the expiration of the public comment period to respond to the comments filed with the Commission.

(i) *Material amendments to application.* The proposed mitigative measures filed under paragraph (g)(2) of this section will not be considered a material amendment to the application unless the Commission finds that the proposed measures are unnecessary to, or exceed the scope of, mitigating substantial adverse effects. If the Commission finds the proposed mitigative measures constitute a material amendment, the application will be considered filed with the Commission on the date on which the applicant filed the proposed mitigative measures, and all other provisions of § 4.35(a) of this chapter will apply.

(j) *Final determination on the petition.* The Commission will make a final determination on the petition at the time the Commission issues a license or exemption for the project.

(k) *Presumption* (1) If, between the Commission's initial and final findings on the AEE petition, the State does not take any action under § 292.208(b)(2), the failure to take action can be the basis for a presumption that there is not substantial adverse effect on the environment (as that term is defined in § 292.202(q)).

(2) If the presumption in paragraph (k)(1) of this section comes into effect, it:

(i) Is only available for those adverse effects related to the natural, recreational, cultural, or scenic attributes of the environment;

(ii) Can only operate during the time between the Commission's initial and final findings on the AEE petition; and

(iii) Has no affect on the Commission's independent obligation to find that the project will not have a substantial adverse effect on the environment under § 292.208(b)(1).

(3) The presumption in paragraph (k)(1) of this section does not take effect if the State, the Commission or an interested person demonstrates that the State has acted to protect the natural watercourse under § 292.208(b)(2).

(4) The presumption in paragraph (k)(1) of this section can be rebutted if:

(i) The Commission determines that the project will have a substantial adverse effect on the environment related to the environmental attributes listed in paragraph (k)(2)(i) of this section; or

(ii) Any interested person, including a State, demonstrates that the project will have a substantial adverse effect on the environment related to the environmental attributes listed in paragraph (k)(2)(i) of this section.

PART 375—THE COMMISSION

24. The authority citation for Part 375 continues to read as follows:

Authority: Omnibus Budget Reconciliation Act of 1986, 42 U.S.C. 7178; Electric Consumers Protection Act 1986, 16 U.S.C. 791a note; Department of Energy Organization Act, 42 U.S.C. 7101–7352, E.O. 12009, 3 CFR 1978 Comp., p. 142; Administrative Procedure Act, 5 U.S.C. 551–557 (1982); Federal Power Act, 16 U.S.C. 791–828c, as amended; Natural Gas Act, 15 U.S.C. 717–717w, as amended; Natural Gas Policy Act of 1978, 15 U.S.C. 3301–3432; Public Utility Regulatory Policies Act of 1978, 16 U.S.C. 2601 *et seq.*, as amended.

25. In § 375.314, a new paragraph (r) is added to read as follows:

§ 375.314 Delegations to the Director of the Office of Hydropower Licensing.

* * * * *

(r) Pass upon petitions filed under §§ 292.210 and 292.211 of this chapter.

[FR Doc. 88-15872 Filed 7-15-88; 8:45 am]

BILLING CODE 6717-01-M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 522

Implantation or Injectable Dosage Form New Animal Drugs Not Subject to Certification; Ivermectin Injection

AGENCY: Food and Drug Administration.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a supplemental new animal drug application (NADA) filed by Merck Sharp & Dohme Research Laboratories providing for safe and effective use of IVOMEC® (ivermectin) injection in swine for treating and controlling infections caused by somatic threadworm larvae, in addition to certain species of gastrointestinal roundworms, lungworms, lice, and mites.

EFFECTIVE DATE: July 18, 1988.

FOR FURTHER INFORMATION CONTACT: Dianne T. McRae, Center for Veterinary Medicine (HFV-135), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301-443-4913.

SUPPLEMENTARY INFORMATION: Merck Sharp & Dohme Research Laboratories, Division of Merck & Co., Inc., P.O. Box 2000, Rahway, NJ 07065, has filed a supplement to NADA 135-008 providing for subcutaneous use of a 1-percent IVOMEC® (ivermectin) injection in swine for treating and controlling infections caused by somatic threadworm larvae (*Strongyloides ransomi*) in addition to the currently approved use for treating and controlling infections caused by certain species of gastrointestinal roundworms, lungworms, lice, and mites.

The supplemental NADA is approved and the regulations in 21 CFR 522.1192(d)(4)(ii)) are amended to reflect the approval. The basis for approval is discussed in the freedom of information summary.

In accordance with the freedom of information provisions of Part 20 (21 CFR Part 20) and § 514.11(e)(2)(ii) (21 CFR 514.11(e)(2)(ii)), a summary of safety and effectiveness data and information submitted to support approval of this application may be seen in the Dockets Management Branch (HFA-305), Food and Drug Administration, Rm. 4-62, 5600 Fishers Lane, Rockville, MD 20857, from 9 a.m. to 4 p.m., Monday through Friday.

The agency has carefully considered the potential environmental effects of this action. FDA has concluded that the action will not have a significant impact on the human environment, and that an environmental impact statement is not required. The agency's finding of no significant impact and the evidence supporting that finding, contained in an environmental assessment, may be seen in the Dockets Management Branch (address above) between 9 a.m. and 4 p.m., Monday through Friday. This action was considered under FDA's final rule implementing the National Environmental Policy Act (21 CFR Part 25).

List of Subjects in 21 CFR Part 522

Animal drugs.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, Part 522 is amended as follows:

PART 522—IMPLANTATION OR INJECTABLE DOSAGE FORM NEW ANIMAL DRUGS NOT SUBJECT TO CERTIFICATION

1. The authority citation for 21 CFR Part 522 continues to read as follows:

Authority: Sec. 512(i), 82 Stat. 347 (21 U.S.C. 360b(i)); 21 CFR 5.10 and 5.83.

2. Section 522.1192 is amended by revising paragraph (d)(4)(ii) to read as follows:

§ 522.1192 Ivermectin injection

* * * * *

(d) * * *

(4) * * *

(ii) *Indications for use.* It is used in swine for treatment and control of gastrointestinal roundworms (adults and fourth-stage larvae) (large roundworm, *Ascaris suum;* red stomach worm, *Hyostrongylus rubidus;* nodular worm, *Oesophagostomum* spp.; threadworm, *Strongyloides ransomi* (adults only)); somatic roundworm larvae (threadworm, *Strongyloides ransomi* (somatic larvae)); lungworms (*Metastrongylus* spp. (adults only)); lice (*Haematopinus suis*); and mites (*Sarcoptes scabiei* var. *suis*).

* * * * *

Dated: July 12, 1988.

Richard H. Teske,

Deputy Director, Center for Veterinary Medicine.

[FR Doc. 88-16048 Filed 7-15-88; 8:45 am]

BILLING CODE 4160-01-M

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21 CFR Part 558

Animal Drugs, Feeds, and Related Products; Mono-alkyl ($C_8 - C_{18}$) Trimethyl Ammonium Oxytetracycline

AGENCY: Food and Drug Administration.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a supplemental new animal drug application (NADA) filed by Pfizer, Inc., providing for safe and effective use of a 100-gram-per-pound mono-alkyl ($C_8 - C_{18}$) trimethyl ammonium oxytetracycline Type A article to make a Type C feed for salmonids and catfish.

EFFECTIVE DATE: July 18, 1988.

FOR FURTHER INFORMATION CONTACT: Henry E. Schmaus, Center for Veterinary Medicine (HFV-140), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301-443-2280.

SUPPLEMENTARY INFORMATION: Pfizer, Inc., 235 East 42d St., New York, NY 10017, has filed supplemental NADA 38-439 providing for use of a 100-gram-per-pound mono-alkyl ($C_8 - C_{18}$) trimethyl ammonium oxytetracycline Type A article to make Type C feeds for salmonids for the control of ulcer disease, furunculosis, bacterial hemorrhagic septicemia, and pseudomonas disease, and for catfish for the control of bacterial hemorrhagic septicemia and pseudomonas disease. Currently, 10- and 50-gram-per-pound Type A articles are approved for making this Type C fish feed.

The supplemental NADA is approved and 21 CFR 558.450(a)(2) is amended to reflect the approval.

This supplement provides for use of a higher strength Type A article to make a previously approved Type C medicated fish feed. The feed is used at previously approved treatment levels for the approved indications and limitations. Since approval of this supplement does not require added safety or effectiveness data or information, a freedom of information (FOI) summary is not required.

The agency has determined under 21 CFR 25.24(d)(1)(iii) that this action is of a type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

List of Subjects in 21 CFR Part 558

Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, Part 558 is amended as follows:

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

1. The authority citation for 21 CFR Part 558 continues to read as follows:

Authority: Sec. 512, 82 Stat. 343-351 (21 U.S.C. 360b); 21 CFR 5.10 and 5.83.

2. Section 558.450 is amended by revising paragraph (a)(2) to read as follows:

§ 558.450 Oxytetracycline.

(a) * * *

(2) 100 grams per pound to 000069 in § 510.600(c) of this chapter for use as in paragraph (d)(1), table 1, item (v) and table 3, item (ii) of this section.

* * * * *

Dated: July 8, 1988.

Suzanne Fitzpatrick,

Acting Director, Division of Drug Manufacturing and Residue Chemistry, Office of New Animal Drug Evaluation, Center for Veterinary Medicine.

[FR Doc. 88-16049 Filed 7-15-88; 8:45 am]

BILLING CODE 4160-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8214]

Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations 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 regulations are necessary because of the changes made to the applicable law by the Tax Reform Act of 1986. The regulations provide the public with guidance needed to comply with that act and affect individuals and entities claiming the foreign tax credit.

DATES: The amendments are generally to be effective for taxable years beginning after December 31, 1986. Paragraphs (c) (2), (3), (4), and (5) of § 1.904-4 apply to taxable years beginning after December 31, 1987.

FOR FURTHER INFORMATION CONTACT: 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) (202-634-5406).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 904 of the Internal Revenue Code of 1954. These amendments are made to conform the regulations to section 1201 of the Tax Reform Act of 1986 (Pub. L. 99-514) and are issued under the authority contained in sections 7805 and 904(d)(5) of the Internal Revenue Code (68A Stat. 637, 26 U.S.C. 7805 and 100 Stat. 2524, 26 U.S.C. 904(d)(5)).

