syrup used in P's soft drinks. P licenses tradenames, trademarks, and certain product designs to S which S relicenses to unrelated bottlers. P is regularly engaged in the development and licensing of such property. The income S receives consists of general limitation non-Subpart F sales income and Subpart F foreign personal holding company royalty income. The royalties received by P for the use of its property are allocable under the look-through rules of § 1.904-7 to the royalty income earned by S. S does not satisfy the active trade or business requirement of § 1.954-2(d)(1) but its activities are an essential economic element in the realization of the royalty income. Therefore, the royalty income S earns is Subpart F foreign personal holding company income that is general limitation income, and the royalties paid to P are general limitation income to P.

(c) *High-taxed income—(1) In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is

determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses of the United States person to that income, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 of section 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph, income that would otherwise be passive income is determined to be high-taxed income, it shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under § 1.904-8.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income—(i) In general.* For purposes of determining whether passive income is high-taxed income, the grouping rules of this paragraph (c)(2) apply. These rules shall be applied separately to items of income received or accrued from or inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder. These rules shall be applied separately to income attributable to each qualified business unit (as defined in section 989(a)) of a taxpayer. These rules shall also be applied separately to income attributable to each qualified business unit of a controlled foreign corporation or any other entity subject to the look-through rules of § 1.904-7. Notwithstanding the preceding sentence, a taxpayer shall not apply these rules separately to income from each qualified business unit that is income described in paragraph (c)(2)(v) of this section (income that does not carry with it any direct foreign tax credits). The rules contained in this paragraph (c)(2) apply to taxable years beginning after December 31, 1987.

(ii) *Amounts received or accrued by a United States shareholder of a controlled foreign corporation—(A) Rents or royalties.* All rents or royalties received or accrued by a taxpayer during the taxable year from a controlled foreign corporation of which the taxpayer is a United States shareholder that are (after application of the look-through rules of section 904(d)(3) and § 1.904-7) allocable to passive income of the controlled foreign

corporation shall be treated as a single item of income and shall not be grouped with other amounts.

(B) *Other amounts received or accrued by a United States shareholder.* All amounts, other than rents or royalties described in paragraph (c)(2)(ii)(A) of this section and dividends described in paragraph (c)(2)(ii)(C) of this section, received or accrued by a taxpayer during the taxable year from a controlled foreign corporation of which the taxpayer is a United States shareholder that are (after application of the look-through rules of section 904(d)(3) and § 1.904-7) allocable to passive income of the controlled foreign corporation shall be treated as a single item of income and shall not be grouped with other amounts.

(C) *Dividends received or accrued by United States shareholders.* Dividends received or accrued by a taxpayer during the taxable year from a controlled foreign corporation of which the taxpayer is a United States shareholder that are (after application of the look-through rules of section 904(d)(3) and § 1.904-7) attributable to periods when the controlled foreign corporation was neither a controlled foreign corporation nor a noncontrolled section 902 corporation (as described in paragraph (g)(3) of this section) shall be treated as a single item of income and shall not be grouped with other amounts.

(iii) *Subpart F inclusions—(A) Attributable to passive rent or royalty income.* All amounts included in the gross income of a United States shareholder under section 951(a)(1) for a particular year that (after application of the look-through rules of section 904(d)(3) and § 1.904-7) are attributable to passive income consisting of rents or royalties received or accrued by a controlled foreign corporation shall be treated as a single item of income and shall not be grouped with other amounts.

(B) *Attributable to passive income other than passive rent or royalty income.* All amounts included in the gross income of a United States shareholder under section 951(a)(1) for a particular year that (after application of the look-through rules of section 904(d)(3) and § 1.904-7) are attributable to passive income consisting of income other than rents or royalties received or accrued by a controlled foreign corporation shall be treated as a single item of income and shall not be grouped with other amounts.

(iv) *Amounts paid or accrued to a taxpayer other than a United States shareholder that carry direct foreign credits—(A) Rents or royalties.* All

passive income consisting of rents or royalties received or accrued by a taxpayer during the taxable year from a person other than a controlled foreign corporation of which the taxpayer is a United States shareholder and with respect to which an income tax described in § 1.901-2(a) is paid or accrued shall be treated as a single item of income and shall not be grouped with other amounts.

(B) *Other income.* All passive income not consisting of rents or royalties that are received or accrued by a taxpayer during the taxable year from a person other than a controlled foreign corporation of which the taxpayer is a United States shareholder with respect to which an income tax described in § 1.901-2(a) is paid or accrued shall be treated as a single item of income and shall not be grouped with other amounts.

(v) *Certain income that does not carry direct foreign tax credits.* All passive income that is received or accrued by a taxpayer during the taxable year from a person other than a controlled foreign corporation of which the taxpayer is a United States shareholder with respect to which no income tax described in § 1.901-2(a) is paid or accrued shall be treated as a single item of income and shall not be grouped with other amounts.

(vi) *Certain partnership income.* A partner's distributive share of partnership income that is treated as passive income under § 1.904-7(i)(2) shall be treated as a single item of income and shall not be grouped with other amounts.

(3) *Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income—(i) Determination made in year of inclusion.* The determination of whether an amount included in gross income under section 951(a) is high-taxed income shall be made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) (hereinafter the "taxable year of inclusion"). Thus, any additional foreign tax paid or accrued, or deemed paid or accrued, when the taxpayer receives an amount that is excluded from gross income under section 959(a) and that is attributable to a controlled foreign corporation's earnings and profits relating to the amount previously included in gross income will not be considered in determining whether the amount included in income in the taxable year of inclusion is high-taxed income.

(ii) *Exception.* The provisions of paragraph (c)(3)(i) of this section shall

not apply to the extent that the taxpayer receives a distribution that is excluded from gross income under section 959(a) and the distribution is received within 30 or more days prior to the day that the taxpayer files its return for the taxable year of inclusion of the amount to which the distribution is attributable (the "prefiling period"). In such a case, for purposes of determining whether the amount included in income in the taxable year of inclusion is high-taxed income, the United States shareholder shall consider as taxes attributable to that inclusion all foreign taxes paid or accrued, or deemed paid or accrued, prior to the end of the prefiling period with respect to that inclusion.

(iii) *Allocation of foreign taxes imposed on distributions of previously taxed income.* If an item of income is considered high-taxed income in the year of inclusion, then any additional foreign income taxes imposed with respect to that item shall be considered to be related to general limitation income. If an item of income is not considered to be high-taxed income in the taxable year of inclusion, the following rules shall apply. The taxpayer shall treat taxes paid or accrued, or deemed paid or accrued, on any distribution of the earnings and profits attributable to the amount included in gross income in the taxable year of inclusion as taxes related to passive income to the extent of the excess of the product of (A) the highest rate of tax in section 11 (determined with regard to section 15 and determined as of the year of inclusion) and (B) the amount of the inclusion (after allocation of parent expenses) over (C) the taxes paid or accrued, or deemed paid or accrued, in the year of inclusion. The taxpayer shall treat any taxes paid or accrued, or deemed paid or accrued, on the distribution in excess of this amount as taxes related to general limitation income.

(4) *Application of this paragraph to certain reductions of tax on distributions of income—(i) In general.* If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income may be reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income without regard to the possibility of subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general limitation income. If the foreign corporation distributes the

earnings and profits to which the inclusion was attributable, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income. If, taking income into account the reduction in foreign tax, the inclusion would not have been considered high taxed income, then the taxpayer shall redetermine its foreign tax credit for the year or years affected and shall treat the inclusion and the associated taxes (as reduced on the distribution) as passive income and taxes. See section 905(c) and the regulations thereunder regarding the method of adjustment.

(ii) *Exception.* The provisions of paragraph (c)(4)(i) of this section shall not apply to the extent that the taxpayer receives a distribution that is excluded from gross income under section 959(a) within the prefilling period, as defined in paragraph (c)(3)(ii) of this section. In such a case, for purposes of determining whether the amount included in income in the taxable year of inclusion is high-taxed income, the United States shareholder shall consider as taxes paid or accrued, or deemed paid or accrued, with respect to that inclusion all foreign taxes paid or accrued, or deemed paid or accrued (as reduced at the time of distribution) prior to the end of the prefilling period with respect to that inclusion.

(iii) *Interaction with section 954(b)(4).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation may be reduced under foreign law on distribution of that income, the rules of section 954(b)(4) shall be applied without regard to the possibility of subsequent reduction of foreign tax. If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then the income shall be considered to be passive income until distribution of that income. At that time, the rules of this paragraph (c) shall apply to determine whether the income is high-taxed income and, therefore, general limitation income.

(5) *Examples.* The following examples illustrate the application of this paragraph (c).

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a single qualified business unit (QBU). In 1988, S earns \$130 of gross passive royalty income, and incurs \$30 of expenses that do not include any payments to P. S's \$100 of net passive royalty income is subject to \$30 of foreign tax, and is included under section 951 in P's gross income for the taxable year. P allocates \$50 of expenses to the \$100 (consisting of the \$70 section 951 inclusion and \$30 section 78 amount),

resulting in a net inclusion of \$50. After application of the high-tax kick-out rules of paragraph (c)(2)(iii)(A) of this section, the \$50 inclusion is treated as general limitation income, and the \$30 of taxes deemed paid are treated as taxes imposed on general limitation income, because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$50 inclusion ($\$30 > \$17 (.34 \times \$50)$).

Example (2). The facts are the same as in example (1) except that instead of earning \$130 of gross passive royalty income, S earns \$65 of gross passive royalty income and \$65 of gross passive interest income. S incurs \$15 of expenses and \$5 of foreign tax with regard to the royalty income and incurs \$15 of expenses and \$10 of foreign tax with regard to the interest income. P allocates \$50 of expenses pro rata to the \$50 inclusion (\$45 section 951 inclusion and \$5 section 78 amount) attributable to the royalty income earned by S and the \$50 inclusion (\$40 section 951 inclusion and \$10 section 78 amount) attributable to the interest income earned by S. Pursuant to paragraph (c)(2)(ii)(A) and (B) of this section, the high-tax kick-out rules are applied separately to the section 951 inclusion attributable to the royalty income and the section 951 inclusion attributable to the interest income. Therefore, after allocation of P's \$50 of expenses, the resulting \$25 inclusion attributable to the royalty income is still treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$5 < \$8.50 (.34 \times \$25)$). The \$25 inclusion attributable to the interest income is treated as general limitation income because the foreign taxes paid and deemed paid exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$10 > \$8.50 (.34 \times \$25)$).

Example (3). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is incorporated in country X and has branches in country Y and country Z. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, S earns \$65 of gross passive royalty income in each QBU and allocates \$15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of \$50 in each QBU. Country X imposes \$5 of foreign tax on the \$50 of net royalty income earned in X, and country Y imposes \$10 of tax on the \$50 of net royalty income earned in Y. All of S's income constitutes subpart F foreign personal holding company income that is passive income and is included in P's gross income for the taxable year. P allocates \$50 of expenses pro rata to the \$100 Subpart F inclusion attributable to each QBU (consisting of the \$45 section 951 inclusion derived through QBU X, the \$5 section 78 amount attributable to QBU X, the \$40 section 951 inclusion derived through QBU Y, and the \$10 section 78 amount attributable to QBU Y), resulting in a net inclusion of \$50. Pursuant to paragraph (c)(2)(iii)(A) of this section, the high-tax kick-out rules must be applied separately to the Subpart F inclusion attributable to the royalty income earned by QBU X and the royalty income earned by QBU Y. After application of the high-tax kick-

out rules, the \$25 inclusion attributable to X will still be treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$5 < \$8.50 (.34 \times \$25)$). The \$25 inclusion attributable to Y will be treated as general limitation income because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$10 > \$8.50 (.34 \times \$25)$).

Example (4). Domestic corporation M operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, QBU X earns passive royalty income, interest income and rental income. The royalty income is not subject to foreign tax, and the interest income and the rental income are subject to a 4 percent and 15 percent withholding tax, respectively. QBU Y earns interest income that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the royalty income earned in QBU X and the interest income earned in QBU Y are treated as one item of income pursuant to paragraph (c)(2)(v) of this section. The interest income earned by QBU X and the rental income earned in QBU X are each treated as a separate item of income.

Example (5). S, a controlled foreign corporation incorporated in foreign country R, is a wholly-owned subsidiary of P, a domestic corporation. For 1988, P is required under section 951(a) to include in gross income \$80 attributable to the earnings and profits of S for such year, all of which is foreign personal holding company income that is passive rent or royalty income. S does not make any distributions in 1988 or 1989. Foreign income taxes paid by S for 1988 that are deemed paid by P for such year under section 960(a) with respect to the section 951(a) inclusion equal \$20. Twenty dollars (\$20) of P's expenses are properly allocated to the section 951(a) inclusion. The foreign income tax paid with respect to the section 951(a) inclusion does not exceed the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ($\$20 < \$27.20 (.34 \times \$80)$). Thus, P's section 951(a) inclusion for 1988 is included in P's passive income and the \$20 of taxes attributable to that inclusion are treated as taxes related to passive income. In 1990, after P has filed its return for its 1988 tax year, S distributes \$80 to P, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by P in 1988 and is excluded from P's gross income. Foreign country R imposes a withholding tax of \$15 on the distribution in 1990. Under paragraph (c)(3)(i) of this section, the withholding tax in 1990 does not affect the characterization of the 1988 inclusion as passive income nor does it affect the characterization of the \$20 of taxes paid in 1988 as taxes paid with respect to passive income. No further parent expenses are allocable to the receipt of that distribution. In 1990, the foreign taxes paid (\$15) exceed the product of the highest United States tax rate and the amount of the

inclusion reduced by taxes deemed paid in the year of inclusion ($\$15 > ((.34 \times \$80) - \$20)$). Thus, under paragraph (c)(3)(iii) of this section, $\$7.20 ((.34 \times \$80) - \$20)$ of the $\$15$ withholding tax paid in 1990 is treated as taxes related to passive income and the remaining $\$7.80 (\$15 - \$7.20)$ of the withholding tax is treated as related to general limitation income.

Example (6). The facts are the same as in Example (5), except that S distributes the $\$80$ in 1989 rather than 1990 and the distribution is made 30 days before P files its return for its 1988 tax year. Under paragraph (c)(3)(ii) of this section both the $\$20$ tax paid by S in 1988 and the $\$15$ withholding tax paid by P in 1989 are considered in determining whether the section 951(a) inclusion for 1988 is high-taxed income. Thus, because the total amount of foreign taxes paid with respect to the 1988 inclusion exceeds the amount determined by multiplying the highest United States rate for 1988 by the amount of the inclusion reduced by allocable parent expenses ($\$35 > \$27.20 (.34 \times \$80)$), the section 951(a) inclusion in 1988 is treated as general limitation income and the entire $\$35$ of tax (the $\$20$ of 1988 taxes and the $\$15$ of 1989 taxes) is treated as taxes related to general limitation income.

Example (7). S, a controlled foreign corporation, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $\$200$ of passive income that is foreign personal holding company income that is earned in a foreign country X that has an integrated tax system. Under this system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings. In 1987, S pays $\$100$ of foreign tax. P does not elect to exclude this income from Subpart F under section 954(b)(4) and includes $\$200$ in gross income ($\$100$ of net foreign personal holding company income and $\$100$ of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general limitation income to P. S does not distribute any of its earnings in 1987. In 1988, S has no earnings. On December 31, 1988, S distributes the $\$100$ of earnings from 1987. At that time, S receives a $\$50$ refund from X attributable to the reduction of the country X corporate tax imposed on those earnings. Under paragraph (c)(4) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income. Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example (8). The facts are the same as in example (7) except that P elects to apply section 954(b)(4) to S's passive income that is Subpart F income. Although the income is not considered to be Subpart F income, it remains passive income until distribution. In 1988, S distributes all of its earnings to P and pays P a $\$150$ dividend consisting of the $\$100$ of earnings in 1987 and the $\$50$ refund in 1988 attributable to the 1987 earnings. P has no

expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-rules under paragraph (c)(4)(iii) of this section. The income is passive income to P because the foreign taxes paid and deemed paid by P with respect to the income do not exceed the highest United States tax rate on that income.

(d) **High withholding tax interest.** The term "high withholding tax interest" means any interest if such interest is subject to a withholding tax of a foreign country or a possession of the United States and the rate of tax applicable to such interest is at least 5 percent. For purposes of the preceding sentence, a withholding tax is any tax imposed by a foreign country or possession of the United States that is determined on a gross basis. A withholding tax shall not be considered to be determined on a gross basis if the tax is not the final tax payable on the interest income, but is merely a prepayment or credit against a final foreign tax liability determined on a net basis on the interest alone or on interest and other income. High withholding tax interest does not include any interest described as export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section). If interest income is excluded from the definition of high withholding tax interest because it is described as export financing interest, the interest shall be treated as general limitation income unless the interest is received or accrued by a financial services entity, as defined in paragraph (e)(3) of this section. In that case, the income shall be treated as financial services income.

(e) **Financial services income**—(1) *In general.* The term "financial services income" means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(i) Income derived in the active conduct of a banking, insurance, financing, or similar business (as defined in paragraph (e)(2) of this section) except income described in paragraph (e)(2)(i)(W) of this section (high withholding tax interest);

(ii) Passive income as determined before the application of the exception for high-taxed income;

(iii) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section that, but for section 904(d)(2)(B)(ii), would also meet the definition of high withholding tax interest; or

(iv) Incidental income as defined in paragraph (e)(5) of this section.

(2) **Income from the active conduct of a banking, insurance, financial or similar business**—(i) *Income included.* For purposes of paragraph (e)(1) and (e)(3) of this section, income is derived

from the active conduct of a banking, insurance, financing, or similar business if it is described in any of the following subdivisions.

(A) Income that is of a kind that would be insurance income as defined in section 953(a) but excluding related party insurance income as defined in section 953(c)(2) and determined without regard to those provisions of section 953(a)(1)(A) that limit insurance income to income from countries other than the country in which the corporation was created or organized.

(B) Income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business.

(C) Income from investing deposits of money received from the public.

(D) Income from making personal, mortgage, industrial, or other loans to the public.

(E) Income from purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.

(F) Income from issuing letters of credit to the public and negotiating drafts drawn thereunder.

(G) Income from providing trust services for the public.

(H) Income from arranging foreign exchange transactions for the public or engaging in foreign exchange transactions with the public.

(I) Income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

(J) Income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments as an agent for a party in the sale.

(K) Service fee income from investment and correspondent banking.

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services to unrelated parties.

(N) Income from services provided to related parties with respect to the management of funds.

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services.

(Q) Income from financing purchases from third parties.

(R) Income from gains on the disposition of tangible or intangible personal property or real property that was used in the active conduct of a banking, insurance, financing, or similar business but only to the extent that the property was held to generate or generated income derived in the active conduct of a banking, insurance, financing, or similar business prior to its disposition.

(S) Income from hedging gain with respect to other financial services income.

(T) Income from providing traveller's check services.

(U) Income that is determined to be financial services income under the look-through rules of § 1.904-7.

(V) Income from finance leasing that would not qualify as active leasing income under section 954(c)(2)(A).

(W) Income from lending activities that give rise to high withholding tax interest.

(X) Such other income as the Secretary may designate.

(ii) *Income excluded.* Income from merely serving as a finance vehicle for a parent corporation or a related person as defined in section 954(d)(3) shall not be considered to be income from the active conduct of a banking, insurance, financing, or similar business.

(3) *Definition of a financial services entity—(i) In general.* The term "financial services entity" means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any taxable year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an entity is a financial services entity shall be done on an entity-by-entity basis. An individual or entity is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any year if for that year 80 percent of its gross income is income described in paragraph (e)(2)(i) of this section. For this purpose, gross income includes all income realized by an individual or entity, whether includible or excludable from gross income under other operative provisions of the Code.

(ii) *Special rule for affiliated groups.* In the case of any domestic corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group (as defined in section 1504 (a)), such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of section (e)(3)(i) of this

section and the group files its return on a consolidated basis.

(iii) *Treatment of partnerships and other pass-through entities—(A) Rule.* For purposes of determining whether a partnership is a financial services entity, all of the partnership's income, including income characterized under the look-through rules of § 1.904-7, shall be taken into account. If the partnership is determined to be a financial services entity and, under § 1.904-7(i)(1), the partner's distributive share of income from the partnership is subject to the look-through rules, then financial services income of the partnership will be treated as income from the active conduct of a banking, insurance, financing, or similar business of the partner for purposes of determining whether the partner is a financial services entity. In such circumstances, for purposes of determining a partner's foreign tax credit limitations, the income shall be considered to be financial services income regardless of whether the partner is itself a financial services entity. If the partnership is determined not to be a financial services entity, then for purposes of determining whether a partner in a partnership is a financial services entity, income of the partnership shall retain its character in the hands of the partner. Thus, if the income is derived in the active conduct of a banking, insurance, financing, or similar business by the partnership, it shall be treated as income derived by the partner in the active conduct of such business. The rules of this paragraph (e)(3)(iii) will apply for purposes of determining whether an owner of an interest in any other pass-through entity the character of the income of which is preserved when such income is included in the income of the owner of the interest is a financial services entity.

(B) *Examples.* The principles of this paragraph (e)(3)(iii) are illustrated by the following examples.

Example (1). PS is a domestic partnership operating in branch form in foreign country X. PS has two equal general partners, A and B. A and B are domestic corporations that each operate in branch form in foreign countries Y and Z. All of A's income, except that derived through PS, is manufacturing income. All of B's income, except that derived through PS, is income from the active conduct of a banking, insurance, financing, or similar business. PS is a financial services entity and all of its income is financial services income. Therefore, A and B's distributive shares of PS's taxable income consist of financial services income whether or not A or B is a financial services entity. In order to determine if A or B are financial services entities, the income from PS is considered to be income of A and B from the active conduct of a banking, insurance, financing, or similar

business and will be combined with A's and B's manufacturing and active banking income, respectively, to determine if either or both satisfy the gross income test of paragraph (e)(3)(i) of this section.

Example (2). PS is a domestic partnership operating in branch form in foreign country X. A and B are domestic corporations that are equal general partners in PS. Fifty (50) percent of PS's gross income is income from the active conduct of a banking, insurance, financing, or similar business. The other 50 percent of PS's income is from manufacturing. PS is therefore not a financial services entity. A's and B's distributive shares of partnership taxable income consist of general limitation manufacturing income and income derived in the active conduct of a banking, insurance, financing, or similar business. Under paragraph (e)(3)(i) of this section, the income derived in the active conduct of a banking, insurance, financing, or similar business shall be financial services income to A or B if either A or B is determined to be a financial services entity. If A or B is not a financial services entity, the income shall be passive income to A or B.

(4) *Definition of incidental income—*

(i) *In general—(A) Rule.* Incidental income is income that is integrally related to financial services income of a financial services entity. Such income includes, for example, income from precious metals trading and commodity trading that is integrally related to futures income. If securities, shares of stock, or other types of property are acquired by a financial services entity as an ordinary and necessary incident to the conduct of a banking, insurance, financing, or similar business, the income from such property will be considered to be financial services income but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus property, including stock, acquired as the result of, or in order to prevent, a loss in banking, insurance, financing, or similar business upon a loan contracted in the ordinary course of such business will be considered ordinary and necessary to the conduct of such business, but income from such property will be considered financial services income only so long as the holding of such property remains an ordinary and necessary incident to the conduct of such business. If a financial services entity holds such property for 12 months or less, the entity shall be considered to hold such property incident to its financial services business. If an entity holds such property for more than 12 months, a presumption will be established that the entity is not holding such property incident to its financial services business. An entity will be able to rebut the presumption by

demonstrating that under the facts and circumstances it is not holding the property as an investment.

(B) *Examples.* The following examples illustrate the application of paragraph (e)(4)(i) of this section.

Example (1). X is a financial services entity within the meaning of paragraph (e) (3) (i) of this section. In 1987, X made a loan in the ordinary course of its business to an unrelated foreign corporation, Y. As security for that loan, Y pledged certain operating assets. Those assets generate income of a type that would be subject to the general limitation. In January 1989, Y defaulted on the loan and forfeited the collateral. From January to February of 1989, X attempted but was unable to sell the forfeited assets. During that period, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In March of 1989, X sold the operating assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from January to February of 1989 and the income on the sale of the assets in March of 1989 are financial services income of X.

Example (2). The facts are the same as in example (1), except that instead of pledging its operating assets as collateral for the loan, Y pledged the stock of its operating subsidiary Z. In March of 1989, X sold the stock of Z in complete satisfaction of Y's obligation. X's income from the sale of Z stock in satisfaction of Y's obligation is financial services income.

Example (3). P, a domestic corporation, is a financial services entity within the meaning of paragraph (e) (3) (i) of this section. P holds a United States dollar denominated debt (the "obligation") of the Central Bank of foreign country X. The obligation evidences a loan of \$100 made by P to the Central Bank. In 1988, pursuant to a program of country X, P delivers the obligation to the Central Bank which credits 70 units of country X currency to M, a country X corporation. M issues all of its only class of capital stock to P. M invests the 70 units of country X currency in the construction and operation of a new hotel in X. In 1990, M distributes 10 units of country X currency to P as a dividend. The dividend is not financial services income to P because, under the facts and circumstances, P is not able to rebut the presumption that it is not holding the property incident to its financial services business.

(ii) *Financing vehicles.* Income from acting as a financing vehicle for borrowing funds for a related person (within the meaning of section 954 (d) (3)) is incidental income within the meaning of paragraph (e) (4) (i) of this section.

(iii) *Income that is not incidental income.* Income that is attributable to non-financial activity is not incidental income within the meaning of paragraph (e) (4) (i) and (ii) of this section solely because such income represents a relatively small proportion of the taxpayer's total income or that the

taxpayer engages in non-financial activity on a sporadic basis. Thus, for example, income from data processing services provided to unrelated parties or income from the sale of goods or non-financial services (for example travel services) is not financial services income, even if the recipient is a financial services entity.

(5) *Exceptions.* Financial services income does not include income that is:

(i) Export financing interest as defined in section 904 (d) (2) (G) and paragraph (h) of this section unless such income also meets the definition of high withholding tax interest;

(ii) High withholding tax interest unless such income also meets the definition of export financing interest; and

(iii) Dividends from noncontrolled section 902 corporations as defined in section 904 (d) (2) (E) and paragraph (g) of this section.

(f) *Shipping income.* The term "shipping income" means any income received or accrued by any person that is of a kind that would be foreign base company shipping income (as defined in section 954 (f) and the regulations thereunder). Shipping income does not include any dividends received or accrued from a noncontrolled section 902 corporation or any income that is financial services income.

(g) *Noncontrolled section 902 corporation—(1) Definition.* Except as otherwise provided, the term "noncontrolled section 902 corporation" means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902 (a) or, for purposes of applying the look-through rules described in section 904 (d) (3) and § 1.904-7, the taxpayer meets the requirements of section 902 (b).