On August 26, 1987, the **Federal Register** published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 904 of the Internal Revenue Code of 1954 (51 FR 3193). The amendments provide rules for determining a taxpayer's foreign tax credit limitations under section 904(d). The proposed regulations reflected proposed technical corrections. Because the technical corrections bill has not yet been passed by the Congress, portions of the final regulations have been reserved. In addition, the regulations have been reserved on the issue of whether payments from a foreign parent to its United States subsidiary should be characterized under the principles of the look-through rules. The reserved portions are:

Section 1.904-4(c)(6)(iv) increase in taxes paid by successors;

Section 1.904-4(e)(1) the definition of financial services income;

Section 1.904-4(e)(5) (i) and (ii) exceptions to the definition of financial services income;

Section 1.904-4(g)(2)(iv) the treatment of section 1293 inclusions attributable to section 902 corporations;

Section 1.904-4(h)(3)(ii) export financing interest received or accrued by a financial services entity;

Section 1.904-4(h)(3)(iii) export financing interest that is high-withholding tax interest;

Section 1.904-4(h)(3)(iv) *Example (2);*

Section 1.904-4(h)(3)(v)(C) *Example (2)* and *Example (4);*

Section 1.904-4(k) priority rules;

Section 1.904-5(c)(1)(ii) *Example (2)* and *Example (3);*

Section 1.904-5(d)(1) de minimis amounts of subpart F income;

Section 1.904-5(d)(3) *Example (1)* and *Example (2);*

Section 1.904-5(h)(3) income from the sale of a partnership interest;

Section 1.904-5(i)(3) special rule for payments from foreign parents to domestic subsidiaries;

Section 1.904-5(j) look-through rules applied to passive foreign investment companies;

Section 1.904-5(l) *Example (2)* and *Example (5);*

Section 1.904-5(m)(7) coordination with treaties.

Numerous written comments were received with respect to the proposed regulations. A public hearing was held on November 12, 1987. The significant points raised by the comments and the changes made to the proposed amendments are discussed in the remainder of the preamble. After consideration of the comments regarding the proposed amendments, the amendments are adopted as modified by this Treasury decision.

Discussion of Major Comments and Revised Amendments

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

In response to comments, an example has been added to paragraph (b)(1) to make it clear that if a taxpayer has foreign currency gain that would not be foreign personal holding company income if the taxpayer were a controlled foreign corporation because the gain is directly related to the business needs of the corporation, that income will not be passive income within the meaning of section 904(d)(2)(A)(i).

Paragraph (b)(2) has been revised to provide that the determination of whether a rent or royalty is an active rent or royalty for purposes of section 904(d) shall be made taking into account the activities of all members of the recipient's affiliated group (as redefined to include foreign corporations). This revision changes the rules in the proposed regulations in several respects. First, the regulations, as revised, now treat rents and royalties received by a domestic corporation and those received by a controlled foreign corporation in the same way. Second, the regulations now provide a rule for qualifying rents received by a controlled foreign corporation as active rents by reference to the activities of an affiliate of the controlled foreign corporation. Third, the requirement that the controlled foreign corporation perform activities that are an essential economic element with respect to the royalties it receives is eliminated. Fourth, the regulations, as revised, provide that a United States shareholder that receives a rent or royalty directly can satisfy the active conduct test by reference to its own activities or the activities of affiliates (including foreign affiliates) of the shareholder. These changes to the proposed regulations were made in response to numerous comments that the proposed regulations were too restrictive because they did not allow the activities of foreign affiliates of the recipient to be considered and because they required a recipient that was a controlled foreign corporation to perform an activity that was an essential economic element in the realization of the royalty. The changes were also in response to comments that the proposed regulations did not provide parallel treatment for rent and royalty income received by a controlled foreign corporation.

Section 1.904-4(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. Numerous comments were received suggesting that the rules be simplified. In response to those comments the grouping rules have been changed and paragraph (c)(2)(ii) is added to provide that a taxpayer that allocates and apportions interest expense on an asset basis may further apportion passive interest expense among the groups of passive income on a gross income basis. Paragraph (c)(3), as revised, groups items of income received directly by a United States person (other than through a foreign branch) according to the rate of withholding tax on the items. These rules apply both to income received from unrelated persons and income received from controlled foreign corporations. These rules also apply to subpart F inclusions and items of income earned through a foreign branch to the extent provided in paragraph (c)(4). Under paragraph (c)(4), income is initially grouped into two groups, income from sources within the QBU's country of operation and income from sources outside the QBU's country of operation. Income from outside the country of operation is then grouped according to the rate of withholding tax. These rules are applied separately for each foreign QBU. Paragraph (c)(5) provides special rules for grouping certain enumerated items of income. The grouping rules are 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, 1988.

Paragraph (c)(6) 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. Several commenters suggested that we should permit taxpayers to elect, on a distribution by distribution basis, whether to go back and amend their returns to reflect the increase in tax. It was also suggested that the exception for distributions received during the prefiling period be changed to expand the prefiling period. The final regulations do not allow such an election but do redefine the prefiling period to be a period ending 90 days prior to the due date of the return (determined with extensions) for the taxable year of inclusion.

The preamble to the proposed regulations asked for comments concerning whether the rules in paragraph (c) should apply 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. Several commenters stated that there should be no recharacterization of the initial inclusion because of exchange rate fluctuations between the time of the inclusion and the time of the distribution of that income. The final regulations do not require such a recharacterization because the foreign currency gain or loss is attributable to an increase or decrease in the value of the controlled foreign corporation's earnings and profits and not to an increase or decrease in the amount of income earned by the controlled foreign corporation in the inclusion year.

Paragraph (c)(7) provides special rules for determining whether income that has been taxed under an integrated tax system is high-taxed income. In the preamble to the proposed regulations taxpayers were 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. One commenter suggested that the regulations adopt a FIFO rule for tracing distributions. The final regulations provide that, in general, the rules of § 1.904-6 apply for purposes of determining to which category the reduction in taxes on distribution relate. However, the reduction in taxes shall be attributable on a last-in first-out (LIFO) basis to foreign taxes potentially subject to reduction that are associated with previously taxed income, on a LIFO basis to foreign taxes associated with income that remains as passive income under paragraph (c)(7)(iii), and then on a LIFO basis to foreign taxes associated with other earnings and profits. The final regulations also clarify that the rules in paragraphs (6) and (7) relating to increases and decreases in foreign tax rate on distributions out of PTI apply only to net increases or decreases in foreign tax liability. Thus, if on distribution the foreign corporate tax is reduced but the reduction is fully offset by a withholding tax on the distribution, no reduction will be considered to have occurred for purposes of determining whether the income is high-taxed.

Paragraph (e)(1) concerning the definition of financial services income has been reserved because of the pending technical corrections bill that limits the financial services category to entities that are predominantly engaged in the active conduct of a banking, insurance, financing or similar business (active financing business). Paragraph (e) (2), (3), and (e)(4) have not been reserved because the definition of active financing income, the determination of when an entity is predominantly engaged in the active financing business and the definition of incidental income are relevant under current law and under the technical corrections bill.

Paragraphs (e)(5) (i) and (ii) have been reserved because of the proposed technical correction concerning the exceptions from financial services income for income that is export financing interest and high withholding tax interest.

Numerous comments were received with respect to what constitutes income from the active conduct of a banking, insurance, financing or similar business (active financing income). Paragraph (e)(2) reflects some of the suggestions for additions to the list of includible income. The list has been changed to include related person insurance income. Paragraph (e)(2) has also been changed to allow taxpayers to include items of income similar to those enumerated if such items are disclosed in a manner designated in the instructions to the Forms 1116 and 1118 or in guidance published by the Internal Revenue Service. For any year in which the instructions to the Forms 1118 and 1116 do not provide a method of designating similar items, a taxpayer may include similar items as active financing income even though they are not designated. This change is made in recognition of the fact that financial institutions constantly market new products, income from which may appropriately be categorized as active financing income.

Several commenters suggested that the requirement that an entity earn eighty percent of its gross income from active financing income should be liberalized. The eighty percent test in paragraph (e)(3)(i) has been maintained. The Conference Report to the 1986 Act makes it clear that an entity shall not be considered predominantly engaged in the active conduct of a financial services business unless a "high percentage" of the entity's income is active financing income. In addition, the eighty percent test seems reasonable in light of two other changes to the proposed regulations. The first of these changes is the addition of similar items of income to the list of active financing income. The second change is a revision of paragraph (e)(3)(i) to exclude from the eighty percent computation any gain from the sale of stock of a corporation controlled by the transferor. This latter change was made to prevent an entity from disqualifying itself from financial services status because of a large one-time gain from the sale of stock. In addition, the application of the eighty percent test has been changed to eliminate from the test any income characterized under the look-through rules that is received from a related person that is a financial services entity. Income received from a related person that is not a financial services entity but that is financial services income under the look-through rules is also eliminated.

In response to comments, paragraph (e)(3)(i) has been changed to require foreign affiliates to be considered when applying the eighty percent test on an affiliated basis. In addition, that paragraph has been changed to make it clear that certain income from intercompany transactions is not considered in applying the affiliated group test, that leasing income will not be considered to be active financing income for purposes of the affiliated group test if any member of the group meets the requirements of section 954 (c)(2)(A), and that passive income will not be considered active financing income for purposes of the affiliated group test merely because that income is earned by a member of the group that is a financial services entity under the entity level test.

Paragraph (e)(3)(iii) provides rules for applying the eighty percent test to partnerships. That paragraph has been changed to conform with changes to the general rule in paragraph (e)(3)(i).

Paragraph (e)(4) describes incidental income that will be considered to be financial services income if earned by a financial services entity. Several commenters stated that the rule regarding debt-equity conversions was too restrictive. That rule has been change to establish that income received within the first five years of the conversion is incidental income.

Section 1.904-4(g)(1) defines the term "noncontrolled section 902 corporation." That paragraph has been changed to make it clear that, in general, a controlled foreign corporation is not a section 902 corporation with respect to distributions out of earnings and profits earned during periods when the corporation is a controlled foreign corporation.

Paragraph (g)(2)(iv) concerning the treatment of inclusions under section 1293 has been reserved.

Paragraph (g)(3) has been changed to provide that dividends from a CFC attributable to a period when the CFC was neither a CFC nor a noncontrolled section 902 corporation will be treated as dividends from a noncontrolled section 902 corporation. This change has been made because it is consistent with the statute. Two commenters suggested that dividends from earnings attributable to periods when the CFC was neither a CFC or a noncontrolled section 902 corporation should be characterized under look-through principles. It was determined that there was no statutory basis for such treatment.

Sections 1.904–4(h)(3) (ii) and (iii) relating to export financing interest that is received or accrued by a financial service entity and export financing interest that is high-withholding tax interest have been reserved.

Section 1.904–4(j) contains a special rule relating to the treatment of certain currency gain or loss.

Section 1.904–4(k) relating to the priority rules has been reserved.

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

Section 1.904–5 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." This paragraph has been changed to include affiliates in the definition of a "United States shareholder."