(2) *Treatment of dividends from each separate noncontrolled section 902 corporation—(i) In general.* Except as otherwise provided, a separate foreign tax credit limitation applies to dividends received or accrued by a person from each noncontrolled section 902 corporation. Any dividend distribution made by a noncontrolled section 902 corporation out of earnings and profits attributable to periods in which the shareholder did not meet the stock ownership requirements of section 902 (a) or section 902 (b) shall be treated as distributions made by a noncontrolled section 902 corporation.

(ii) *Special rule for dividends received by a controlled foreign corporation.* If—

(A) Stock in a foreign corporation is owned by a controlled foreign corporation,

(B) There are two or more United States shareholders of that controlled foreign corporation, and

(C) The ownership requirements of section 902(b) with respect to the foreign corporation are met by one of the United States shareholders of the controlled foreign corporation,

then any dividends received by the controlled foreign corporation from the foreign corporation shall be treated in their entirety to the controlled foreign corporation as dividends from a noncontrolled section 902 corporation, notwithstanding that all the United States shareholders of the controlled foreign corporation do not meet the requirements of section 902(b). Any income received or accrued by a United States shareholder of a controlled foreign corporation described in the preceding sentence that is attributable to a dividend paid by a foreign corporation shall be considered to be passive income if the shareholder's interest in that foreign corporation does not satisfy the requirements of section 902(b).

(iii) *Special rules for high withholding tax interest.* If a taxpayer receives or accrues a dividend distribution from a noncontrolled section 902 corporation out of earnings and profits attributable to high withholding tax interest earned or accrued by the noncontrolled section 902 corporation, any gross basis foreign tax (as defined in paragraph (d) of this section) imposed on such interest, to the extent that the taxes are imposed at a rate in excess of 5 percent, shall not be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid or accrued by the taxpayer under section 902. The preceding sentence shall have no effect upon the determination of the amount of earnings and profits of a noncontrolled section 902 corporation.

(3) *Special rule for controlled foreign corporations.* Distributions from a controlled foreign corporation shall be treated as dividends from a noncontrolled section 902 corporation, and therefore not subject to the look-through rules of § 1.904-7, only to the extent that the distribution is out of earnings and profits for periods during which the controlled foreign corporation was a noncontrolled section 902 corporation. Distributions from a controlled foreign corporation that are attributable to periods when the controlled foreign corporation was neither a controlled foreign corporation nor a noncontrolled section 902 corporation shall be treated as passive income.

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

Example (1). A and B are domestic corporations. A owns 90 percent of the stock of C, a foreign corporation and B owns the remaining 10 percent of the C stock. C is a controlled foreign corporation. A and B are United States shareholders. C owns 20 percent of the stock of D, a foreign corporation, not a controlled foreign corporation, that is incorporated in a different country than C. D is a noncontrolled section 902 corporation with respect to C and A, but not with respect to B. In 1987, C has foreign personal holding company income of \$1000, \$100 of which is attributable to a dividend from D. The remainder of the foreign personal holding company income is passive income. Assume that gross income and net income are equal and that C pays no foreign taxes on its foreign personal holding company income. In 1987, A and B have section 951(a)(1)(A) inclusions of \$900 and \$100, respectively, attributable to foreign personal holding company income. Under paragraph (g)(2)(ii) of this section the \$900 included by A consists of \$810 passive income and \$90 of income attributable to a dividend from a noncontrolled section 902 corporation. The \$100 included by B in gross income is characterized as passive income in its entirety although \$10 of the \$100 is attributable to the dividend from D, and, as to C, is characterized as a dividend from a noncontrolled section 902 corporation. As to B, the \$10 is characterized as passive income because B does not meet the ownership requirements of section 902(b) with regard to D.

Example (2). In 1987, A, a domestic corporation, owned 9 percent of the stock of B, a foreign corporation. In 1988, A acquired an additional 20 percent of the stock of B. Thus, in 1988, B is a noncontrolled section 902 corporation with regard to A. In 1989, A acquired an additional 25 percent of the stock of B. A acquired no additional stock in 1990. In 1989 and 1990, A owned 54 percent of the stock of B. For 1989 and 1990, B is a controlled foreign corporation in which A is a United States shareholder. B has no Subpart F income in 1989 or 1990. In 1990, B pays a dividend of \$3,000 to A. One thousand dollars (\$1,000) of the dividend is attributable to earnings and profits from 1987, \$1,000 is attributable to earnings and profits from 1988, and \$1,000 is attributable to earnings and profits from 1989. Under paragraph (g)(3) of this section, the \$1,000 attributable to the earnings and profits from 1989 is subject to the look through rules of section 904(d)(3) and § 1.904-7(c)(4) and is characterized in A's hands according to those rules. The \$1,000 attributable to the 1988 earnings and profits is treated as income subject to a separate limitation for dividends from a noncontrolled section 902 corporation (B corporation), and the \$1,000 attributable to the earnings and profits in 1987 is treated as passive income.

Example (3). M owns 40 percent of the voting stock of foreign corporation N. N is a noncontrolled section 902 corporation. In 1987, N earns \$2,000 of gross interest income and incurs \$1,700 of interest expense. N

incurs no other expenses and earns no other income. One thousand dollars (\$1,000) of the interest income is subject to a 10 percent withholding tax and is, therefore, high withholding tax interest. N's earnings and profits are \$200 (\$2,000 gross interest income less \$1,700 interest expense less \$100 withholding tax). N pays the full \$200 out as a dividend. M receives \$80 (40 percent of the \$200). Under paragraph (g)(3) of this section, \$50 ($\$100 - 5\% \times \$1,000$) of the \$100 withholding tax is not treated as a foreign tax for purposes of determining the amount of foreign taxes deemed paid by M under section 902. M's deemed paid credit with respect to the \$80 dividend it receives is, therefore, reduced from \$40 ($\$100 \times \$80/\$200$) to \$20 ($\$50 \times \$80/\$200$).

(h) *Export financing interest—(1) In general.* The term "export financing interest" means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For purposes of this paragraph, the term "United States" includes the fifty States, the District of Columbia, and the Commonwealth of Puerto Rico.

(2) *Fair market value.* For purposes of this paragraph, the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. For purposes of determining the foreign content of an item of property imported into the United States, see § 1.927(a)-1T(e)(4).

(3) *Related person.* For purposes of this paragraph, a related person is an individual, corporation, partnership, trust, or estate that is controlled by the same person or persons that control the recipient of the export financing interest. In the case of a corporation, control means the direct or indirect ownership of stock possessing 50 percent or more of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation. In the case of a partnership, trust, or estate, control means the direct or indirect ownership of 50 percent or more by value of the beneficial interests in the partnership, trust, or estate. Ownership of stock and ownership of beneficial interests shall be determined under the principles of section 958(b).

(4) *Interaction of export financing interest and related person factoring income—(i) Export financing interest that is also related person factoring*

income. Section 904(d)(2)(A)(iii)(II) (providing that passive income excludes export financing interest) does not apply to income that also meets the definition of export financing interest (with the result that such income shall be treated as passive income) if such income is—

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

(B) Income received or accrued by any person (other than a financial services entity) that is income described in section 864(d)(1) (income from a trade or service receivable acquired from a related person).

If the income described in the preceding sentence is received or accrued by a financial services entity, it shall be treated as financial services income.

(ii) *Examples.* The following examples illustrate the operation of paragraph (h)(4)(i) of this section.

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P sells the receivables at a discount ("factors") to S. The income derived by S on the receivables is described in section 864(d)(1). The income is also export financing interest. Because the income is described in section 864(d)(1), section 904(d)(2)(A)(iii)(II) does not apply and the income is passive income to S.

Example (2). The facts are the same as in example (1) except that S is a financial services entity and derives the income in the conduct of a banking business. The income derived by S on the receivables is income described in section 864(d)(1). The income is also export financing interest. Section 904(d)(2)(C)(iii)(III) does not apply and the income is financial services income to S.

Example (3). Domestic corporation S is a wholly-owned subsidiary of domestic corporation P. S has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P factors the receivables to S. The income derived by S on the receivables is income described in section 864(d)(1). The income is also export financing interest. Because the income is described in section 864(d)(1), section 904(d)(2)(A)(iii)(II) does not apply and the income will be passive income to S.

Example (4). The facts are the same as in example (3) except that instead of factoring P's receivable, S finances the sales of P's goods by making loans to the purchasers of P's goods. The interest derived by S on these loans is export financing interest and is not income described in section 864(d)(6) (S is not a controlled foreign corporation) or section

864(d)(1)(P does not factor receivables). The income will be general limitation income to S.

(iii) *Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment—(A) Income other than interest.* If any foreign person that is not a financial services entity receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) as such income would also meet the definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income shall be considered to be export financing interest for purposes of section 904(d)(2)(A)(iii)(II) and shall be treated as general limitation income. If a financial services entity receives or accrues such income, the income shall not be considered to be export financing interest under section 904(d)(2)(C)(iii)(III) and shall therefore be treated as financial services income.

(B) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income under section 864(d)(6) If section 864(d)(7) did not apply, section 904(d)(2)(A)(iii)(II) shall apply, and the interest shall be treated as general limitation income unless the interest is received or accrued by a financial services entity. In that case, section 904(d)(2)(C)(iii)(III) shall not apply and the interest shall therefore be treated as financial services income.

(C) *Examples.* The following examples illustrate the operation of paragraph (h)(4)(iii) (A) and (B) of this section.

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. In 1987, P sells tractors to T, which T sells to X, a foreign corporation organized in country M. The tractors are to be used in country M. T has uncollected trade receivables from X that it factors to S. The income derived by S from the receivables is not derived in the conduct of a banking business, and S is not a financial services entity. The income is not described in section 864(d)(1)(related person factoring interest income) because it is described in section 864(d)(7)(income eligible for the same country exception). Because the income derived by S from the receivables would meet the definition of export financing interest if the income were described in section 864(d)(1), the income is considered to be export financing interest for purposes of section 904(d)(2)(A)(iii)(II) and is general limitation income to S.

Example (2). The facts are the same as in example (1) except that S is a financial services entity and derives the income on the receivables in the conduct of a banking business. The income derived by S from the receivables is not described in section 864(d)(1) because it is described in section 864(d)(7). Because the income is not considered to be export financing interest for purposes of section 904(d)(2)(C)(iii)(III), the income is financial service income to S.

Example (3). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. S is not a financial services entity. In 1987, P sells tractors to T, which T sells to X, a foreign partnership that is organized in country M and is related to S and T. S makes a loan to X to finance the tractor sales. The interest earned by S from financing the sales is export financing interest. Under paragraph (h)(4)(iii)(B) of this section, since the interest is described in section 864(d)(7) and is export financing interest, section 904(d)(2)(A)(iii)(II) shall apply and the income shall be general limitation income to S.

Example (4). The facts are the same as in example (3) except that S is a financial services entity and derives the interest on the loan to X in the conduct of a banking business. The interest earned by S is export financing interest that is not described in section 864(d)(1) because it is described in section 864(d)(7). Since the interest is described in section 864(d)(7) and is export financing interest, section 904(d)(2)(C)(iii)(III) shall not apply and the income shall be financial service income to S.

(i) *Interaction of section 907(c) and income described in this section.* If a person receives or accrues income that is income described in section 907(c) (relating to oil and gas income), the rules of section 907(c) and the regulations thereunder, as well as the rules of this section, shall apply to the income. Thus, for example, if a taxpayer receives or accrues a dividend distribution from two separate noncontrolled section 902 corporations out of earnings and profits attributable to income received or accrued by the noncontrolled section 902 corporations that is income described in section 907(c), the rules provided in section 907 shall apply separately to the dividends received from each noncontrolled section 902 corporation. The reduction in amount allowed as foreign tax provided by section 907(a) shall therefore be calculated separately for dividends received or accrued by the taxpayer from each separate noncontrolled section 902 corporation.

(j) *Priority rules.* In the case of income that meets the definitions of more than one category of separate limitation income the following priority rules apply:

(1) Income that meets the definitions of passive income and of any other separate limitation income will be subject to the other separate limitation;

(2) Income that meets the definitions of financial services income and of either shipping income or passive income will be subject to the separate limitation for financial services income;

(3) Income that meets the definitions of financial services income and of any separate limitation income other than shipping or passive income will be subject to the other separate limitation;

(4) Income that meets the definitions of dividends from a noncontrolled section 902 corporation and of any other separate limitation income will be subject to the separate limitation for dividends from a noncontrolled section 902 corporation; and

(5) Income that meets the definitions of high withholding tax interest and of any other separate limitation income will be high withholding tax interest.

§ 1.904-7 Look-through rules as applied to controlled foreign corporations and other entities.

(a) *Definitions.* For purposes of section 904(d)(3) and this section, the following definitions apply:

(1) The term "separate category" means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (E), (F), (G), (H), or (I) and in § 1.904-6 (b), (d), (e), (f), and (g), or any category of earnings and profits to which income described in such provisions is attributable.

(2) The term "controlled foreign corporation" has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(3) The term "United States shareholder" has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(b) *In general.* Except as otherwise provided in section 904(d)(3) and this section, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as general limitation income.

(c) *Rules for specific types of inclusions and payments—(1) Subpart F inclusions—(i) Rule.* Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by the

controlled foreign corporation that is described as income in such category. For purposes of this paragraph, the priority rules of § 1.904(d)-6(j) shall apply prior to application of the rules of this paragraph.