Section 1.904–5(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 United States shareholder of the CFC (related person interest). Pursuant to section 954(b)(5), this paragraph provides that related person interest is allocated to passive income of the CFC to the extent of such passive income (the "netting rule").

Two commenters suggested that unrelated person interest should be allocated to passive income before related person interest. One commenter suggested that the netting rule should be applied to financial services income. These changes were not adopted because they lack statutory support.

The final regulations do, however, change paragraph (c)(2) in some important respects. Under the final regulations, non-interest expenses that are not definitely related, or that are definitely related to all classes of income, are allocated to the separate categories after the allocation of related person interest. This change was made to avoid the creation of passive losses and because it seemed more consistent with the theory underlying the netting rule that passive investments of a controlled foreign corporation that are funded by related person debt should be treated as if they were direct investments of the related person. In addition, the final regulations have been changed to combine into one step the allocation of these non-definitely related expenses and non-definitely related third person interest. This change is a simplifying change and is consistent with the theory of the netting rule. The final regulations also provide rules for allocating expenses when the CFC allocates interest expense on a gross income basis. This rule reflects the anticipated adoption of this alternative in § 1.861–8.

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. This rule has been changed to make it clear that it applies to an amount included in gross income under section 951(a)(1)(B). Paragraph (c)(4)(ii) provides a special rule for dividends attributable to loans made to the CFC payor by a related person. In response to several comments, this rule has been changed to clarify the situations in which it will apply.

Section 1.904–5(d) concerning the de minimis rule for subpart F income has been reserved pending the passage of the technical corrections bill. Several commenters suggested that de minimis rules should be adopted in other contexts, *e.g.* for partnership income or for income earned directly by a United States person. These changes were not adopted because they lack statutory support.

Section 1.904–5(g) provides for the application of the look-through rules to certain foreign source payments between related United States corporations. The final regulations expand the types of entities to which the look-through rules apply.

Section 1.904–5(h)(1) provides rules for the application of the look-through rules to partnerships. Paragraph (h)(2) provides an exception to the look-through rules for certain less than 10 percent general and limited partnership interests. Several commenters suggested that the exception should be deleted. The final regulations retain the exception, because it is felt that these interests are properly characterized as passive investments.

In response to comments, paragraph (h)(4) has been added to provide rules for valuing a partnership interest.

Section 1.904–5(i) provides rules for the application of the look-through rules to related CFCs. Several commenters suggested that the definition of a related CFC be expanded to include all situations in which there is 10 percent common ownership of the CFCs or in which the CFC owns at least 10 percent of other CFCs. This change was not adopted because it was felt that it would allow significant dilution of the ownership requirements when income is paid through tiers. In response to comments, these rules have been expanded to provide rules for determining when entities other than CFCs are related.

Section 1.904–5(j) concerning the application of the look-through rules to passive foreign investment company inclusions has been reserved.

Section 1.904–5(k) 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. These rules have been clarified to deal with partnership distributions and offsetting interest payments when more than two related persons are involved.

Section 1.904–5(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) has been changed to reflect the changes to the treatment of related person interest.

Section 1.904–5(n) provides rules for the order of application of sections 904 (d) and (g). This rule does not address how principles similar to those of section 904(f) apply to income earned at the CFC level because the Service is still considering this issue. See Notice 88–71, 1988–27 I.R.B. 17, for the effect of deficits in one separate category on earnings and profits in other categories.

Section 1.904–6 Allocation of taxes.

Section 1.904–6 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. This rule has been changed to make it clear that the principles of section 954(b)(5) apply for purposes of determining the net amount of income in a separate category. In response to comments, paragraph (a)(1)(iii) has been added to provide rules for apportioning taxes to groups of passive income for purposes of the high-tax kickout. One commenter suggested that foreign taxes should be allocated on a multi-year basis. This suggestion was not adopted. Paragraph (a)(2) provides a special rule for the treatment of foreign taxes allocable to certain dividends from noncontrolled section 902 corporations. An example has been added that clarifies the application of this paragraph.

Section 1.904-6(b)(1) provides rules for the determination of foreign taxes deemed paid under sections 902 and 960 for taxes allocated to different categories of income. The proposed regulations provided a special allocation rule for taxes on income excluded from subpart F under section 954(b)(4). In response to comments, this rule has been eliminated.

Section 1.904-7 Transition rules.

Section 1.904-7 provides transition rules for the application of section 904(d). The heading of paragraph (a)(1) has been modified to refer to controlled foreign corporations because some taxpayers were incorrectly reading this paragraph as applying to distributions from noncontrolled corporations out of pre-effective date earnings. Under the rules of § 1.904-4(g)(1), distributions from a noncontrolled section 902 corporation are treated as distributions from a noncontrolled section 902 corporation even if out of pre-effective date earnings and profits.

Paragraph (e) provides a rule for the characterization of amounts subject to recapture under section 585(c). This rule has been changed to provide that the recapture income can be treated as attributable to high-withholding tax interest if the taxpayer establishes to the satisfaction of the Secretary that the recapture amount is attributable to high-withholding tax interest. In determining whether recapture income is attributable to high-withholding tax interest or financial services income, the transition rule of section 1201(e)(2) of the Tax Reform Act of 1986 will be taken into account to the extent this rule is applicable in the recapture year.

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.

Special Analyses

It has been determined that this rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The Internal Revenue Service has also 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 regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Drafting Information

The principal author of this regulation is Carolyn M. DuPuy of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Income Tax Regulations

PART 1—[AMENDED]

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

Authority: 26 U.S.C. 7805. * * * Sections 1.904-4 through 1.904-7 also issued under 26 U.S.C. 904(d)(5). * * *

Par. 2. Sections 1.904-4 and 1.904-5 are removed. New § 1.904-0 is added immediately before § 1.904-1. New § 1.904-4 through § 1.904-7 are added immediately after § 1.904-3. The added sections read as follows:

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

(I) Reserved.
(II) Reserved.
(III) Reserved.
(IV) *§ 1.904-4 Separate application of section 904 with respect to certain categories of income.*
(a) In general.
(b) Passive income.
(1) In general.
(i) Rule.
(ii) Example.
(2) Active rents or royalties.
(i) In general.
(ii) Exception for certain rents and royalties.
(iii) Unrelated person.
(iv) Example.
(c) High-Taxed Income.
(1) In general.
(2) Grouping of items of income in order to determine whether passive income is high-taxed income.
(i) Effective date.
(ii) Allocation and apportionment of expenses.
(3) Amounts received or accrued by United States persons.
(4) Income of controlled foreign corporations and foreign branches.
(i) Income from sources within the QBU's country of operation.
(ii) Income from sources without the QBU's country of operation.
(iii) Determination of the source of income.
(5) Special rules.
(i) Certain rents and royalties.
(ii) Treatment of partnership income.
(iii) Currency gain or loss on distributions out of previously taxed income.
(6) 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.
(ii) Exceptions.
(iii) Allocation of foreign taxes imposed on distributions of previously taxed income.
(iv) Increase in taxes paid by successors.
(7) Application of this paragraph to certain reductions of tax on distributions of income.
(i) In general.
(ii) Allocation of reductions of foreign tax.
(iii) Interaction with section 954(b)(4).
(8) Redeterminations of foreign tax.
(9) Examples.
(d) High withholding tax interest.
(e) Financial services income.
(1) In general.
(2) Active financing income.
(i) Income included.
(3) Financial services entities.
(i) In general.
(ii) Special rule for affiliated groups.
(iii) Treatment of partnerships and other pass-through entities.
(A) Rule.
(B) Examples.
(4) Definition of incidental income.
(i) In general.
(A) Rule.
(B) Examples.
(ii) Income that is not incidental income.
(5) Exceptions.
(f) Shipping income.
(g) Non-controlled section 902 corporations.
(1) Definition.
(2) Treatment of dividends for each separate non-controlled section 902 corporation.
(i) In general.
(ii) Special rule for dividends received by a controlled foreign corporation.
(iii) Special rule for high withholding tax interest.

(iv) Treatment of inclusions under section 1293.
(3) Special rule for controlled foreign corporations.
(4) Examples.
(h) Export financing interest.
(1) Definitions.
(i) Export financing interest.
(ii) Fair market value.
(iii) Related person.
(2) Treatment of export financing interest.
(3) Interaction of export financing interest and related person factoring income.
(i) Export financing interest that is also related person factoring income.
(ii) Export financing interest that is received and accrued by a financial services entity.
(iii) Export financing interest that is high withholding tax interest.
(iv) Examples.
(v) Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment.
(A) Income other than interest.
(B) Interest income.
(C) Examples.
(i) Interaction of section 907(c) and income described in this section.
(j) Special rule for certain currency gains and losses.
(k) Priority rules.
(V) *§ 1.904-5 Look through rules as applied to controlled foreign corporations and other entities.*
(a) Definitions.
(b) In general.
(c) Rules for specific types of inclusions and payments.
(1) Subpart F inclusions.
(i) Rule.
(ii) Examples.
(2) Interest.
(i) In general.
(ii) Allocating expenses including interest paid to a related person.
(iii) Definitions.
(A) Value of assets and reduction in value of assets and gross income.
(B) Related person debt allocated to passive assets.
(iv) Examples.
(3) Rents and royalties.
(4) Dividends.
(i) Look-through rule.
(ii) Special rule for dividends attributable to certain loans.
(iii) Examples.
(d) Effect of exclusions from Subpart F income.
(1) De minimis amount of Subpart F income.
(2) Exception for certain income subject to high foreign tax.
(3) Examples.
(e) Treatment of Subpart F income in excess of 70 percent of gross income.
(1) Rule.
(2) Example.
(f) Modifications of look-through rules for certain income.
(1) High withholding tax interest.
(2) Dividends from a non-controlled section 902 corporation.
(3) Distributions from a FSC.
(4) Example.
(g) Application of the look-through rules to certain domestic corporations.
(h) Application of the look-through rules to partnerships and other pass-through entities.
(1) General rule.
(2) Exception for certain partnership interests.
(i) Rule.
(ii) Exceptions.
(3) Income from the sale of a partnership interest.
(4) Value of a partnership interest.
(i) Application of look-through rules to related entities.
(1) In general.
(2) Exception for distributive shares of partnership income.
(3) Special rule for payments from foreign parents to domestic subsidiaries.
(j) Look-through rules applied to passive foreign investment company industries.
(k) Ordering rules.
(1) In general.
(2) Specific rules.
(l) Examples.
(m) Application of section 904 (g)
(1) In general.
(2) Treatment of interest payments.
(3) Examples.
(4) Treatment of dividend payments.
(i) Rule.
(ii) Determination of earnings and profits from United States sources.
(iii) Example.
(5) Treatment of Subpart F inclusions.
(i) Rule.
(ii) Example.
(6) Treatment of section 78 amount.
(7) Coordination with treaties.
(n) Order of application of sections 904 (d) and (g).
(o) Effective date.
(VI) *§ 1.904-6 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.
(ii) Apportionment of taxes related to more than one separate category.
(iii) Apportionment of taxes for purposes of applying the high tax income test.
(2) Treatment of certain dividends from non-controlled section 902 corporations.
(b) Application of paragraph (a) to sections 902 and 960.
(1) Determination of foreign taxes deemed paid.
(2) Distributions received from foreign corporations that are excluded from gross income under section 959(b).
(3) Application of section 78.
(4) Increase in limitation.
(c) Examples.
(VII) *§ 1.904-7 Transition rules.*
(a) Characterization of distributions and section 951(a)(1)(B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987 during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986.
(1) In general.
(2) Limitation on establishing the character of earnings and profits.
(b) Application of look-through rules to distributions (including deemed distributors) 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.
(2) Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.
(3) Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.
(4) Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.
(5) Examples.
(c) Installment sales.
(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.
(e) Treatment of certain recapture income.

§ 1.904-4 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*—(i) *Rule.* The term "passive income" means any—

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

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

Passive income does not include any income that is also described in section 904(d)(1) (B) through (H), 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).

(ii) *Example.* The following example illustrates the application of paragraph (b)(1)(i) of this section:

P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 1988, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign corporation because the gain is directly related to the business needs of P. The currency gain is, therefore, general limitation income to P because it is not income of a kind that would be foreign personal holding company income.

(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.

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

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

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of § 1.904–5 to the royalties S receives from the franchisees. All of the franchisees are unrelated to S or P and operate in S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of § 1.954–2(d)(1). 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.

(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 or 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 § 1.904–6. Income and taxes shall be translated at the appropriate rates, as determined under sections 986 and 989 and the regulations thereunder, before application of this paragraph.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective Date.* For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3), (c)(4), and (c)(5) of this section apply to taxable years beginning after December 31, 1987. See notice 87–6 for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988.

(ii) *Allocation and apportionment of expenses.* For purposes of determining whether passive income is high-taxed, expenses shall be allocated and apportioned to each of the groups of passive income (described in paragraphs (c)(3), (c)(4), and (c)(5) of this section) under the rules of § 1.861–8. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis.

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

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

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

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

(4) *Income of controlled foreign corporations and foreign branches.* Except as provided in paragraph (c)(5) of this section, 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 § 1.904–5) are attributable to passive income received or accrued by a controlled foreign corporation and all amounts received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). These rules shall be applied separately to inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder. These rules shall also be applied separately to income attributable to each foreign QBU of a United States person and to each QBU of a controlled foreign corporation or any other entity subject to the look-through rules of § 1.904–5.

(i) *Income from sources within the QBU's country of operation.* Passive income from sources within the QBU's country of operation shall be treated as one item of income.

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the withholding tax imposed on that income as provided in paragraph (c)(3) (i) through (iii) of this section.

(iii) *Determination of the source of income.* For purposes of this paragraph (c)(4), income will be determined to be from sources within or without the QBU's country of operation under the laws of the foreign country of the payor of the income.

(5) *Special rules*—(i) *Certain rents and royalties.* All items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts.

(ii) *Treatment of partnership income.* A partner's distributive share of partnership income that is not subject to the look-through rules and that is treated as passive income under § 1.904–5(h)(2) shall be treated as a single item of income and shall not be grouped with other amounts. A distributive share of partnership income that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(4) of this section that are applicable to subpart F inclusions.

(iii) *Currency gain or loss on distributions out of previously taxed income.* Any currency gain or loss with respect to a distribution received by a United States shareholder of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as an item of passive income shall be treated as an item of passive income that is subject to no withholding tax for purposes of paragraph (c)(3) of this section, unless the distribution is received by a controlled foreign corporation or a foreign QBU of the United States shareholder. Any currency gain or loss with respect to a distribution of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as passive income, and that is received by a controlled foreign corporation or a foreign QBU of a United States person shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4) of this section. The preceding sentence shall be applied separately for each foreign QBU of the United States person and for each QBU of a controlled foreign corporation.

(6) *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"). Any increase in foreign taxes 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) *Exceptions.* Paragraph (c)(6)(i) of this section shall not apply to an increase in tax in a case in which the taxpayer is required to adjust its foreign taxes in the year of inclusion under section 905(c). Paragraph (c)(6)(i) of this section shall also not apply to the extent that the taxpayer receives a distribution of earnings and profits that is excluded from gross income under section 959(a), the distribution is received 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, and the distribution is received in the "prefiling period." For this purpose the "prefiling period" is the period ending 90 days prior to the due date of the return (determined with extensions) for the taxable year of inclusion. 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. A United States shareholder may also elect to consider as taxes paid or accrued, or deemed paid or accrued, with respect to the inclusion all foreign taxes paid or accrued or deemed paid or accrued after the end of the prefiling period but before the taxpayer files its return for the year of 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 and paragraph (c)(6)(i) of this section applies, then any increase in 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 and paragraph (c)(6)(i) of this section applies, the following rules shall apply. The taxpayer shall treat an increase in 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. If these additional taxes are not creditable in the year of distribution the carryover rules of section 904(c) apply. For purposes of this paragraph, the foreign tax on a subpart F inclusion shall be considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is greater than the total taxes deemed paid in the year of inclusion. Any foreign currency loss associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered as giving rise to an increase in tax.

(iv) *Increase in taxes paid by successors.* [Reserved]

(7) *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 is 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. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income provided that a redetermination of United States tax liability is required under section 905(c). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its United States tax liability for the year or years affected, 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. For this purpose, the foreign tax on a subpart F inclusion shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less that the total taxes deemed paid in the year of inclusion. Any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered a reduction of tax.

(ii) *Allocation of reductions of foreign tax.* For purposes of paragraph (c)(7)(i) of this section, reductions in foreign tax shall be allocated among the separate categories under the same principles as those of § 1.904-6 for allocating taxes among the separate categories. For purposes of determining to which year's taxes the reduction in taxes relate, the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income under section 954(b)(4), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c) (1) and (2), then on a LIFO basis out of earnings and profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F under section 954(b)(4), and finally on a LIFO basis out of other earnings and profits.

(iii) *Interaction with section 954(b)(4).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation is 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 shall apply to determine whether the income is high-taxed income and, therefore, general limitation income. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section shall apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income.

(8) *Redeterminations of foreign tax.* If in the prefiling period there is a redetermination of foreign taxes, within the meaning of section 905(c) and the regulations thereunder, then, for purposes of this paragraph (c), the amount of foreign taxes paid or deemed paid for the taxable year will be the taxes as redetermined.

(9) *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) operating in foreign country X. In 1988, S earns $130 of gross passive royalty income from country X sources, 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)(1) 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×$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 from country X sources and $65 of gross passive interest income from country Y sources. 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. Under paragraph (c)(4) of this section, the high-tax test is applied separately to the section 951 inclusion attributable to the income from X sources and the section 951 inclusion attributable to the income from Y sources. Therefore, after allocation of P's $50 of expenses, the resulting $25 inclusion attributable to the royalty income from X sources 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×$25)). The $25 inclusion attributable to the interest income from Y sources 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×$25)).

Example (3). Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is incorporated and operating in country Y and has a branch in country Z. S has two QBUs (QBU Y and QBU Z). In 1988, S earns $65 of gross passive royalty income in country Y through QBU Y and $65 of gross passive royalty income in country Z through QBU Z. S allocates $15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of $50 in each QBU. Country Y imposes $5 of foreign tax on the royalty income earned in Y, and country Z imposes $10 of tax on royalty income earned in Z. 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 the QBUs (consisting of the $45 section 951 inclusion derived through QBU Y, the $5 section 78 amount attributable to QBU Y, the $40 section 951 inclusion derived through QBU Z, and the $10 section 78 amount attributable to QBU Z), resulting in a net inclusion of $50. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the $25 inclusion attributable to Y 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×$25)). The $25 inclusion attributable to Z 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×$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. All of the QBU X passive income is from country Z sources. The royalty income is not subject to a withholding tax, and the interest income and the rental income are subject to a 5 percent and 10 percent withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraphs (c)(4)(ii) and (c)(3) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4)(i) and (c)(4)(ii) and (c)(3) of this section.

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×$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)(6)(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×$80)−$20)). Thus, under paragraph (c)(6)(iii) of this section, $7.20 ((.34×$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 during the prefiling period with respect to P's 1988 tax year. Under paragraph (c)(6)(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×$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 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. 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. In 1989, during P's prefiling period, foreign country R redetermines the tax liability of S for 1987 to be $30. Under paragraph (c)(8) of this section the entire $30 of foreign tax is taken into account in determining if the inclusion is high-taxed. The inclusion is considered to be high-taxed because the foreign income tax paid with respect to the section 951(a) inclusion exceeds the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ($30<$27.20 (.34×$80)). Thus, P's section 951(a) inclusion for 1988 is included in P's general limitation, and the $20 of taxes attributable to that inclusion are treated as taxes related to general limitation taxes. $10 will be added to S's pool of general limitation taxes in 1989.

Example (8). 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. Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. 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 paragraphs (c)(1) and (c)(6)(i) 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)(7)(i) 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 (9). The facts are the same as in *Example* (8) 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 $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988). P has no expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-out rules under paragraph (c)(7)(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.

Example (10). The facts are the same as in Example (8) except that the distribution in 1988 is subject to a withholding tax of $25. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income because there is a net $25 reduction of foreign tax. By taking into account both the reduction in foreign corporate tax and the withholding tax, the inclusion would continue to be considered high-taxed income. P must follow the appropriate section 905(c) procedures. P must redetermine its foreign tax credit for 1987, but the inclusion and the $75 taxes ($50 of deemed paid tax and $25 withholding tax) will continue to be treated as general limitation income and taxes.

Example (11). (i) S, a controlled foreign corporation operating in country G, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. Country G imposes a tax of 50 percent on S's earnings. Under country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30 percent and no withholding tax is imposed. Under country G's law, distributions are treated as made pro rata from each year's earnings. For 1987, S's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign country G. S has taxable income of $110 for United States purposes and $100 for country G purposes. Country G, therefore, imposes a tax of $50 on the 1987 earnings of S. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes $110 in gross income ($60 of net foreign personal holding company income and $50 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 taxable income in 1987.