(ii) *Examples.* The following examples illustrate the application of this paragraph (c)(1):

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns \$200 of net income, \$85 of which is foreign base company shipping income, \$15 of which is foreign personal holding company income, and \$100 of which is non-Subpart F general limitation income. No foreign tax is imposed on the income. One hundred dollars (\$100) of S's income is Subpart F income taxed currently to P under section 951(a)(1)(A). Because \$85 of the Subpart F inclusion is attributable to shipping income of S, \$85 of the Subpart F inclusion is shipping income to P. Because \$15 of the Subpart F inclusion is attributable to passive income of S, \$15 of the Subpart F inclusion is passive income to P.

Example (2). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a financial services entity. P manufactures cars. In 1987, S earns \$200 of interest income unrelated to its banking business and \$900 of interest related to its banking business. Assume that S pays no foreign taxes and has no expenses. All of S's income is included in P's gross income as foreign personal holding company income. Because S is a financial services entity, income that would otherwise be passive income is considered to be financial services income. Therefore, P treats the entire Subpart F inclusion as financial services income.

Example (3). Controlled corporation S is a wholly-owned subsidiary of domestic corporation P. P is a financial services entity and S manufactures cars. In 1987, S earns \$200 of passive income that is Subpart F income and \$900 of general limitation non-Subpart F income. Assume that S pays no foreign taxes on its passive earnings. P includes the \$200 of Subpart F income in gross income. Because P is a financial services entity, the inclusion will be financial services income to P.

Example (4). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 40 percent of foreign corporation A, 45 percent of foreign corporation B, 30 percent of foreign corporation C and 20 percent of foreign corporation D. A, B, C, and D are noncontrolled section 902 corporations. In 1987, S's only income is a \$100 dividend from each foreign corporation. Assume that S pays no foreign taxes and has no expenses. All \$400 of the income is foreign personal holding company income and is included in P's gross income. P must include \$100 in its separate limitation for dividends from A, \$100 in its separate limitation for dividends from B, \$100 in its separate limitation for dividends from C, and \$100 in its separate limitation for dividends from D.

(2) *Interest*—(i) *In general.* Any interest that is received or accrued from

a controlled foreign corporation by a taxpayer that is a United States shareholder in such foreign corporation shall be treated as income in a separate category to the extent it is allocable to income of the controlled foreign corporation in that category. If related person interest (as defined in this paragraph (c)(2)(ii)) is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to any separate category of income shall be determined by multiplying the amount of related person interest allocable to that separate category of income by a fraction. The numerator of the fraction is the amount of related person interest received or accrued by that person and the denominator is the total amount of related person interest paid or accrued by the controlled foreign corporation.

(ii) *Allocating expenses including interest paid to a related person.* If interest is paid or accrued by a controlled foreign corporation to any United States shareholder in such corporation (or to any related controlled foreign corporation within the meaning of paragraph (g) of this section) ("related person interest"), such related person interest and other expenses of a controlled foreign corporation shall be allocated and apportioned in the following manner:

(A) Gross income in each separate category shall be determined;

(B) Any expenses, including unrelated person interest, that are definitely related expenses shall be directly allocated and apportioned under the principles of § 1.861-8 to, and reduce, income in each separate category;

(C) Any expenses, excluding interest, that are not definitely related expenses shall be apportioned under the principles of § 1.861-8 to, and reduce, income in each separate category;

(D) Related person interest shall be allocated to and shall reduce (but not below zero) the amount of passive foreign personal holding company income as determined after the application of paragraph (c)(2)(ii) (B) and (C) of this section;

(E) To the extent that related person interest exceeds passive foreign personal holding company income as determined after the application of paragraph (c)(2)(ii) (B) and (C) of this section, the related person interest shall be allocated to separate categories other than passive income according to the following formula:

Related person interest minus Related person interest allocated under paragraph (c)(2)(ii)(D) times Value (as determined under § 1.861-8) of assets in a separate category (other than passive) divided by Value (as determined under § 1.861-8) of all assets (other than passive)

(F) Interest expense other than definitely related interest and related person interest ("unrelated person interest expense") shall be allocated according to the following formula:

Unrelated person interest expense allocable to a separate category equals Total unrelated person interest times Value of adjusted assets in a separate category divided by Value of adjusted total assets

(iii) *Value (as determined under § 1.861-8) of assets.* For purposes of this section, the value of assets shall be determined under the principles of § 1.861-8. For this purpose, the value of assets in any category shall be reduced by the principal amount of any indebtedness to the extent that interest on such indebtedness is definitely related and therefore directly allocated to income in such category.

(iv) *Adjusted assets.* Adjusted assets in a separate category equals the value of assets in a separate category minus the related person debt in that category for the year. Adjusted total assets equals the value of total assets minus the total related person debt for the year. Related person debt allocable to assets in a separate category shall be determined according to the following formula:

Related person debt allocated to a separate category equals Total related person debt times Related person interest allocable to a separate category under paragraph (c)(2)(ii) (D) or (E) divided by All related person interest

The term "total related person debt" means the sum of the principle amounts of obligations of a controlled foreign corporation owed to any United States shareholder of such corporation or to any controlled foreign corporation related to such shareholder (within the meaning of paragraph (g) of this section).

(v) *Examples.* The following examples illustrate the operation of this paragraph (c)(2).

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$200 of foreign personal holding company income that is passive income. S also earns \$100 of foreign base company sales income that is general limitation income. S has \$2000 of passive assets and \$2000 of general limitation assets. In 1987, S makes a \$150 interest payment to P with respect to a \$1500 loan from P. S also pays \$100 of interest to an

unrelated person on a \$1000 loan from that person. S has no other expenses.

Under paragraph (c)(2)(ii)(D) of this section, the \$150 related person interest payment is allocable to S's passive foreign personal holding company income. Therefore, the \$150 interest payment is passive income to P.

Because the entire related person interest payment is allocated to passive income under paragraph (c)(2)(ii)(D) of this section, none of the related person interest payment is allocable to general limitation income under paragraph (c)(2)(ii)(E) of this section.

Under paragraph (c)(2)(iv) of this section, the entire amount of the related person debt is allocable to passive assets (\$1500 = \$1500 × \$150/\$150).

Under paragraph (c)(2)(ii)(F) of this section, \$20 of interest expense paid to an unrelated person is allocated to passive income (\$20 = \$100 × (\$2000 - \$1500)/(\$4000 - \$1500)). Eighty dollars (\$80) of the interest expense paid to an unrelated person is allocated to general limitation income (\$80 = \$100 × (\$2000 - \$0)/(\$4000 - \$1500)).

Example (2). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$100 of foreign personal holding company income that is passive income. S also earns \$100 of foreign base company sales income that is general limitation income. S has \$1000 of general limitation assets and \$1000 of passive assets. In 1987, S makes a \$150 interest payment to P on a \$1500 loan from P and has \$20 of general and administrative expenses (G & A). S also makes a \$25 interest payment to an unrelated person on a \$250 loan from the unrelated person. S has no other expenses.

Under paragraph (c)(2)(ii)(C) of this section, \$10 of the G & A is allocable to S's passive foreign personal holding company income and \$10 of the G & A is allocable to S's general limitation income.

Under paragraph (c)(2)(ii)(D) of this section, \$90 of the interest payment to P is allocable to S's passive foreign personal holding company income.

Under paragraph (c)(2)(ii)(E) of this section, the additional \$60 of related person interest expense is allocated to general limitation income (\$60 = \$60 × \$1000/\$1000).

Under paragraph (c)(2)(iv) of this section, related person debt is allocated to passive and general limitation assets. The related person debt allocable to passive assets equals \$900 (\$900 = \$1500 × \$90/\$150). The related party debt allocable to general limitation assets equals \$600 (\$600 = \$1500 × \$60/\$150).

Under paragraph (c)(2)(ii)(F) of this section, \$5 of the \$25 of interest expense paid to an unrelated person is allocated to passive income (\$5 = \$25 × (\$1000 - \$900)/(\$2000 - \$1500)). Twenty dollars (\$20) of the interest expense paid to an unrelated person is allocated to general limitation income (\$20 = \$25 × (\$1000 - \$600)/(\$2000 - \$1500)).

Example (3). Controlled foreign corporation T is a wholly-owned subsidiary of S, a controlled foreign corporation. S is a wholly-owned subsidiary of P, a domestic corporation. S and T are incorporated in the same country. In 1987, P sells tractors to T,

which T sells to X, a foreign corporation that is related to both S and T and is organized in the same country as S and T. S makes a loan to X to finance the tractor sales. Assume that the interest earned by S from financing the sales is export financing interest that is neither related person financing income nor foreign personal holding company income. S earns no passive income. S makes a \$100 interest payment to P. The \$100 of interest paid to P is allocable under the look-through rules of paragraph (c)(2)(ii) of this section to the export financing interest earned by S and is general limitation income to P.

Example (4). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. P manufactures industrial equipment in the United States and sells some of the equipment to S for use in S's business. P provides financing to S in connection with the purchase of P's equipment. In 1987, S pays P \$100 of interest relating to the financing. S also pays P \$150 on a loan unrelated to the financing. In 1987, S has assets that generate general limitation income and income attributable to dividends from a noncontrolled section 902 corporation. Under paragraph (c)(2)(ii) of this section, \$150 of the interest payments to P are allocable to S's general limitation income and \$100 are allocable to S's dividends from a noncontrolled section 902 corporation. Therefore, under the look-through rules of paragraph (c)(2)(i) of this section, \$150 of interest is general limitation income to P and \$100 of interest is included in P's separate limitation for dividends from the noncontrolled section 902 corporation.

(3) Rents and Royalties. Any rents or royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent they are allocable to income of the controlled foreign corporation in that category under the principles of § 1.861-8.

(4) Dividends—(i) Look-through rule. Any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the controlled foreign corporation.

(ii) Special rule for dividends attributable to certain loans. If a dividend is distributed to a taxpayer by a controlled foreign corporation, that controlled foreign corporation is the recipient of loan proceeds from a related person (within the meaning of paragraph (g) of this section), and the purpose of such loan is to alter the characterization of the dividend for purposes of this section, then, to the extent of the principal amount of the loan, the dividend shall be characterized with respect to the earnings and profits of the related person lender rather than with

respect to the earnings and profits of the dividend payor.

(iii) Examples. The following examples illustrate the application of this paragraph (c)(4).

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S has earnings and profits of \$1,000, \$600 of which is attributable to manufacturing income that is not Subpart F income and \$400 of which is attributable to dividends received by S from a noncontrolled section 902 corporation, T. T is incorporated and operates in the same country as S, and S has a 50 percent ownership interest in T. In December of 1987, S pays a dividend of \$200, all of which is attributable to earnings and profits earned in 1987. Six-tenths of the dividend, \$120, is treated as general limitation income because six-tenths of S's earnings and profits are attributable to general limitation income. Four-tenths of the dividend, \$80, is treated as income subject to a separate limitation for dividends from a noncontrolled section 902 corporation because four-tenths of S's earnings and profits are attributable to dividends from T, a noncontrolled section 902 corporation.

Example (2). A, a United States person, has been the sole shareholder in controlled foreign corporation X since its organization on January 1, 1963. X's earnings and profits for 1983 through the end of 1987 totaled \$3,000. A sells his stock in X at the end of 1987 and realizes a gain of \$4,000. Of the total \$4,000 gain, \$3,000 (A's share of the post-1962 earnings and profits) is includible in A's gross income as a dividend and is subject to the look-through rules. The remaining \$1,000 of the gain is includible as gain from the sale or exchange of the X stock and is passive income to A.

(d) Effect of exclusions from Subpart F income—(1) De minimis amount of Subpart F income. If the sum of a controlled foreign corporation's foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the taxable year is less than the lesser of 5 percent of gross income or \$1,000,000, then all such income shall be treated as general limitation income.

(2) Exception for certain income subject to high foreign tax. For purposes of the dividend look-through rule of paragraph (c)(4)(i) of this section, an item of net income that would otherwise be passive income (after application of the priority rules of § 1.904-6 (f)) that is received or accrued by a controlled foreign corporation shall be treated as general limitation income, and the earnings and profits attributable to such income shall be treated as general limitation earnings and profits, if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater

than 90 percent of the maximum rate of tax specified in section 11 (with reference to section 15, if applicable). The preceding sentence has no effect on amounts (other than dividends) paid or accrued by a controlled foreign corporation to a United States shareholder of such controlled foreign corporation to the extent those amounts are allocable to passive income of the controlled foreign corporation. For treatment of foreign taxes imposed on income described in this paragraph (d)(2), see § 1.904-8.

(3) *Examples.* The following examples illustrate the application of this paragraph.

(*Example (1).*) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$100 of gross income, \$4 of which is interest that is Subpart F foreign personal holding company interest and \$96 of which is gross manufacturing income that is not Subpart F income. S has no other earnings for 1987. S has no expenses and pays no foreign taxes. S pays P a \$100 dividend. Under the de minimis rule of section 954(b)(3), none of S's income is treated as foreign base company income. Therefore, all of S's income is treated as general limitation income. The entire \$100 dividend is general limitation income to P.

(*Example (2).*) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$50 of shipping income of a type that is foreign base company shipping income. S also earns \$50 of dividends from T, a foreign corporation in which S owns 45 percent of the voting stock, and \$50 of dividends from U, a foreign corporation in which S owns 5 percent of the voting stock. Foreign persons hold the remaining voting stock of both T and U. S, T, and U are all incorporated in different foreign countries. The dividends received by S from T and U are of a type that would normally be Subpart F foreign personal holding company income that is passive income. However, under § 1.904-6 (j), the dividends from T are dividends from a noncontrolled section 902 corporation rather than passive income. S has no expenses. The earnings and profits of S are equal to the net income of S. The dividends and the shipping income are taxed abroad by S's country of incorporation at an effective rate of 40 percent. P establishes to the satisfaction of the Secretary that the effective rate of tax on both the dividends and the shipping income exceeds 90 percent of the maximum United States tax rate. Therefore, under section 954(b)(4), neither the shipping income nor the dividends are currently taxed to P under Subpart F. Under paragraph (d)(2) of this section, S's earnings attributable to the dividends from U are treated as earnings attributable to general limitation income.