(ii) In 1988, S earns general limitation income that is not subpart F income. S again has $110 in taxable income for United States purposes and $100 in taxable income for country G purposes, and S pays $50 of tax to foreign country G. In 1989, S has no taxable income or earnings. On December 31, 1989, S distributes $60 of earnings and receives a refund of foreign tax of $24. Country G treats the distribution of earnings as pro rata from the earnings accumulated in 1987 and 1988. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the $60 of passive earnings attributable to income previously taxed in 1987. However, because, under foreign law, only 40 percent of the $50 of foreign taxes on the passive earnings can be refunded, $20 of the $24 foreign tax refund reduces foreign taxes on passive earnings. The other $4 of the tax refund reduces the general limitation taxes from $50 to $46 (even though for United States purposes the $60 distribution is entirely out of passive earnings).

(iii) Under paragraph (c)(7) 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 ($\$30 < .34 \times \$110$). 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 (12). Controlled foreign corporation S is a wholly owned subsidiary of domestic corporation P. S is incorporated in foreign country X. Under country X's tax system, the foreign corporate tax on particular earnings is reduced on distribution and no withholding tax is imposed. In 1987, S has $200 of foreign personal holding company income that is passive income that is subject to a foreign tax of $100. P does not elect section 954(b)(4) with respect to that income. S has no earnings and profits in 1988. In 1988, S distributes the earnings and profits attributable to the 1987 income on a date that is 30 days before P files its return for the taxable year of inclusion and S receives a $50 refund of foreign tax on the distribution. P may file its return for the year of inclusion to reflect the decrease in foreign tax or file an amended return to reflect the decrease in foreign tax if P does not reflect the decrease in its original return. The prefiling exception does not apply when there is a reduction in foreign taxes imposed because, under the rules of paragraph (c)(7)(i) of this section and section 905(c), P must redetermine its foreign tax credit for the year of inclusion and must redetermine whether the inclusion should be considered high-taxed 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).

(e) *Financial services income*—(1) *In general.* [Reserved]

(2) *Active financing income*—(i) *Income included.* For purposes of paragraph (e)(1) and (e)(3) of this section, income is active financing income only 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) (including 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, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services.

(C) Income from investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates.

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

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

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

(G) Income from providing trust services.

(H) Income from arranging foreign exchange transactions, or engaging in foreign exchange transactions.

(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 and dividend and interest income earned by broker dealers on stock, debt obligations, or other financial instruments that are held for sale.

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

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services.

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

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services or for factoring receivables obtained in the course of providing such 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 financing business (as defined in paragraph (e)(3)(i) of this section) but only to the extent that the property was held to generate or generated active financing income prior to its disposition.

(S) Income from hedging gain with respect to other active financing income.

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

(U) Income from servicing mortgages.

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

(W) High withholding tax interest that would otherwise be described as active financing income.

(X) Income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services.

(Y) Any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Internal Revenue Service.

(3) *Financial services entities*—(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 (active financing 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 financing 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 excludible from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the transferor within the meaning of section 267(b). For this purpose, income received from a related person that is a financial services entity shall be excluded if such income is characterized under the look-through rules of section 904(d)(3) and § 1.904-5. In addition, income received from a related person that is not a financial services entity but that is characterized as financial services income under the look-through rules shall be excluded. Any income received from a related person that is characterized under the look-through rules and that is not otherwise excluded by this paragraph will retain its character either as active financing income or other income in the hands of the recipient for purposes of determining if the recipient is a financial services entity and if the income is financial services income to the recipient.

(ii) *Special rule for affiliated groups.* In the case of any 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) without regard to section 1504(b)(3)), 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. For purposes of determining if the affiliated group meets the requirements of paragraph (e)(3)(i) of this section the rules of this paragraph (e)(3)(ii) apply. The income of the group will not include any income from transactions with other members of the group. Leasing income of any member of the group will not be considered active financing income if any member of the recipient's group satisfies the active trade or business requirements of section 954(c)(2)(A), and the regulations thereunder, with respect to that income. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule in this paragraph (e)(3)(ii).

(iii) *Treatment of partnerships and other pass-through entities*—(A) *Rule.* For purposes of determining whether a partner (including a partnership that is a partner in a second partnership) is a financial services entity, all of the partner's income shall be taken into account, except that income that is excluded under paragraph (e)(3)(i) of this section shall not be taken into account. Thus, if a partnership is determined to be a financial services entity none of the income of the partner received from the partnership that is characterized under the look-through rules shall be included for purpose of determining if the partner is a financial services entity. If a partnership is determined not to be a financial services entity, then income of the partner from the partnership that is characterized under the look-through rules will be taken into account (unless such income is financial services income) and such income will retain its character either as active financing income or as other income in the hands of the partner for purposes of determining if the partner is a financial service entity and if the income is financial services income to the partner. If a partnership is a financial services entity and the partner's income from the partnership is characterized as financial services income under the look-through rules, then, for purposes of determining a partner's foreign tax credit limitation, the income from the partnership shall be considered to be financial services income to the partner regardless of whether the partner is itself a financial services entity. 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 paragraph (e)(3)(iii) of this section 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 active financing income. A and B's only income from PS are distributive shares of PS's income. PS is a financial services entity and all of its income is financial services income. The income from PS is excluded in determining if A or B are financial services entities. Thus, A is not a financial services entity because none of A's income is active financing income and B is a financial services entity because all of B's income is active financing income. However, both A and B's distributive shares of PS's taxable income consist of financial services income even though A is not a financial services entity.

Example (2). PS is a domestic partnership operating in foreign country X. A and B are domestic corporations that are equal general partners in PS and, therefore, the look-through rules apply for purposes of characterizing A's and B's distributive shares of PS's income. Fifty (50) percent of PS's gross income is active financing income that is not high withholding tax interest. The active financing income includes income that also meets the definition of passive income and income that meets the definition of general limitation income. 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 active financing income. Under paragraph (c)(3)(i) of this section, the active financing income 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 distributive shares of income from PS will not be financial services income to A or B and will consist of passive and general limitation income. All of the income from PS is included in determining if A or B are financial services entities.

(4) *Definition of incidental income*—(i) *In general*—(A) *Rule.* Incidental

income is income that is integrally related to active financing 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 active financing 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 an active financing business upon a loan held by the taxpayer 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 an entity holds such property for five years or less then the property is considered held incident to the financial services business. If an entity holds such property for more than five years, 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. However, the fact that an entity holds the property for more than five years and is not able to rebut the presumption that it is not holding the property incident to its financial services business will not affect the characterization of any income received from the property during the first five years as financial services income.

(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. During the period X held the assets, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In 1993, X sold the forfeited assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from 1989 to 1993 and the income on the sale of the assets in 1993 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 1993 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 1994, M distributes 10 units of country X currency to P as a dividend. P is not able to rebut the presumption that it is not holding the stock of M incident to its financial services business. The dividend to P is, therefore, not financial services income.

(ii) *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 related or 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) [Reserved];

(ii) [Reserved]; 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 § 1.904-5, the taxpayer meets the requirements of section 902(b). A controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902 (a) or (b) will be made with respect to the partner's indirect ownership, and not the partnership's direct ownership, in the foreign corporation.

(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 corporation 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 shareholders of that controlled foreign corporation, and

(C) The ownership requirements of section 902(b) with respect to the foreign corporation are met by at least 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.

(iv) *Treatment of inclusions under section 1293.* [Reserved]

(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 § 1.904–5, to the extent that the distribution is out of earnings and profits for periods during which the controlled foreign corporation was not a controlled foreign corporation.

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

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 the 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, that dividend 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)(1) 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 § 1.904–5(c)(4) and is characterized in A's hands according to those rules. Under paragraph (g)(3) of this section, the $2,000 attributable to the 1987 and 1988 earnings and profits is treated as income subject to a separate limitation for dividends from a noncontrolled section 902 corporation (B corporation).

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% × $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 × $80/$200) to $20 ($50 × $80/$200).

(h) *Export financing interest*—(1) *Definitions*—(i) *Export financing interest.* 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.

(ii) *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 section 927 and the regulations thereunder.

(iii) *Related person.* For purposes of this paragraph, the term "related person" has the meaning given it by section 954(d)(3) except that such section shall be applied by substituting "the person with respect to whom the determination is being made" for "controlled foreign corporation" each place it applies.

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer derives export financing interest from an unrelated person, then that interest shall be treated as general limitation income.

(3) *Interaction of export financing interest and related person factoring income*—(i) *Export financing interest that is also related person factoring income.* Export financing interest shall be treated as passive income if that income is also related person factoring income. For this purpose related person factoring 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).

(ii) *Export financing interest that is received or accrued by a financial services entity.* [Reserved]

(iii) *Export financing interest that is high-withholding tax interest.* [Reserved]

(iv) *Examples.* The following examples illustrate the operation of this paragraph (h)(3).

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 related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive income to S.

Example (2). [Reserved]

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 related person factoring income. The income is also export financing interest. 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 receivables, 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 related person factoring income. The income will be general limitation income to S.

(v) *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) and 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 and shall be treated as general limitation 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.

(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 an active financing business, and S is not a financial services entity. The income is not related person factoring 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 and is, therefore, general limitation income to S.

Example (2). [Reserved]

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 described in section 864(d)(7) and is export financing interest. Therefore, the income shall be general limitation income to S.

Example (4). [Reserved]

(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) *Special rule for certain currency gains and losses.* Any currency gain or loss computed under § 1.985-3T(d)(2) will be allocated among the separate categories of income on the basis of foreign source gross income in that category before the application of the section 904(d)(2)(A)(iii)(III) (the exception from passive income for high-taxed income).

(k) *Priority rules.* [Reserved]

§ 1.904-5 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 § 1.904-4 (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)), except that for purposes of this section, a United States shareholder shall include any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(2) except that 50 percent shall be substituted for 80 percent wherever it appears in section 1504(a)(2).