In 1988, S has no earnings and pays a \$150 dividend to P. The dividend is paid out of S's post-1986 pool of earnings and profits. One-third of the dividend, \$50, is attributable to S's shipping earnings, one-third, \$50, is attributable to the dividend from T, and one-third, \$50 is attributable to the dividend from

U. Under section 904(d)(2)(E) and paragraph (c)(4) of this section, one-third of the dividend is shipping income, one-third is a from a noncontrolled section 902 corporation, T, and one-third is general limitation income to P.

(e) *Treatment of subpart F income in excess of 70 percent of gross income—*

(1) *Rule.* If the sum of a controlled foreign corporation's foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the taxable year exceeds 70 percent of the gross income, then all of the controlled foreign corporation's gross income shall be treated as foreign base company income and, thus, included in a United States shareholder's gross income. However, the inclusion in gross income of an amount that would not otherwise be Subpart F income does not affect its character for purposes of determining whether the income is within a particular category of income.

(2) *Example.* The following example illustrates the application of this paragraph.

(*Example.*) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns \$100, \$75 of which is foreign base company shipping income, as defined in section 954(f), and \$25 of which is non-Subpart F services income. S's gross and net income are equal. The \$75 of shipping income includes \$10 of rental income that also meets the definition of foreign personal holding company income. That \$10 is treated as shipping income to S under § 1.904-6(f). Under the 70 percent full inclusion rule of section 954(b)(3)(B), the entire \$100 is foreign base company income currently taxable to P under section 951. Because \$75 of the \$100 section 951 inclusion is attributable to S's shipping income, \$75 of the inclusion is shipping income to P. The remaining \$25 of the inclusion is treated as general limitation income to P because \$25 is attributable to S's general limitation income.

(f) *Modification of look-through rule for certain income—(1) High withholding tax interest.* If a taxpayer receives or accrues interest from a controlled foreign corporation that is a financial services entity, and the interest would be described as high withholding tax interest if section 904(d)(3) and paragraph (c)(2) of this section did not apply, then the interest shall be treated as high withholding tax interest to the extent that the interest is allocable under section 904(d)(3) and paragraph (c)(2)(i) of this section to financial services income of the controlled foreign corporation.

(2) *Dividends from a noncontrolled section 902 corporation.* If a United States shareholder receives or accrues income from a controlled foreign corporation that is attributable to dividends from a noncontrolled section

902 corporation, such income shall be subject to a separate limitation for such dividends except as provided in § 1.904-6(g)(2)(i).

(3) *Example.* The following example illustrates the operation of paragraph (f)(1) of this section.

(*Example.*) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1988, S earns \$80 of financial services income and \$20 of high withholding tax interest. S makes a \$100 interest payment to P. The interest payment to P is subject to a withholding tax of 15 percent. Twenty dollars (\$20) of the interest payment to P is considered to be high withholding tax interest because, under section 904(d)(3), it is allocable to the high withholding tax interest earned by S. The remaining eighty dollars (\$80) of the interest payment is also treated as high withholding tax interest to P because, under paragraph (f)(1) of this section, interest that is subject to a high withholding tax but would not be considered to be high withholding tax interest under the look-through rules of paragraph (c)(2) of this section, shall be treated as high withholding tax interest to the extent that the interest would have been treated as financial services income under the look-through rules of paragraph (c)(2)(i) of this section.

(g) *Application of look-through rules to related controlled foreign corporations.* The principles of paragraphs (b), (c), and (f) of this section shall apply to distributions and payments from a controlled foreign corporation to a related controlled foreign corporation. For purposes of the preceding sentence, two controlled foreign corporations shall be considered to be related to each other if one controlled foreign corporation owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes entitled to vote or of the total value of stock of such corporation or the same United States shareholders own, directly or indirectly, stock possessing 50 percent or more of the total voting power of all classes entitled to vote or of the total value of stock of each controlled foreign corporation. For purposes of this preceding sentence, indirect ownership shall be determined under section 958 (b) and the regulations thereunder.

(h) *Application of look-through rules to certain domestic corporations.* If a domestic corporation meets the 80 percent foreign business requirements described in section 861(c)(1), the look-through rules of paragraphs (b), (c), and (f) apply to interest, rents or royalties paid by or accrued by the domestic corporation to a related person within the meaning of section 861(c)(2)(B).

(i) *Application of look-through rules to partnerships and other pass-through entities*—(1) *General rule.* Except as provided in paragraph (i)(2) of this section, a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. Payments to a partner described in section 707 (e.g., payments to a partner not acting in capacity as a partner) shall be characterized as income in a separate category to the extent that the income is attributable to income earned or accrued by the partnership in such category and the payments would be characterized under the look-rules of this section if the partnership were a foreign corporation. The disposition of a partnership interest shall be treated as a disposition of the partner's proportionate share of each of the assets of the partnership for purposes of characterizing the gain or loss allocable to a separate category. For purposes of allocating the purchase price of the interest and the seller's basis in the interest to partnership assets, the principles of § 1.751-1(a) will apply. The rules of this paragraph (i)(1) also apply to inclusions and gains with respect to, and payments from, an S corporation, simple trust, and any other pass-through entity described in § 1.904-6(e)(3)(iii)(A).

(2) *Exception for certain partnership interests.* Except as otherwise provided, if any limited partner or corporate general partner owns less than 10 percent (by value) of the beneficial interest in a partnership, the partner's distributive share of partnership income from the partnership shall be passive income to the partner, and the partner's distributive share of partnership deduction from the partnership shall be allocated and apportioned under the principles of § 1.861-8 only to the partner's passive income from that partnership. However, if a less than 10 percent partnership interest is held in the ordinary course of a partner's active trade or business, the rules of paragraph (i)(1) of this section shall apply and the partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. A partnership interest will be considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations (within the meaning of

section 1504(a) and without regard to section 1504(b)(3))) engages (other than through a less than 10 percent interest in a partnership) in the same or similar trade or business as the partnership. To the extent that the partner's distributive share of income from the partnership is a share of high withholding tax interest received or accrued by the partnership, the partner's distributive share of partnership income from the partnership shall be high withholding tax interest to the partner. Any gain or loss from the sale of a partnership interest described in this paragraph (i)(2) shall be treated as passive income or loss. The rules of this paragraph (i)(2) apply to less than 10 percent owners of other passthrough entities described in paragraph (i)(1) of this section.

(j) *Ordering rules*—(1) *In general.* The rules of paragraph (j)(2) of this section apply for purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also received or accrues income from the recipient and the look-through rules apply to the income in all cases.

(2) *Specific rules.* For purposes of characterizing income under this paragraph, the following types of income are characterized in the order stated:

- (i) Rent, royalty, interest, or other amounts definitely related to income of the payor;
- (ii) Interest that is not definitely related to income of the payor;
- (iii) Subpart F inclusions;
- (iv) Dividend distributions.

The amount of interest paid or accrued by a person to a related person shall be offset against and eliminate any interest received or accrued by a person from that related person before application of the ordering rules of this paragraph.

(k) *Examples.* The following examples illustrate the application of paragraphs (g), (h), (i), and (j) of this section.

Example (1). S and T, controlled foreign corporations, are wholly-owned subsidiaries of P, and domestic corporation. S and T are incorporated in two different foreign countries and T is a financial services entity. In 1987, S earns \$100 of income that is general limitation foreign base company sales income. After expenses, including a \$50 interest payment to T, S's income is subject to foreign tax at an effective rate of 40 percent. P elects to exclude S's \$50 of net income from Subpart F under section 954 (b) (4). T earns \$350 of income that consists of \$300 of Subpart F financial services income and \$50 of interest received from S. The \$50 of interest is foreign personal holding company income in T's hands because section 954 (c)(3)(A)(i) (same country exception for interest payments) does not apply. The \$50 of interest is also general limitation income to T because the look-

through rules of paragraph (c)(2)(i) of this section apply to characterize the interest payment. Thus, with respect to T, P includes in its gross income \$50 of general limitation foreign personal holding company income and \$300 of financial services income.

Example (2). The facts are the same as in example (1) except that, instead of earning \$100 of general limitation foreign base company sales income, S earns \$100 of foreign personal holding company income that is passive income. Although the interest payment to T would otherwise be passive income, because T is a financial services entity, under § 1.904-6(e)(1), the income is treated as financial services income in T's hands. Thus, P's entire \$350 section 951 inclusion consists of financial services income.

Example (3). P, a domestic corporation, wholly owns S, a domestic corporation. S meets the 80 percent active foreign business requirements described in section 861 (c) (1). In 1987, S's earnings consist of \$100 of shipping income and \$100 of high withholding tax interest. S makes a \$100 interest payment to P. The interest payment to P is subject to the look-through rules of paragraph (c)(2)(i) of this section, and is characterized as shipping income and high withholding tax interest to the extent that it is allocable to such income in S's hands.

Example (4). PS is a domestic partnership that is the sole shareholder of controlled foreign corporation S. PS has two general partners, A and B. A and B each have a greater than 10 percent interest in PS. PS also has two limited partners, C and D. C has a 50 percent interest in the partnership and D has a 9 percent interest. A, B, C and D are all United States persons. In 1987, S has \$100 of general limitation non-subpart F income on which it pays no foreign tax. S pays a \$100 dividend to PS. The dividend is the only income of PS. Under the look-through rule of paragraph (c) (4) of this section, the dividend to PS is general limitation income. Under paragraph (i) (1) of this section, A's, B's, and C's distributive shares of PS's income are general limitation income. Under paragraph (i) (2) of this section, because D is a partner with a less than 10 percent interest in PS, D's distributive share of PS's income is passive income.

Example (5). P has a 25 percent interest in partnership PS that he sells to X for \$110. P's basis in his partnership interest is \$35. PS has the following assets: A passive asset with a basis of \$80 and a fair market value of \$40 and a general limitation asset with a basis of \$60 and a fair market value of \$400. None of the assets in the partnership are described in section 751 (c) or (d). Under the principles of § 1.751-1 (a), P recognizes \$85 of general limitation gain (\$100 - \$15) and \$10 of passive loss (\$10 - \$20) on the sale of his partnership interest.

Example (6). P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. S has \$100 of passive foreign personal holding company income from unrelated persons and \$100 of general limitation income. S also has \$50 of interest

income from T. S pays T \$100 of interest. Under paragraph (j) (2) of this section, the \$100 interest payment from S to T is reduced for limitation purposes to the extent of the \$50 interest payment from T to S before application of the rules in paragraph (c) (2) (ii) of this section. Therefore, the interest payment from T to S is disregarded. S is treated as if it paid \$50 of interest to T, all of which is allocable to S's passive foreign personal holding company income. Therefore the \$50 interest payment from S to T is passive income.

Example (7). P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. In 1987, S earns \$100 of passive foreign personal holding income and \$100 of general limitation non-Subpart F sales income from unrelated persons and \$100 of general limitation non-Subpart F interest income from a related person, W. S pays \$150 of interest to T. T earns \$200 of general limitation sales income from unrelated persons and the \$150 interest payment from S. T pays \$100 of interest.

Under paragraph (j) (2) of this section, the \$100 interest payment from T to S reduces the \$150 interest payment from S to T. S is treated as though it paid \$50 of interest to T. T is treated as though it made no interest payment to S.

Under paragraph (j) (2) (ii) of this section, the remaining \$50 interest payment from S to T is then characterized. The interest payment is first allocable under the rules of paragraph (c) (2) (ii) of this section to S's passive income. Therefore, the \$50 interest payment to T is passive income. The interest income is foreign personal holding company income in T's hands. T, therefore, has \$50 of Subpart F passive income and \$200 of non-Subpart F general limitation income.

Under paragraph (j) (2) (iii) of this section, Subpart F inclusions are characterized next. P has a Subpart F inclusion with respect to T of \$50 that is attributable to passive income of T and is treated as passive income to P.

Example (8). P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1987, S earns \$100 of passive foreign personal holding company income and \$200 of non-Subpart F general limitation income from unrelated persons. S also receives \$150 of dividend income from T. S pays \$100 of interest to T and \$100 of interest to U. U earns \$300 of non-Subpart F general limitation income and the \$100 of interest received from S. U pays a \$100 royalty to T. T earns the \$100 interest payment received from S and the \$100 royalty received from U.

Under paragraph (j) (2) (i) of this section, the royalty paid by U to T is characterized first. Assume that the royalty is definitely related to U's general limitation income. Also assume that the royalty is not Subpart F income to T. With respect to T, the royalty is general limitation income.

Under paragraph (j) (2) (ii) of this section, the interest payments from S to T and U are characterized next. This characterization is

done without regard to any dividend income received by S because, under paragraph (j) (2) of this section, dividends are characterized after interest payments from a related person. The interest payments are first allocable to S's passive income under paragraph (c) (2) (ii) (D) of this section. Therefore, \$50 of the interest payment to T is passive and \$50 of the interest payment to U is passive. The remaining \$50 paid to T is general limitation income and the remaining \$50 paid to U is general limitation income. The entire amount of the interest payments to T and U is subpart F foreign personal holding company income to both recipients.

Under paragraph (j) (2) (iii) of this section, P has a \$100 subpart F inclusion with respect to T that is characterized next. Fifty dollars (\$50) of the Subpart F inclusion is passive income to P because it is attributable to the passive income portion of the interest income received by T from S, and \$50 of the inclusion is treated as general limitation income to P because it is attributable to the general limitation portion of the interest income received by T from S.

Under paragraph (j) (2) (iii) of this section, P also has a \$100 subpart F inclusion with respect to U. Fifty dollars (\$50) of the subpart F inclusion is passive income to P because it is attributable to the passive portion of the interest income received by U from S, and \$50 of the inclusion is general limitation income to P because it is attributable to the general limitation portion of the interest income received by U from S.

Under paragraph (j) (2) (iv) of this section, the \$150 distribution from T to S is characterized next. One-hundred dollars (\$100) of the distribution is out of earnings and profits attributable to previously taxed income. Therefore, only \$50 is a dividend that is subject to the look-through rules of paragraph (d) of this section. The \$50 dividend is attributable to T's general limitation income and is general limitation income to S in its entirety.

Example (9). P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S, owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. S, T and U are all incorporated in the same foreign country. In 1987, S earns \$100 of passive foreign personal holding income and \$200 of general limitation non-Subpart F income from unrelated persons. S pays \$100 of interest to T and \$100 of interest to U. U earns \$300 of general limitation non-Subpart F income and the \$100 of interest received from S. T's only income is the \$100 interest payment received from S.

Under paragraph (j) (2) (ii) of this section, the interest payments from S to T and U are characterized. The interest payments are first allocated under the netting rule of paragraph (c) (2) (ii) (D) to S's passive income. Therefore, under that provision and paragraph (c) (2) (i) of this section, \$50 of the interest payment to T is passive income to T and \$50 of the interest payment to U is passive income to U. The remaining \$50 paid to T is general limitation income and the remaining \$50 paid to U is general limitation income.

Under paragraph (j) (2) (iii) of this section, any subpart F inclusion of P is determined

and characterized next. Under paragraph (g) of this section, paragraphs (c) (2) (i) and (c) (2) (ii) apply not only for purposes of determining the separate category of income of S to which the interest payments from S to T and U are allocable but also for purposes of determining the Subpart F income of T and U. Although the interest payments from S to T and U are "same country" interest payments that would otherwise be excludible from T's and U's Subpart F income under section 954 (c) (3) (A) (i), section 954 (c) (3) (B) provides that the exception for same country payments between related persons shall not apply to the extent such payments have reduced the Subpart F income of the payor. In this case, \$50 of the \$100 interest payment from S to T reduced S's Subpart F income and \$50 of the \$100 interest payment from S to U reduced the remaining \$50 of S's Subpart F income. Therefore, T has \$50 of Subpart F income that is passive income and U has \$50 of Subpart F income that is passive income. P includes \$100 of Subpart F income in gross income that is passive income to P.

The remaining \$50 of interest paid by S to T and the remaining \$50 of interest paid by S to U is not Subpart F income to T or U because it did not reduce S's Subpart F income and is therefore eligible for the same country exception.

(1) *Application of section 904 (g)—(1) In general.* For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation from sources within the United States under section 904 (g) (3), the rules in paragraph (l) (2) of this section apply. For purposes of determining the portion of a dividend paid or accrued by a controlled foreign corporation that is treated as from sources within the United States under section 904 (g) (4), the rules in paragraph (l) (4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951 (a) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904 (g) (2), the rules in paragraph (l) (5) of this section apply. In order to determine whether section 904 (g) applies, section 904 (g) (5) (exception if controlled foreign corporation has a de minimis amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation for a taxable year without regard to the characterization of those earnings under section 904 (d).

(2) *Treatment of interest payments.* If interest is received or accrued by a United States shareholder or a person related to a United States shareholder (within the meaning of paragraph (c) (2) (ii) of this section) from a controlled foreign corporation, the interest shall be considered to be

allocable to income of the controlled foreign corporation from sources within the United States for purposes of section 904(d) to the extent that the interest is allocable under paragraph (c)(2)(ii)(D) of this section to passive income that is from sources within the United States. If related person interest is less than passive income, the related person interest will be allocable to United States source passive income based on the ratio of United States source passive income to total passive income. To the extent that related person interest exceeds passive income, and, therefore, is allocated under paragraph (c)(2)(ii)(E) of this section to income in a separate category other than passive, the following formula applies in determining the portion of the interest payment that is from sources within the United States:

The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(E) of this section times value of domestic assets in that category divided by value of total assets in that category

(3) *Examples.* The following examples illustrate the application of this paragraph.

Example (1). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays P \$300 of interest to P. S has no other expenses. In 1988, S has \$3000 of assets that generate \$650 of foreign source general limitation sales income and a \$1000 loan to an unrelated foreign person that generates \$20 of foreign source passive interest income. S also has a \$400 loan to an unrelated United States person that generates \$70 of United States source passive income and \$4000 of inventory that generates \$100 of United States source general limitation income. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Pas- sive....	1,000	4,000	5,000
Gener- al	3,000	4,000	7,000
Total..	4,000	8,000	12,000
Income:			
Pas- sive....	20	70	90
Gener- al	650	100	750
Total..	670	170	840

Under paragraph (c)(2)(ii)(D) of this section, \$90 of the related person interest payment is allocable to S's passive income. Under paragraph (l)(2) of the section, \$70 is from sources within the United States and \$20 is from foreign sources.

Under paragraph (c)(2)(ii)(E) of this section, the remaining \$210 of the related person interest payment is allocated to general

limitation income. Under paragraph (l)(2) of this section, \$120 of the remaining \$210 is allocated to general limitation United States source income (\$120 = \$210 x \$4000/\$7000). Ninety dollars (\$90) of the remaining \$210 of the related person interest payment is allocated to general limitation foreign source income. (\$90 = \$210 x \$3000/\$7000).

Example (2). Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays \$300 of interest to P. S has no other expenses. In 1988, S has \$4000 of assets that generate \$650 of foreign source general limitation manufacturing income and a \$1000 loan to an unrelated foreign person that generates \$100 of foreign source passive interest income. S has \$500 of shipping assets that generate \$200 of foreign source shipping income and \$500 of shipping assets that generate \$200 of United States source shipping income. S also has a \$1,000 loan to an unrelated United States person that generates \$100 of United States source passive income. S's passive income is not also described as shipping income. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Pas- sive....	1,000	1,000	2,000
Ship- ping ...	500	500	1,000
Gener- al	4,000	0	4,000
Total..	5,500	1,500	7,000
Income:			
Pas- sive....	100	100	200
Ship- ping ...	200	200	400
Gener- al	650	0	650
Total..	950	300	1,250

Under paragraph (c)(2)(ii)(D) of this section, \$200 of the related person interest payment is allocable to S's passive income. Under paragraph (l)(2) of this section, \$100 of this amount is from foreign sources and \$100 is from United States sources.

Under paragraph (c)(2)(ii)(E) of this section, \$80 of the remaining \$100 of the related person interest payment is allocated to general limitation income (\$80 = \$100 x \$4000/\$5000) and \$20 is allocated to shipping income (\$20 = \$100 x \$1000/\$5000).

Under paragraph (l)(2) of this section, none of \$80 of the interest payment allocated to general limitation income is allocated to United States source income (\$0 = \$80 x \$0/\$4000). Therefore, \$80 is allocated to general limitation foreign source income.

Under paragraph (l)(2) of this section, \$10 of the \$20 of the interest payment allocated to the shipping income is allocated to United source income (\$10 = \$20 x \$500/\$1000) and \$10 of the \$20 is allocated to foreign source income (\$10 = \$20 x \$500/\$1000).

(4) *Treatment of dividend payments—*
(i) *Rule.* Any dividend or distribution treated as a dividend under this section that is received or accrued by a United States shareholder from a controlled foreign corporation shall be treated as income in a separate limitation derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation in that separate category.

(ii) *Determination of earnings and profits from United States sources.* In order to determine the portions of earnings and profits from United States sources and from foreign sources within each separate category, related person interest shall be allocated to the United States source portion of income in a separate category by applying the rules of paragraph (l)(2) of this section. Other expenses shall be allocated by applying the rules of paragraph (c)(2)(ii) of this section separately to the United States source income and the foreign source income in each category. For example, unrelated person interest expense that is allocated among categories of income based upon the relative amounts of assets in a category must be allocated between United States and foreign source income within each category by applying the rules of paragraph (c)(2)(ii)(F) of this section separately to United States source and foreign source assets in the separate category.

(iii) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation, S, is a wholly owned subsidiary of P, a domestic corporation. In 1987, S has \$100 of non-Subpart F general limitation earnings and profits and \$100 of shipping earnings and profits that are not attributable to Subpart F income because the taxpayer elected to exclude the income from Subpart F income under section 954(b)(4). None of the general limitation earnings and profits are from sources within the United States, and \$50 of the shipping earnings and profits are from United States sources. In 1988, S earns \$300 of non-Subpart F general limitation earnings and profits and \$500 of non-Subpart F shipping earnings and profits. The shipping earnings and profits are attributable to income that is excluded from Subpart F under section 954(b)(4). One hundred dollars (\$100) of the general limitation earnings and profits are from sources within the United States. None of the shipping earnings and profits are from United States sources. In 1988, S pays P a \$500 dividend. Under paragraph (c)(4) of this section, \$200 of the dividend is attributable to general limitation earnings and profits (\$200 = \$500 x \$400/\$1000). Under

this paragraph (1)(3), the portion of the dividend that is attributable to general limitation earnings and profits from sources within the United States is \$50 ($\$200 \times \$100 / \$400$). Under paragraph (c)(4) of this section, \$300 of the dividend is attributable to shipping earnings and profits ($\$300 = \$500 \times \$600 / \$1000$). Under this paragraph (1)(3), the portion of the dividend that is attributable to shipping earnings and profits from sources within the United States is \$25 ($\$300 \times \$50 / \$600$).

(5) *Treatment of subpart F inclusions*—(i) *Rule*. Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a) shall be treated as income subject to a separate limitation that is derived from sources within the United States to the extent such amount is attributable to income of the controlled foreign corporation in the corresponding category of income from sources within the United States. In order to determine a controlled foreign corporation's taxable income and earnings and profits from sources within the United States in each separate category, the principles of paragraph (1)(4)(ii) of this section shall apply.

(ii) *Example*. The following example illustrates the application of this paragraph (1)(5).

Example. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. In 1987, S earns \$100 of Subpart F foreign personal holding company income that is passive income. Of this amount, \$40 is derived from sources within the United States. S also earns \$50 of Subpart F general limitation income. None of this income is from sources within the United States. Assume that S pays no foreign taxes and has no expenses. P is required to include \$150 in gross income under section 951(a). Of this amount, \$60 will be foreign source passive income to P and \$40 will be United States source passive income to P. Fifty dollars (\$50) will be foreign source general limitation income to P.

(6) *Treatment of section 78 amount*. For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that are paid or accrued with respect to United States source income in a separate category shall be treated as United States source income in that separate category.

(7) *Coordination with treaties*. If any amount of income derived from a United States-owned foreign corporation, as defined in section 904(g)(6), would be treated as derived from sources within the United States under section 904(g), and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits of the convention that treat

such amount as arising from sources outside the United States, then such amount will be treated as foreign source income. However, section 904 (a), (b), (c), and (d), and sections 902, 907, and 960 shall be applied separately to amounts described in the preceding sentence with respect to each treaty under which the taxpayer has claimed benefits.

(m) *Order of application of sections 904 (d), (f), and (g)*. In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation to determine the amount of income and earnings and profits derived by the controlled foreign corporation in each separate category. The income and earnings and profits in each separate category that is from United States sources shall then be determined. Section 904(f)(5) (A) and (B) shall then be applied to the controlled foreign corporation. Sections 904(d)(3), 904(g), and this section shall then be applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder in the controlled foreign corporation that is attributable or allocable to income or earnings and profits of the controlled foreign corporation.

(n) *Effective date*. Section 904(d)(3) and this section apply to distributions and section 951 inclusions of earnings and profits of a controlled foreign corporation (or other entity to which this section applies) derived during the first taxable year of the controlled foreign corporation (or other entity) beginning after December 31, 1986, and thereafter, and to payments made by a controlled foreign corporation (or other entity) during such taxable years, without regard to whether the corresponding taxable year of the recipient of the distribution or payment or of one or more of the United States shareholders of the controlled foreign corporation begins after December 31, 1986.

§ 1.904-8 Allocation of taxes.

(a) *Allocation of taxes to a separate category or categories of income*—(1) *In general*—(i) *Taxes related to a separate category of income*. The amount of taxes paid or accrued with respect to a separate category of income shall include only those taxes that are related to income in that separate category. Taxes are related to income if the income is included in the base upon which the tax is imposed. If, for example, foreign law exempts certain types of income from foreign taxes, or certain types of income are exempt from foreign tax under an income tax convention, then no taxes are

considered to be related to such income for purposes of this paragraph. As another example, if foreign law provides for a specific rate of tax with respect to certain types of income (e.g., capital gains), or certain expenses or deductions are allowed under foreign law only with respect to a particular type of income, then such provisions shall be taken into account in determining the amount of foreign tax imposed on such income. A withholding tax (unless it is a withholding tax that is not the final tax payable on the income as described in § 1.904-6(d)) is related to the income from which it is withheld. A tax that is imposed on a base that includes more than one separate category of income is considered to be imposed on income in all such categories and, thus, the taxes are related to all such categories included within the foreign country or possession's taxable income base.