(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 § 1.904-4(k) 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). [Reserved]

Example (3). [Reserved]

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 other related person) and the look-through rules apply ("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 that are definitely related to less than all classes of gross income, including unrelated person interest (as defined in paragraph (c)(2)(ii)(E) of this section) that is directly allocated to income from a specific property, shall be allocated and apportioned under the principles of § 1.861–8 to income in each separate category;

(C) 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) of this section;

(D) 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 under the rules of this paragraph to separate categories other than passive income. If under § 1.861–8, the gross income method of allocating interest expense is elected, related person interest shall be allocated as follows:

$$\left(\text{Related person interest} \ - \ \text{Related person interest allocated under paragraph (c)(2)(ii)(C)}\right) \times \frac{\text{Gross income in a separate category (other than passive)}}{\text{Total gross income (other than passive)}}$$

If under § 1.861–8, the asset method of allocating interest expense is elected, related person interest shall be allocated according to the following formula:

$$\left(\text{Related person interest} \ - \ \text{Related person interest allocated under paragraph (c)(2)(ii)(C)}\right) \times \frac{\text{Value of assets in a separate category (other than passive)}}{\text{Value of total assets (other than passive)}}$$

(E) Any other expenses (including unrelated person interest that is not directly allocated to income from a specific property)) that are not definitely related expenses or that are definitely related to all classes of gross income shall be apportioned under the rules of this paragraph to reduce income in each separate category. For this purpose, unrelated person interest is all interest other than related person interest. If the taxpayer elects to use the gross income method to apportion the expense, then the expense shall be apportioned according to the following formula:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Gross income in a separate category (minus related person interest allocated under paragraph (c)(2)(ii)(C) if the category is passive)}}{\text{Total gross income minus related person interest allocated to passive income under paragraph (c)(2)(ii)(C)}}$$

If the taxpayer uses the asset method to apportion the expense, then the expense shall be apportioned according to the following formula:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Value of assets in a separate category (minus related person debt allocated to passive assets if the category is passive)}}{\text{Value of total assets minus related person debt allocated to passive assets}}$$

(iii) *Definitions*—(A) *Value of assets and reduction in value of assets and gross income.* For purposes of paragraph (c)(2)(ii) (D) and (E) of this section, the value of total assets is the value of assets in all categories (determined under the principles of § 1.861–8). See § 1.861–8 to determine the reduction in value of assets and gross income for purposes of apportioning additional third person interest expense that is not directly allocated when some interest expense has been directly allocated. For purposes of this paragraph and paragraph (c)(2)(ii)(E) of this section, any reduction in the value of assets for indebtedness that relates to interest allocated under paragraph (c)(2)(ii)(C) of this section is made before determining the average of asset values. For rules relating to the averaging of reduced asset values see § 1.861–8.

(B) *Related person debt allocated to passive assets.* For purposes of paragraph (c)(2)(ii)(E) of this section, related person debt allocated to passive assets is determined as follows:

$$\text{Related person debt allocated to the passive category} = \text{Total related person debt} \times \frac{\text{Related person interest allocable to passive income under paragraph (c)(2)(ii)(C)}}{\text{All related person interest}}$$

For this purpose, the term "total related person debt" means the sum of the principal amounts of obligations of a controlled foreign corporation owed to any United States shareholder of such corporation or to any related entity (within the meaning of paragraph (g) of this section) determined at the end of the taxable year.

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

Example (1). (i) 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. S uses the asset method to allocate interest expense.

(ii) Under paragraph (c)(2)(ii)(C) 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)(C) of this section, none of the related person interest payment is allocable to general limitation income under paragraph (c)(2)(ii)(D) of this section. Under paragraph (c)(2)(iii)(B) 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)(E) 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/($4000−$1500)).

Example (2). The facts are the same as in *Example* (1), except that S uses the gross income method for allocating interest expense. Under paragraph (c)(2)(ii)(E) of this section, the unrelated person interest expense would be allocated on a gross income method. Therefore, $33 of interest expense paid to unrelated persons would be allocated to passive income ($33=$100×($200−$150)/($300−$150) and $67 of interest expense paid to unrelated persons would be allocated to general limitation income ($67=$100×$100/($300−$150).

Example (3). (i) The facts are the same as in *Example* (1), except that S has an additional $50 of third person interest expense that is directly allocated to income from a specific property that produces only passive income. The principal amount of indebtedness to which the interest relates is $500. S also has $50 of additional non-interest expenses that are not definitely related expenses and that are allocated on an asset basis.

(ii) Under paragraph (c)(2)(ii)(B) of this section, the $50 of directly allocated third person interest is first allocated to reduce the passive income of S. Under paragraph (c)(2)(ii)(C) of this section, the $150 of related person interest is allocated to the remaining $150 of passive income. Under paragraph (c)(2)(iii)(B) of this section, all of the related person debt is allocated to passive assets. ($1500=$1500×$150/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, the non-interest expenses that are not definitely related are allocated on the basis of the asset values reduced by the allocated related person debt. Therefore $10 of these expenses are allocated to the passive category ($50×($2000−$1500)/($4000−$1500)) and $40 are allocated to the general category ($50×($2000/($4000−$1500)).

(iv) In order to allocate third person interest between the categories of assets, the value of assets in a separate category must also be reduced under the principles of § 1.861–8 by the indebtedness relating to the specifically allocated interest. Therefore, under paragraph (c)(2)(iii)(B) of this section, the value of assets in the passive category for purposes of allocating the additional third person interest =0 ($2000 minus $500 (the principal amount of the debt, the interest payment on which is directly allocated to specific interest producing properties) minus $1500 (the related person debt allocated to passive assets)). Under paragraph (c)(2)(ii)(E) of this section, all $100 of the non-definitely related third person interest is allocated to the general limitation ($100=$100×$2000/($4000−$500−$1500)).

Example (4). (i) 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) that under the principles of § 1.861–8 is treated as directly allocable to all of P's gross income. S also makes a $25 interest payment to an unrelated person on a $250 loan from the unrelated person. S has no other expenses. S uses the asset method to allocate interest expense. S uses the gross income method to allocate G & A.

(ii) Under paragraph (c)(2)(ii)(B) of this section, $100 of the interest payment to P is allocable to S's passive foreign personal holding company income. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is allocated to general limitation income ($50=$50×$1000/$1000). Under paragraph (c)(2)(iii)(B) of this section, related person debt allocated to passive assets equals $1000 ($1000=$1500×$100/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, none of the $25 of interest expense paid to an unrelated person is allocated to passive income ($0=$25×($1000−$1000)/($2000−$1000). Twenty-five dollars ($25) of the interest expense paid to an unrelated person is allocated to general limitation income ($25=$25×$1000/($2000−$1000). Under paragraph (c)(2)(ii)(E) of this section, none of the G & A is allocable to S's passive foreign personal holding company income ($0=$20×($100−$100)/($200−$100). All $20 of the G & A is allocable to S's general limitation income ($20=$20×$100/($200−$100).

Example (5). The facts are the same as in *Example* (4), except that S uses the gross income method to allocate interest expense. As in *Example* (4), $100 of the interest payment to P is allocated to passive income under paragraph (c)(2)(ii)(C) of this section. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is allocated to general limitation income ($150−100×$100/$100). Under paragraph (c)(2)(ii)(E) of this section, none of the unrelated person interest expense and none of the G & A is allocated to passive income, because after the application of paragraph (c)(2)(ii)(C) of this section, no passive income remains in the passive income category.

Example (6). 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 is not a financial services entity. 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 factoring income nor foreign personal holding company income. The export financing interest earned by S is, therefore, general limitation income. S earns no other income. S makes a $100 interest payment to P. The $100 of interest paid is allocable under the look-through rules of paragraph (c)(2)(ii) of this section to the general limitation income earned by S and is therefore general limitation income to P.

(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. For purposes of this paragraph, the term "dividend" includes any amount included in gross income under section 951(a)(1)(B) as a pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(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 look-through entity (within the meaning of paragraph (i) 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. A loan will not be considered made for the purpose of altering the characterization of a dividend if the loan would have been made or maintained on substantially the same terms irrespective of the dividend. The determination of whether a loan would have been made or maintained on substantially the same terms irrespective of the dividend will be made taking into account all the facts and circumstances of the relationship between the lender and the borrower. Thus, for example, a loan by a related party lender to a controlled foreign corporation that arises from the sale of inventory in the ordinary course of business will not be considered a loan made for the purpose of altering the character of any dividend paid by the borrower.

(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 general limitation 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. Both X and A are calendar year taxpayers. X's earnings and profits for 1963 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 including the transition rule of § 1.904–7(a) with respect to the portion of the distribution out of pre-87 earnings and profits. 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.* [Reserved]

(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 § 1.904–4 (k)) and 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.

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

Example (1). [Reserved]

Example (2). [Reserved]

(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 gross 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 separate category. The determination of whether the controlled foreign corporation's gross foreign base company income and gross insurance income exceeds 70 percent of gross income is made before the exception for certain income subject to a high rate of foreign tax.

(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 personal holding company income and $25 of which is non-subpart F services income. S is not a financial services entity. S's gross and net income are equal. 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 passive income, $75 of the inclusion is passive 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 rules 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 (the look-through rules for interest) 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. The amount treated as high-withholding tax interest under this paragraph (f)(1) shall not exceed the interest, or equivalent income, of the payor that would be taken into account in determining the financial services income of the payor if the look-through rules applied.

(2) *Dividends from a noncontrolled section 902 corporation.* If a United States shareholder that is a corporation 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 § 1.904–4(g)(2)(ii) (relating to dividends from a foreign corporation with respect to which the United States shareholder does not meet the stock ownership requirements of section 902).

(3) *Distributions from a FSC.* Income received or accrued by a taxpayer that, under the rules of paragraph (c)(4) of this section (look-through rules for dividends), would be treated as foreign trade income or as passive income that is qualified interest and carrying charges (as defined in section 245(c)), and that is also a distribution from a FSC (or former FSC), shall be treated as a distribution from a FSC (or former FSC).

(4) *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 interest that meets the definition 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 interest income under the look-through rules of paragraph (c)(2)(i) of this section.

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents, and royalties that are paid by one United States corporation to another related United States corporation. For this purpose, two United States corporations are considered to be related if one owns, directly or indirectly, stock possessing 50 percent or more of the total voting power of all classes of stock of the other corporation or 50 percent or more of the total value of the corporation. In addition, two United States corporations shall be considered related if the same United States shareholders own, directly or indirectly, stock possessing 50 percent or more of the total voting power of all classes of stock or 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 apply.

(h) *Application of look-through rules to partnerships and other pass-through entities*—(1) *General rule.* Except as provided in paragraph (h)(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 payment is attributable under the principles of § 1.861–8 and this section to income earned or accrued by the partnership in such category, if the payments are interest, rents, or royalties that would be characterized under the look-through rules of this section if the partnership were a foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership. A payment by a partnership to a member of the controlled group (as defined in paragraph (a)(3) of this section) of the partner shall be characterized under the look-through rules of this section if the payment would be a section 707 payment entitled to look-through treatment if it were made to the partner.

(2) *Exception for certain partnership interests*—(i) *Rule.* Except as otherwise provided, if any limited partner or corporate general partner owns less than 10 percent of the value 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 deductions 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.