(ii) *Apportionment of taxes related to more than one separate category*. If a tax is related to more than one separate category, then, in order to determine the amount of the tax paid or accrued with respect to each separate category, the tax shall be apportioned among the separate categories on the basis of the following formula:

Foreign tax related to more than one separate category times net income subject to that foreign tax included in a separate category divided by net income subject to that foreign tax

For purposes of this apportionment, gross income is determined under the law of the foreign country or a possession of the United States to which the foreign income taxes have been paid or accrued. The net amount of income in a separate category and the total net income are to be next determined by deducting any credits, expenses, losses, and any other deductions that are properly allocable to the gross amount of such income under the laws of that foreign country or possession. If foreign law does not provide for the direct allocation of expenses, losses, or other deductions to a particular category of income, then the principles of § 1.861-8 shall apply in allocating such expenses, losses, or other deductions to gross income as determined under foreign law. For example, the principles of § 1.861-8 apply to require definitely related expenses to be directly allocated to particular categories of gross income and provide the methods of apportioning expenses that are definitely related to more than one category of gross income or that are not definitely related to any particular category of gross income. For

purposes of this paragraph, the gross income method of allocating expenses that are not definitely related is acceptable even if the expense to be apportioned is interest expense. Also for this purpose, the apportionment of expenses required to be made under § 1.861-8 need not be made on other than a separate company basis. The rules in this paragraph apply only for purposes of the apportionment of taxes among separate categories of income and do not affect the computation of a taxpayer's foreign tax credit limitation with respect to a specific category of income.

(2) *Treatment of certain dividends from noncontrolled section 902 corporations.* If a taxpayer receives or accrues a dividend from a noncontrolled section 902 corporation, and if the Commissioner establishes that there is an agreement, express or implied, that such dividend is paid out of a designated pool of earnings of the foreign corporation, then only the foreign taxes imposed on that pool of earnings will be considered to be taxes related to the dividend.

(b) *Application of paragraph (a) to sections 902 and 960—(1) Determination of deemed paid credit.* If, for the taxable year, there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a controlled foreign corporation for any taxable year and the amount included consists of income in more than one separate category of the controlled foreign corporation, then the domestic corporation shall be deemed to have paid only a portion of the taxes paid or accrued, or deemed paid or accrued, by the controlled foreign corporation that are allocated to each separate category to which the inclusion is attributable. The portion of the taxes allocated to a particular separate category that shall be deemed paid by the United States shareholder shall be equal to the taxes allocated to that separate category multiplied by the amount of the inclusion with respect to that category (as determined under § 1.904-7(c)(1)) and divided by the earnings and profits of the controlled foreign corporation with respect to that separate category (as determined under § 1.904-7(c)(2)(ii)). The rules of this paragraph (b)(1) also apply for purposes of computing the foreign tax credit of United States shareholders of controlled foreign corporations under section 902.

(2) *Taxes on income excluded from Subpart F under section 954(b)(4).* Whether an item of income is high-taxed for purposes of section 954(b)(4) shall be

determined after the allocation of taxes under paragraph (a) of this section. If a controlled foreign corporation receives or accrues income in a separate category that is excluded from the corporation's Subpart F income under section 954(b)(4) and also receives or accrues income in that category that is included in a United States shareholder's gross income under section 951(a)(1), then any foreign income taxes that are allocable to the items of income in that category that are excluded from the corporation's Subpart F income under section 954(b)(4) shall be considered to be related only to the non-Subpart F income in that category. The taxes that are related to the income that is excluded from Subpart F under section 954(b)(4) shall be deemed paid only when the related earnings and profits are distributed to the United States shareholder or otherwise included in the United States shareholder's gross income.

(3) *Distributions received from foreign corporations that are excluded from gross income under section 959(b).* The principles of this paragraph shall be applied to—

(i) Any portion of a distribution received from a first-tier corporation by a domestic corporation that is excluded from the domestic corporation's gross income under section 959(a) and § 1.959-1, and

(ii) Any portion of a distribution received from an immediately lower-tier corporation by a second- or first-tier corporation that is excluded from such foreign corporation's gross income under section 959(b) and § 1.959-2, if such distribution is treated as a dividend pursuant to § 1.960-2(a).

(4) *Application of section 78.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that were allocated to income in a separate category shall be treated as income in that same separate category.

(5) *Increase in limitation.* The amount of the increase in the foreign tax credit limitation allowed by section 960(b) and § 1.960-4 shall be determined with regard to the applicable category of income under section 904(d).

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

Example (1). M, a domestic corporation, conducts business in foreign country X. M earns \$400 of shipping income, \$200 of general limitation income and \$200 of passive income as determined under foreign law. Under foreign law, none of M's expenses are directly allocable to a particular category of income. Under the principles of § 1.861-8, M allocates \$75 of definitely related expenses to

shipping income, \$10 of expenses to general limitation income, and no expenses to passive income. M also allocates non-definitely related expenses of \$40 to shipping income, \$20 to general limitation income, and \$20 to passive income. Therefore, for purposes of paragraph (a) of this section, M has \$285 of net shipping income, \$170 of net general limitation income, and \$180 of net passive income. Country X imposes tax of \$100 on a base that includes M's shipping income and general limitation income. Country X exempts passive income from tax. The tax paid M is related to M's shipping and general limitation income. The \$100 tax is apportioned between those limitations. Thus, M is considered to have paid \$63 of X tax on its shipping income ($\$100 \times \$285/\$455$) and \$37 of tax on its general limitation income ($\$100 \times \$170/\$455$). None of the X tax is allocated to M's passive income.

Example (2). The facts are the same as in example (1) except that X does not exempt all passive income from tax but only exempts interest income. M's passive income consists of \$100 of gross dividend income, to which \$10 of non-definitely related expenses are allocated, and \$100 of interest income, to which \$10 of non-definitely related expenses are allocated. The \$90 of net dividend income is subject to X tax, and \$90 of net interest income is exempt from X tax. M pays \$130 of tax to X. The \$130 of tax is related to M's general, shipping, and passive income. The tax is apportioned among those limitations as follows: \$68 to shipping income ($\$130 \times \$285/\$545$), \$41 to general limitation income ($\$130 \times \$170/\$545$), and \$21 to passive income ($\$130 \times \$90/\$545$).

Example (3). P, a domestic corporation, owns 100 percent of S, a controlled foreign corporation organized in country X. S owns 100 percent of T, a controlled foreign corporation that is also organized in country X. Country X grants group relief to S and T. In 1987, S earns \$100 of income and T incurs an \$80 loss. Under country X's group relief provisions, only \$20 of S's income is subject to country X tax. Country X imposes a 30 percent tax on this income (\$6). P includes \$100 of S's income in gross income under section 951. Six dollars (\$6) of foreign tax is related to that income for purposes of section 960.

Example (4). P, a domestic corporation, owns all the stock of S, a foreign corporation organized in country F. S is a shipping company that operates in foreign countries X, Y, and Z. Under both foreign and United States law, S earns a total of \$500. The income is foreign base company shipping income. The foreign base company shipping income is subject to varying rates of foreign tax. S pays \$80 of tax to X on \$200 of income, \$40 of tax to Y on \$200 of income and no tax on \$100 of income earned in Z. P excludes the \$200 derived in X from foreign base company shipping income under section 954(b)(4). Under paragraph (b)(3) of this section, the \$80 of taxes that are related to that income are not deemed paid under section 960 with respect to the \$300 included in P's income under section 951(a)(1). Thus, only the taxes related to that income (\$40) would be creditable. The \$80 of taxes related to the

income excluded under section 954(b)(4) are not deemed paid by P until the income to which those taxes are related is included in P's income.

Example (5). Domestic corporation P owns all of the stock of controlled foreign corporation S, which owns all of the stock of controlled foreign corporation T. All such corporations use the calendar year as the taxable year. Assume that earnings and profits are equal to net income and that the income amounts are identical under United States and foreign law principles. In 1987, T earns \$187.50 of gross passive income and \$62.50 of gross general limitation income and pays \$50 of foreign taxes. Assume that T incurs no other expenses. S earns no income in 1987 and pays no foreign taxes. For 1987, P is required under section 951 to include in gross income \$175 attributable to the earnings and profits of T for such year. One hundred and fifty dollars (\$150) of the Subpart F inclusion is attributable to passive income earned by T, and \$25 of the Subpart F inclusion is attributable to general limitation income earned by T. In 1988, T earns no income and pays no foreign taxes. T pays a \$200 dividend to S, consisting of \$175 from its earnings and profits attributable to amounts required to be included in P's gross income with respect to T and \$25 from its other earnings and profits. Assume that no withholding taxes imposed with respect to the distribution from T to S. In 1988, S earns \$100 of gross general limitation income and receives a \$200 dividend from T. S pays \$30 of foreign taxes. Assume that S incurs no other expenses. For 1988, P is required under section 951 to include in gross income \$22.50 attributable to the earnings and profits of S for such year. The entire Subpart F inclusion is attributable to general limitation income earned by S. In 1988, S pays P a dividend of \$247.50, consisting of \$157.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to T, \$22.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to S, and \$67.50 from its other earnings and profits. The foreign income taxes deemed paid by P for 1987 and 1988 under section 960(a)(1) and section 902(a) are determined as follows upon the basis of the following facts and computations.

T corporation (Second-Tier Corporation)

1. Pre-tax earnings and profits

- (a) Passive income (p.i.): 187.50
Plus:
- (b) General limitation income (g.l.i.): 62.50
- (c) Total: 250
Less:
- (d) Foreign income taxes paid on or with respect to T's earnings and profits (20%): 50
- (e) Earnings and profits: 200

2. Allocation of taxes

- (a) Foreign income taxes paid by T that are allocable to p.i. earned by T:
Line 1(d) taxes: 50
Multiplied by: foreign law net p.i.: 187.50
Divided by: foreign law total net income: 250

Result: 37.50

- (b) Foreign income taxes paid by T that are allocable to g.l.i. earned by T:

Line 1(d) taxes: 50
Multiplied by: foreign law net g.l.i.: 62.50
Divided by: foreign law total net income: 250

Result: 12.50

3. T's earnings and profits

- (a) Earnings and profits attributable to T's p.i.:

Line 1(a) e & p: 187.50
Less: line 2(a) taxes: 37.50
Result: 150

- (b) Earnings and profits attributable to T's g.l.i.:

Line 1(b) e & p: 62.50
Less: line 2(b) taxes: 12.50
Result: 50

4. Subpart F inclusion attributable to T:

- (a) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's p.i.: 150

- (b) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's g.l.i.: 25

5. Foreign income taxes deemed paid by P under section 960(a)(1) with respect to T

- (a) Taxes deemed paid that are attributable to T's Subpart F inclusion that are attributable to T's p.i.:

Line 2(a) taxes: 37.50
Multiplied by: line 4(a) section 951 incl.: 150
Divided by: line 3 (a) e & p: 150
Result: 37.50

- (b) Taxes deemed paid that are attributable to T's Subpart F inclusion that are attributable to T's g.l.i.:

Line 2(b) taxes: 12.50
Multiplied by: line 4(b) section 951 incl.: 25
Divided by: line 3 (b) e & p: 50
Result: 6.26

6. Dividends paid to S

- (a) Dividends attributable to T's previously taxed p.i.: 150
Plus:

- (b) Dividends attributable to T's previously taxed g.l.i.: 25
Plus:

- (c) Dividends from T's non-previously taxed earnings and profits attributable to p.i.: 0
Plus:

- (d) Dividends from T's non-previously taxed earnings and profits attributable to g.l.i.: 25

- (e) Total dividends paid to S: 200

7. Taxes deemed paid by S

- (a) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's p.i.:

Line 2(a) taxes: 37.50
Multiplied by: line 6(c) dividend: 0
Divided by: line 3(a) e & p: 150
Result: 0

- (b) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's g.l.i.:

Line 2(b) taxes: 12.50
Multiplied by: line 6(d) dividend: 25
Divided by: line 3(b) e & p: 50
Result: 6.25

S Corporation (First-Tier Corporation)

8. Pre-tax earnings and profits:

- (a) Dividends from T attributable to T's non-previously taxed p.i.: 0
Plus:

- (b) Dividends from T attributable to T's non-previously taxed g.l.i.: 25
Plus:

- (c) Dividends from T attributable to T's previously taxed p.i.: 150
Plus:

- (d) Dividends from T attributable to T's previously taxed g.l.i.: 25
Plus:

- (e) Passive income other than dividend from T: 0
Plus:

- (f) General limitation income other than dividend from T: 100

- (g) Total pre-tax earnings and profits: 300

- (h) Foreign income taxes paid on or with respect to S's earnings and profits (10%): 30

- (i) Earnings and profits: 270

9. Allocation of Taxes

- (a) Foreign income taxes paid by S that are allocable to non-previously taxed p.i. earned by S:

Line 8(h) taxes: 30
Multiplied by: foreign law line 8(a) & 8(e) p.i. amounts: 0
Divided by: foreign law total net income: 300
Result: 0

- (b) Foreign income taxes paid by S that are allocable to S's previously taxed p.i. received from T:

Line 8(h) taxes: 30
Multiplied by: foreign law line 8(c) p.i. amount: 150
Divided by: foreign law total net income: 300
Result: 15

- (c) Foreign income taxes paid by S that are allocable to non-previously taxed g.l.i. earned by S:

Line 8(h) taxes: 30
Multiplied by: foreign law line 8(b) & line 8(f) g.l.i. amounts: 125
Divided by: foreign law total net income: 300
Result: 12.50