(ii) *Exceptions.* To the extent a partner's distributive share of income from a partnership is a share of high withholding tax interest received or accrued by the partnership, that partner's distributive share of partnership income will be high withholding tax interest regardless of the partner's level of ownership in the partnership. If a partnership interest described in paragraph (h)(2)(i) of this section is held in the ordinary course of a partner's active trade or business, the rules of paragraph (h)(1) of this section shall apply for purposes of characterizing the partner's distributive share of the partnership income. 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 related trade or business as the partnership.

(3) *Income from the sale of a partnership interest.* [Reserved]

(4) *Value of a partnership interest.* For purposes of paragraphs (i), (h)(1), and (h)(2) of this section, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner has 10 percent of the capital and profits interest of the partnership. Similarly, a partnership (first partnership) is considered as owning 50 percent of the value of another partnership (second partnership) if the first partnership owns 50 percent of the capital and profits interests of another partnership. For this purpose, value will be determined at the end of the partnership's taxable year.

(i) *Application of look-through rules to related entities*—(1) *In General.* Except as provided in paragraph (i)(2) of this section, the principles of this section shall apply to distributions and payments that are subject to the look-through rules of section 904(d)(3) and this section from a controlled foreign corporation (or other entity described in paragraph (h) of this section) (look-through entities) to a related look-through entity. Two look-through entities shall be considered to be related to each other if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of voting stock of the other entity or more than 50 percent of the total value of such entity. In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing 50 percent or more of the total voting power of all voting classes of stock (in the case of a corporation) or 50 percent or more of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 31B and the regulations thereunder.

(2) *Exception for distributive shares of partnership income.* In the case of tiered partnership arrangements, a distributive share of partnership income will be characterized under the look-through rules of section 904(d)(3) and this section if the partner meets the requirements of paragraph (h)(1) of this section with respect to the partnership (first partnership), whether or not the income is received through another partnership or partnerships (second partnership) and whether or not the first partnership and the second partnership are considered to be related under the rules of paragraph (i)(1) of this section.

(3) *Special rule for payments from foreign parents to domestic subsidiaries.* [Reserved]

(j) *Look-through rules applied to passive foreign investment company inclusions.* [Reserved]

(k) *Ordering rules*—(1) *In general.* The rules of paragraph (k)(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 receives 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) Rents and royalties;

(ii) Interest;

(iii) Subpart F inclusions and distributive shares of partnership income;

(iv) Dividend distributions.

If an entity is both a recipient and a payor of income described in any one of the categories described in (k)(2) (i) through (iv) of this section, the income received will be characterized before the income that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by a person to a related person shall be offset against and eliminate any interest received or accrued, directly or indirectly, by a person from that related person before application of the ordering rules of this paragraph. In a case in which a person pays or accrues interest to a related person, and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amount of all other interest payments are reduced by the amount of the smallest interest payment.

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

Example (1). S and T, controlled foreign corporations, are wholly-owned subsidiaries of P, a 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). [Reserved]

Example (3). P, a domestic corporation, wholly-owns S, a domestic corporation that is a 80/20 corporation. In 1987, S's earnings consist of $100 of foreign source shipping income and $100 of foreign source high withholding tax interest. S makes a $100 foreign source 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 (h)(1) of this section, A's, B's, and C's distributive shares of PS's income are general limitation income. Under paragraph (h)(2) of this section, because D is a limited partner with a less than 10 percent interest in PS, D's distributive share of PS's income is passive income.

Example (5). [Reserved]

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 (k)(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. S owns 100 percent of the stock of T, a controlled foreign corporation and 100 percent of the stock of U, a controlled foreign corporation. In 1988, T pays S $5 of interest, S pays U $10 of interest and U pays T $20 of interest. Under paragraph (k)(2) of this section, the interest payments from S to U must be offset by the amount of interest that S is considered as receiving indirectly from U and the interest payment from U to T is offset by the amount of the interest payment that U is considered as receiving indirectly from T. The $10 payment by S to U is reduced by $5, the amount of the interest payment from T to S that is treated as being paid indirectly by U to S. Similarly, the $20 interest payment from U to T is reduced by $5, the amount of the interest payment from S to U that is treated as being paid indirectly by T to U. Therefore, under paragraph (k)(2) of this section, T is treated as having made no interest payment to S, S is treated as having paid $5 of interest to U, and U is treated as having paid $15 to T.

Example (8). (i) 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 S $100 of interest.

(ii) Under paragraph (k)(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.

(iii) Under paragraph (k)(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)(C) 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.

(iv) Under paragraph (k)(2)(iii) of this section, subpart F inclusions are characterized next. P has a subpart F inclusion with respect to S of $50 that is attributable to passive income of S and is treated as passive income to P. 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 (9). (i) 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.

(ii) Under paragraph (k)(2)(i) of this section, the royalty paid by U to T is characterized first. Assume that the royalty is directly allocable 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.

(iii) Under paragraph (k)(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 (k)(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)(C) 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. All of the interest payments to T and U are subpart F foreign personal holding company income to both recipients.

(iv) Under paragraph (k)(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 (k)(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.

(v) Under paragraph (k)(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 (10). (i) 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.

(ii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized first. The interest payments are first allocated under the rule of paragraph (c)(2)(ii)(C) of this section 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.

(iii) Under paragraph (k)(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.

(iv) 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.

(m) *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 (m)(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 (m)(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 (m)(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)(C) of this section to passive income that is from sources within the United States. If related person interest is less than or equal to 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)(D) of this section to income in a separate category other than passive, the following formulas apply in determining the portion of the interest payment that is from sources within the United States. If the taxpayer uses the gross income method to allocate interest, the portion of the interest payment from sources within the United States is determined as follows:

$$\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section} \times \frac{\text{Gross income from United States sources in that category}}{\text{Gross income from all sources in that category}}$$

If the taxpayer uses the asset method to allocate interest, then the portion of the interest payment from sources within the United States is determined as follows:

$$\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section} \times \frac{\text{Value of domestic assets in that category}}{\text{Value of total assets in that category}}$$

For purposes of this paragraph, the value of assets in a separate category is the value of assets as determined under the principles of § 1.861–8. See § 1.861–8 for purposes of determining the value of assets and gross income in a separate category as reduced for indebtedness the interest on which is directly allocated.

(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. 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 $4000 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. S uses the asset method to allocate interest expense. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	4000	5000
General	3000	4000	7000
Total	4000	8000	12000
Income:			
Passive	20	70	90
General	650	100	750
Total	670	170	840

Under paragraph (c)(2)(ii)(C) of this section, $90 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, $70 is from sources within the United States and $20 is from foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest payment is allocated to general limitation income. Under paragraph (m)(2) of this section, $120 of the remaining $210 is treated as income from sources within the United States ($120=$210×$4000/$7000) and $90 is treated as income from foreign sources. ($90=$210×$3000/$7000).

Example (2). The facts are the same as in *Example* (1) except that S uses the gross income method to allocate interest expense. The first $90 of related person interest expense is allocated to passive income in the same manner as in Example (1). Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest expense is allocated to general limitation income. Under paragraph (m)(2) of this section, $28 of the remaining $210 is treated as income from United States sources ($28=$210×$100/$750) and $182 is treated as income from foreign sources ($182=$210×$650/$750).

Example (3). 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. S uses the asset method to allocate interest expense. 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 $1000 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:			
Passive	1000	1000	2000
Shipping	500	500	1000
General	4000	0	4000
Total	5500	1500	7000
Income:			
Passive	100	100	200
Shipping	200	200	400
General	650	0	650
Total	950	300	1250

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

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

Under paragraph (m)(2) of this section, none of $80 of the interest payment allocated to general limitation income is treated as income from United States sources ($0=$80×$0/$4000). Therefore, the entire $80 is treated as income from foreign sources.

Under paragraph (m)(2) of this section, $10 of the $20 of the interest payment allocated to the shipping income is treated as income from United States sources ($10=$20×$500/$1000) and $10 of the $20 is treated as income from foreign sources ($10=$20×$500/$1000).

Example (4). The facts are the same as in *Example* (3) except that S uses the gross income method to allocate interest expense. The interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section is the same, $200, $100 from United States sources and $100 from foreign sources.

Under paragraph (c)(2)(ii)(D) of this section, the remaining $100 of related person interest is allocated between the shipping and general limitation categories based on the gross income in those categories. Therefore, $38 of the remaining $100 interest payment is allocated to shipping income ($38=$100×$400/($1250−$200)) and $62 is treated as allocated to general limitation income ($62=$100×$650/($1250-$200)).

Under paragraph (m)(2) of this section, $16 of the $38 allocable to shipping income is treated as income from United States sources ($16=$38×$200/$400) and $16 is treated as income from foreign sources ($16=$38×$200/$400).

Under paragraph (m)(2) of this section, all of the $62 allocated to general limitation income is treated as income from foreign sources ($62=$62×$650/$650).

(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 category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation 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 (m)(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)(E) 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. S is a financial services entity. In 1987, S has $100 of non-subpart F general limitation earnings and profits and $100 of non-subpart F financial services income. None of the general limitation earnings and profits are from sources within the United States, and $50 of the financial services 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 financial services earnings and profits. One hundred dollars ($100) of the general limitation earnings and profits are from sources within the United States. None of the financial services 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×$400/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to general limitation earnings and profits from sources within the United States is $50 ($200×$100/$400). Under paragraph (c)(4) of this section, $300 of the dividend is attributable to financial services earnings and profits ($300=$500×$600/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to financial services earnings and profits from sources within the United States is $25 ($300×$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 (m)(4)(ii) of this section shall apply.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(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.* [Reserved]

(n) *Order of application of sections 904 (d) and (g).* In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation 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. 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.

(o) *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.

§ 1.904-6 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 foreign taxes paid or accrued with respect to a separate category of income (including United States source 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, deductions, or credits 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 § 1.904-4(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 on an annual basis among the separate categories on the basis of the following formula:

$$\text{Foreign tax related to more than one separate category} \times \frac{\text{Net income subject to that foreign tax included in a separate category}}{\text{Net income subject to that foreign tax}}$$

For purposes of apportioning foreign taxes among the separate categories, 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. Gross income, as determined under foreign law, in the passive category shall first be reduced by any related person interest expense that is allocated to the income under the principles of section 954(b)(5) and § 1.904-5(c)(2)(ii)(C) (adjusted gross passive income). Gross income in all separate categories (including adjusted gross passive income) is next reduced by deducting any expenses, losses, or other amounts that are deductible under foreign law that are specifically allocable to the gross amount of such income under the laws of that foreign country or possession. If expenses are not specifically allocated under foreign law then the expenses will be apportioned under the principles of foreign law but only after taking into account the reduction of passive income by the application of section 954(b)(5). Thus, for example, if foreign law provides that expenses will be apportioned on a gross income basis, the gross income amounts will be those amounts determined under foreign law except that, in the case of passive income, the amount will be adjusted gross passive income. If foreign law does not provide for the direct allocation or apportionment of expenses, losses, or other deductions to a particular category of income, then the principles of § 1.861-8 and section 954(b)(5) shall apply in allocating such expenses, losses, or other deductions to gross income as determined under foreign law after reduction of passive income by the amount of related person interest allocated to passive income under section 954(b)(5) and § 1.904-5(c)(2)(ii)(C). 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 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.