- (d) Foreign income taxes paid by S that are allocable to S's previously taxed g.l.i. received from T:

Line 8(h) taxes: 30
Multiplied by: foreign law line 8(d) amount: 25
Divided by: foreign law total net income: 300
Result: 2.50

10. (a) Non-previously Taxed Earnings and Profits of S

Lines 8(a), 8(b), 8(e), & 8(f) e & p: 125
Less: lines 9(a) & 9(c) taxes: 12.50
Result: 112.50

- (b) Portion of result in 10(a) attributable to S's p.i.: 0

- (c) Portion of result in 10(a) attributable to S's g.l.i.: 112.50

11. (a) Previously Taxed Earnings and Profits of S:

Lines 8(c) and 8(d) e & p: 175
Less: lines 9(b) & 9(d) taxes: 17.50

- Result: 157.50
- (b) Portion of result of 11(a) attributable to T's p.i.:
Line 8(c): 150
Less: line 9(b) taxes: 15
Result: 135
- (c) Portion of result in 11(a) attributable to T's g.l.i.:
Line 8(d): 25
Less: line 9(d) taxes: 2.50
Result: 22.50
12. Subpart F Inclusion Attributable to S:
- (a) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's p.i.: 0
- (b) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's g.l.i.: 22.50
13. Foreign Income Taxes Deemed paid by P Under Section 960(a)(1) With Respect to S:
- (a) Taxes deemed paid that are attributable to S's Subpart F inclusion that are attributable to S's p.i.:
Line 9(a) taxes: 0
Multiplied by: line 12(a) sec. 951 incl: 0
Divided by: line 10(b) e & p: 0
Result: 0
- (b) Taxes deemed paid that are attributable to S's Subpart F inclusion that are attributable to S's g.l.i.:
Line 9(c) taxes: 12.50
Multiplied by: line 12(b) 951 incl: 22.50
Divided by: line 10(c) e & p: 112.50
Result: 2.50
- (c) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's p.i.:
Line 7(a) taxes deemed paid by S: 0
Multiplied by: line 12(a) section 951 incl: 0
Divided by: line 10(b) e & p: 0
Result: 0
- (d) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's g.l.i.:
Line 7(b) taxes deemed paid by S: 6.25
Multiplied by: line 12(b) section 951 incl: 22.50
Divided by: line 10(c) e & p: 112.50
Result: 1.25
14. Dividends paid to P
- (a) Dividends from S attributable to S's previously taxed p.i.: 0
Plus:
- (b) Dividends from S attributable to S's previously taxed g.l.i.: 22.50
Plus:
- (c) Dividends to which section 902(a) applies:
(i) Consisting of S's earnings and profits attributable to T's previously taxed p.i.: 135
Plus:
(ii) Consisting of S's earnings and profits attributable to T's previously taxed g.l.i.: 22.50
Plus:
(iii) Consisting of S's other p.i. earnings and profits: 0
Plus:
(iv) Consisting of S's other g.l.i. earnings and profits: 67.50
(v) Total section 902 dividend: 225
(d) Total dividends paid to P: 247.50

15. Foreign Income Taxes Deemed Paid by P under section 902 and section 960(a)(3) with respect to S:

(a) Taxes paid by S deemed paid by P under section 902(a) with regard to S's p.i.:
Line 9(a) taxes: 0
Multiplied by: line 14(c)(iii) div.: 0
Divided by: line 10(b) e & p: 0
Result: 0

(b) Taxes paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:
Line 9(c) taxes: 12.50
Multiplied by: line 14(c)(iv) div.: 67.50
Divided by: line 10(c) e & p: 112.50
Result: 7.50

(c) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's p.i.:
Line 7(a) deemed paid taxes: 0
Multiplied by: line 14(c)(iii) div.: 0
Divided by: line 10(b) e & p: 0
Result: 0

(d) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:
Line 7(b) deemed paid taxes: 6.25
Multiplied by: line 14(c)(iv) div.: 67.50
Divided by: line 10(c) e & p: 112.50
Result: 3.75

(e) Foreign income taxes paid by S under section 960(a)(3) deemed paid by P with regard to S's previously taxed p.i.:
Line 9(b) taxes: 15
Multiplied by: line 14(c)(i) div.: 135
Divided by: line 11(b) e & p: 135
Result: 15

(f) Foreign income taxes paid by S under section 960 (a) (3) deemed paid by P with regard to S's previously taxed g.l.i.:
Line 9(d) taxes: 2.50
Multiplied by: line 14(c)(ii) div.: 22.50
Divided by: line 11(c) e & p: 22.50
Result: 2.50

Summary

Total taxes deemed paid by P under section 960 (a) (1) with respect to—
Passive income of S and T included under section 951 in income of P:

Line 5(a): 37.50

Plus:

Line 13(a): 0

Plus:

Line 13(c): 0

Result: 37.50

General limitation income of S and T included under section 951 in income of P:

Line 5(b): 6.25

Plus:

Line 13(b): 2.50

Plus:

Line 13(d): 1.25

Result: 10

Total deemed paid taxes under section 960 (a) (1): 47.50

Total taxes deemed paid by P under section 902 and section 960 (a)(3) attributable to passive income of S and T (line 15(e)): 15

Total taxes deemed paid by P under section 902 and section 960 (a) (3) Attributable to general limitation income of S and T:

Line 15(b): 7.50

Plus:

Line 15(d): 3.75

Plus:

Line 15(f): 2.50

Result: 13.75

§ 1.904-9 Transition rules.

(a) *Characterization of distributions and section 951(a)(1)(B) inclusions of earnings of a foreign corporation accumulated in taxable years beginning before January 1, 1987 during taxable years of both the payor foreign corporation and the recipient which begin after December 31, 1986—(1) In general.* Income derived by a foreign corporation in taxable years beginning before January 1, 1987, is characterized in the foreign corporation's hands under section 904(d)(1)(A) (separate limitation interest income), or section 904(d)(1)(E) (general limitation income) (prior to their amendment by the Tax Reform Act of 1986 (the Act)) after application of the de minimis rule of former section 904(d)(3)(C) (prior to its amendment by the Act). When, in a taxable year after the effective date of the Act, earnings and profits attributable to such income are distributed, or included in the gross income of a United States shareholder under section 951(a)(1)(B), the ordering rules of section 904(d)(3)(D) and § 1.904-7(c)(4), shall be applied in determining initially the character of the income of the distributee or United States shareholder. Thus, a proportionate amount of a distribution described in this paragraph will be initially characterized as separate limitation interest income in the hands of the distributee based on the ratio of the separate limitation interest earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The distribution or section 951(a)(1)(B) inclusion must then be recharacterized in the hands of the distributee or United States shareholder on the basis of the following principles:

(i) Distributions and section 951(a)(1)(B) inclusions that are initially characterized as separate limitation interest income shall be treated as passive income;

(ii) Distributions and section 951(a)(1)(B) inclusions that are initially characterized as old general limitation income shall be treated as general limitation income, unless the taxpayer establishes to the satisfaction of the Commissioner that the distribution or section 951(a)(1)(B) inclusion is attributable to:

(A) Earnings and profits accumulated with respect to shipping income, as defined in section 904(d)(2)(D) and § 1.904-6(f), or

(B) In the case of a financial services entity, earnings and profits accumulated with respect to financial services

income, as defined in section 904(d)(2)(C)(ii) and § 1.904-6(e)(1).

(2) *Limitation on establishing the character of earnings and profits.* In order for a taxpayer to establish that distributions or section 951(a)(1)(B) inclusions that are attributable to general limitation earnings and profits of a particular taxable year beginning before January 1, 1987, are attributable to shipping or financial services earnings and profits, the taxpayer must establish the amounts of foreign taxes paid or accrued with respect to income attributable to those earnings and profits that are to be treated as taxes paid or accrued with respect to shipping or financial services income, as the case may be, under section 904(d)(2)(I). Conversely, in order for a taxpayer to establish the amounts of general limitation taxes paid or accrued in a taxable year beginning before January 1, 1987, that are to be treated as taxes paid or accrued with respect to shipping or financial services income, as the case may be, the taxpayer must establish the amount of any distribution or section 951(a)(1)(B) inclusions that are attributable to shipping or financial services earnings and profits. For purposes of establishing the amounts of general limitation taxes that are to be treated as taxes paid or accrued with respect to shipping or financial services income, the principles of § 1.904-8 shall be applied.

(b) *Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986—(1) In general.* This paragraph provides rules relating to the application of section 904(d)(3) to payments made by a controlled foreign corporation or other entity to which the look-through rules apply during its taxable year beginning after December 31, 1986, but received in a taxable year of the recipient beginning before January 1, 1987. The paragraph also provides rules relating to distributions (including deemed distributions) or payments made by a controlled foreign corporation to which section 904(d)(3) (as in effect before the Act) applies during its taxable year beginning before January 1, 1987, and received in a taxable year of the recipient beginning after December 31, 1986.

(2) *Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.* If interest, rents, or royalties are paid or accrued on or after the start of the payor's first taxable year beginning on

or after January 1, 1987, but prior to the start of the recipient's first taxable year beginning on or after January 1, 1987, such interest, rents, or royalties shall initially be characterized in accordance with section 904(d)(3) and § 1.904-7. To the extent that interest payments in the hands of the recipient are initially characterized as passive income under these rules, they will be treated as separate limitation interest in the hands of the recipient. To the extent that rents or royalties in the hands of the recipient are initially characterized as passive income under these rules, they will be recharacterized as general limitation income in the hands of the recipient.

(3) *Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.* If interest, rents, or royalties are paid or accrued before the start of the payor's first taxable year beginning on or after January 1, 1987, but on or after the start of the recipient's first taxable year beginning after January 1, 1987, the income in the recipients' hands shall be initially characterized in accordance with former section 904(d)(3) (prior to its amendment by the Act). To the extent interest income is characterized as separate limitation interest income under these rules, that income shall be recharacterized as passive income in the hands of the recipient. Rents or royalties will be characterized as general limitation income.

(4) *Recipient of dividends and Subpart F inclusions is subject to the Act and payor is not subject to the Act.* If dividends are paid or accrued or section 951(a)(1) inclusions occur before the start of the first taxable year of a controlled foreign corporation beginning on or after January 1, 1987, but on or after the start of the first taxable year of the distributee or United States shareholder beginning on or after January 1, 1987, the dividends or section 951(a)(1) inclusions in the hands of the distributee or United States shareholder shall be initially characterized in accordance with former section 904(d)(3) (including the ordering rules of section 904(d)(3)(A)). Therefore, under former section 904(d)(3)(A), dividends are considered to be paid or derived first from earnings attributable to separate limitation interest income. To the extent the dividend or section 951(a)(1) inclusion is initially characterized under these rules as separate limitation interest income in the hands of the distributee or United States shareholder, the dividend or section 951(a)(1) inclusion shall be recharacterized as passive income in the hands of the distributee or United States shareholder.

The portion, if any, of the dividend or section 951(a)(1) inclusion that is not characterized as passive income shall be characterized according to the rules in paragraph (a) of this section. Therefore, a taxpayer may establish that income that would otherwise be characterized as general limitation income is shipping or financial services income. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing foreign taxes deemed paid with respect to distributions and section 951(a)(1) inclusions covered by this paragraph (b)(4).

(5) *Examples.* The following examples illustrate the application of this paragraph.

Example (1). P is a domestic corporation that is a fiscal year taxpayer (July 1-June 30). S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a calendar taxable year. On June 1, 1987, S makes a \$100 interest payment to P. Because the payment is made after January 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) apply to characterize the payment made by S. To the extent, however, that the interest payment to P is allocable to passive income earned by S, the payment will be included in P's separate limitation for interest as provided in former section 904(d)(1)(A).

Example (2). P is a domestic corporation that is a calendar year taxpayer. S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a July 1-June 30 taxable year. On June 1, 1987, S makes a \$100 interest payment to P. Because the payment is made prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), the interest payment would be characterized as separate limitation interest income. For purposes of determining P's foreign tax credit limitation, the interest payment will be passive income as provided in section 904(d)(1)(A).

Example (3). The facts are the same as in example (2) except that on June 1, 1987, S makes a \$100 dividend distribution to P. Because the dividend is paid prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), S's earnings and profits for the taxable year ending June 30, 1987 consist of \$200 of earnings attributable to general limitation income and \$75 of earnings attributable to separate limitation interest income. The portion of the dividend that is attributable to S's separate limitation interest and is treated as separate limitation interest income under former section 904(d)(3) is \$75. The remaining \$25 of the dividend is treated as general limitation income under former section 904(d)(3). For purposes of determining P's foreign tax credit limitation, \$75 of the dividend will be recharacterized as passive

income. The remaining \$25 of the dividend will be characterized as general limitation income, unless P can establish that the general limitation portion is attributable to shipping or financial services income.

(c) *Installment sales.* If income is received or accrued by any person on or after the effective date of the Act (as applied to such person) that is attributable to a disposition of property by such person with regard to which section 453 or section 453(A) applies (installment sale treatment), and the disposition occurred prior to the effective date of the Act, that income

shall be characterized according to the rules of §§ 1.904-6 through 1.904-9.

(d) *Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act.* For purposes of characterizing interest received or accrued by any person, the definition of high withholding tax interest in § 1.904-6(d) shall apply to taxable years beginning after December 31, 1986 except as provided in section 1201(e)(2) of the Act.

(e) *Treatment of certain recapture income.* Except as otherwise provided, if

income is subject to recapture under section 585(c), the income shall be general limitation income. If the income is recaptured by a taxpayer that is a financial services entity, the entity may treat the income as financial services income if the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to financial services income.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

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