(iii) *Apportionment of taxes for purposes of applying the high-tax income test.* If taxes have been allocated and apportioned to passive income under the rules of paragraph (a)(1) (i) or (ii) of this section, the taxes must further be apportioned to the groups of income described in § 1.904-4(c) (3), (4) and (5) for purposes of determining if the group is high-taxed income. Taxes will be related to income in a particular group under the same rules as those in paragraph (a)(1) (i) and (ii) of this section except that those rules shall be applied by substituting the term "group" for the term "category."

(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 foreign taxes deemed paid.* 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 § 1.904-5(c)(1)) and divided by the earnings and profits of the controlled foreign corporation with respect to that separate category (in accordance with § 1.904-5(c)(2)(ii)). The rules of this paragraph (b)(1) also apply for purposes of computing the foreign taxes deemed paid of United States shareholders of controlled foreign corporations under section 902.

(2) *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).

(3) *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.

(4) *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 allocated or apportioned to a particular category of income. Under the principles of § 1.861–8, M allocates $75 of directly allocable expenses to shipping income, $10 of directly allocable expenses to general limitation income, and no such expenses to passive income. M also allocates expenses that are not directly allocable to a specific class of gross income—$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 by 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×$285/$455) and $37 of tax on its general limitation income ($100×$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 expenses that are not directly allocable are apportioned, and $100 of interest income, to which $10 of expenses that are not directly allocable are apportioned. 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×$285/$545) $41 to general limitation income ($130×$170/$545), and $21 to passive income ($130×$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 100 percent of S, a controlled foreign corporation organized in country X and 100 percent of T, a controlled foreign corporation organized in country Y. T has $200 of gross manufacturing general limitation income and $50 of passive income. T also pays S $100 for shipping T's goods, a price that may be justified under section 482. T has no other expenses and S has no other income or expense. T's income and earnings and profits are the same. Foreign country X does not tax S on its shipping income. Foreign country Y taxes all of T's income at a rate of 20 percent. Under the law of foreign country Y, T is only allowed a $50 deduction for the payment to S. Therefore, for foreign law purposes, T has $150 of manufacturing income and earnings and profits and $50 of passive income and earnings and profits upon which it pays $40 of tax. Under the principles of foreign law, $30 of that tax is imposed on the general limitation manufacturing income and $10 of the tax is imposed on passive income. Therefore, the foreign effective rate on the general limitation income is 30 percent and the foreign effective rate on the passive income is 20 percent. T has $100 of general limitation income and $50 of passive income and pays $30 of general limitation taxes and $10 of passive taxes. S has $100 of shipping income and pays no foreign tax.

Example (5). R, a domestic corporation, owns 50 percent of T, a foreign corporation that is not a controlled foreign corporation and that is organized in foreign country X. R licenses certain property to T. T then relicenses this property to a third person. In 1987, T paid R a royalty of $100 all of which is treated as passive income to R because it was not an active royalty as defined in § 1.904–4(b)(2). R has $10 of expenses associated with the royalty income and no foreign tax was imposed on the royalty so the high-tax kickout does not apply. In 1988, the Commissioner determined that the correct arm's length royalty was $150 and under the authority of section 482 reallocated an additional $50 of income to R for 1987. Under a closing agreement with the Commissioner, R elected the benefits of Rev. Proc. 65–17 in relation to the income reallocated from R and established an account receivable from T. In 1988, T paid R an additional $50 to reflect the section 482 adjustment and the account receivable that was established because of the adjustment. Foreign country X treats the $50 payment in 1988 as a dividend by T and imposes a $10 withholding tax on the payment. Under paragraph (a)(1) of this section, the $10 of withholding tax is treated as fully allocable to the $50 payment because under foreign law the tax is imposed only on that income. For U.S. purposes, the income is not characterized as a dividend but as a repayment of a bona fide debt and therefore the $50 of income is not required to be recognized by P in 1988. The $10 of tax is treated as a tax on the $50 of passive income included by P in 1987 pursuant to the section 482 adjustment rather than as taxes associated with a dividend from a noncontrolled section 902 corporation and the taxes are therefore taxes imposed on passive income.

Example (6). P, a domestic corporation owns all of the stock of S, a controlled foreign corporation that is incorporated in country X. In 1989, S has $100 of passive income, $200 of dividends from a noncontrolled section 902 corporation and $200 of general limitation income. S also has $100 of related person interest expense and $100 of other expenses that under foreign law are directly allocable to the general limitation income of S. S has no other expenses. Country X imposes a tax of 25% on all of the net income of S and S, therefore, pays $75 in foreign tax. Under paragraph (a)(1)(ii) of this section, the passive income of S is first reduced by the amount of related person interest for purposes of determining the net amount for purposes of allocating the $75 of tax. Under paragraph (a)(1)(ii) of this section, the general limitation income of S is reduced by the $100 of other expenses. Therefore, $50 of the foreign tax is allocated to the dividends from a noncontrolled section 902 corporation ($25=$75×$200/$300), $25 is allocated to the general limitation income of S ($25=$75×$100/$300), and no taxes are allocated to S's passive income.

Example (7). R, a domestic corporation owns preferred stock in T, a foreign corporation that is not a controlled foreign corporation, incorporated in foreign country X. R's stock represents 15 percent of the value of T. Dividends on the preferred stock are paid only out of certain designated passive investments of T. Foreign country X does not tax the passive income of T. Under paragraph (a)(2) of this section, no taxes will be considered to be related to any dividend paid by T to R.

Example (8). 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 250.00
   - Less:
   - (d) Foreign income taxes paid on or with respect to T's earnings and profits (20%) 50.00
   - (e) Earnings and profits 200.00
2. Allocation of taxes:
   - (a) Foreign income taxes paid by T that are allocable to p.i. earned by T:
     - Line 1(d) taxes 50.00
     - Multiplied by: foreign law net p.i. 187.50
     - Divided by: foreign law total net income 250.00
     - Result 37.50
   - (b) Foreign income taxes paid by T that are allocable to g.l.i. earned by T:
     - Line 1(d) taxes 50.00
     - Multiplied by: foreign law net g.l.i. 62.50
     - Divided by: foreign law total net income 250.00
     - 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 150.00
   - (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 50.00
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. 150.00
   - (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. 25.00
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) sec. 951 incl. 150.00
     - Divided by: line 3(a) e & p 150.00
     - 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) sec. 951 incl. 25.00
     - Divided by: line 3(b) e & p 50.00
     - Result 6.25
6. Dividends paid to S:
   - (a) Dividends attributable to T's previously taxed p.i. 150.00
   - Plus:
   - (b) Dividends attributable to T's previously taxed g.l.i. 25.00
   - 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. 25.00
   - (e) Total dividends paid to S 200.00
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
     - Dividend by: line 3(a) e & p 150.00
     - 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 25.00
     - Dividend by: line 3(b) e & p 50.00
     - 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 100.00

(g) Total pre-tax earnings and profits 300.00
(h) Foreign income taxes paid on or with respect to S's earnings and profits (10%) 30.00

(i) Earnings and profits 270.00

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 30.00
Multiplied by: foreign law line 8(a) & 8(e) p.i. amounts 0
Dividend by: foreign law total net income 300.00

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 30.00
Multiplied by: foreign law line 8(c) p.i. amount 150.00
Divided by: foreign law total net income 300.00

Result 15.00

(c) Foreign income taxes paid by S that are allocable to non-previously taxed g.l.i. earned by S:
Line 8(h) taxes 30.00
Multiplied by: foreign law line 8(b) & line 8(f) g.l.i. amounts 125.00
Divided by: foreign law total net income 300.00

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 30.00
Multiplied by: foreign law line 8(d) amount 25.00
Divided by: foreign law total net income 300.00

Result 2.50

10. (a) Non-previously taxed earnings and profits of S:
Lines 8(a), 8(b), 8(e), & 8(f) e & p 125.00
Less: lines 9(a) & 9(c) taxes 12.50

Result 112.50

(b) Portion of result in 10(a) attributable tc 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 175.00
Less: lines 9(b) & 9(d) taxes 17.50

Result 157.50

(b) Portion of result in 11(a) attributable to T's p.i.:
Line 8(c) 150.00
Less: line 9(b) taxes 15.00

Result 135.00

(c) Portion of result in 11(a) attributable to T's g.l.i.:
Line 8(d) 25.00
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) sec. 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) sec. 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) sec. 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. 135.00
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........ 225.00
(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........ 15.00
Multiplied by: line 14(c)(i) div........ 135.00
Divided by: line 11(b) e & p........ 135.00

Result........ 15.00

(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........ 10.00

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))		15.00
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	

§ 1.904-7 Transition rules.

(a) *Characterization of distributions and section 951(a)(1)(B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987 during taxable years of both the payor controlled 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 § 1.904-5(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 § 1.904-4(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 § 1.904-4(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 distributions 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 § 1.904-6 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 § 1.904-5. 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 recipient's 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 (b).

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 §§ 1.904-4 through 1.904-7.

(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. If the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to high-withholding tax interest income, the taxpayer may treat the income as high-withholding tax interest.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved: June 27, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

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26 CFR Parts 1 and 602

[T.D. 8215]

Special Allocation Rules for Certain Asset Acquisitions

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to allocation rules for certain asset acquisitions under section 1060 of the Internal Revenue Code of 1986 ("Code"). The temporary regulations provide guidance concerning the application of section 1060 and also modify certain rules relating to stock purchases treated as asset purchases under section 338 of the Code. In addition, the temporary regulations coordinate the application of section 755 with the rules of section 1060. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the proposed rules section of this issue of the **Federal Register.**

EFFECTIVE DATE: These regulations are effective July 18, 1988. These temporary regulations under section 1060 generally apply to asset acquisitions made after May 6, 1986. The reporting requirements apply to asset acquisitions (and to certain adjustments of consideration) occurring in a taxable year for which the due date (including extensions of time) of the income tax return or return of income is on or after September 13, 1988.

FOR FURTHER INFORMATION CONTACT: Judith C. Winkler of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, Attention: CC:LR:T (Telephone 202-566-3458, not a toll-free number). For information concerning the temporary regulations under section 755, contact Robert E. Shaw of the Legislation and Regulations Division,