

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602**

[TD 9452]

RIN 1545-BB28

Application of Separate Limitations to Dividends From Noncontrolled Section 902 Corporations**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final regulations, temporary regulations, and removal of temporary regulations.

SUMMARY: This document contains final regulations regarding the application of separate foreign tax credit limitations to dividends received from noncontrolled section 902 corporations. The American Jobs Creation Act of 2004 (AJCA) modified the treatment of such dividends effective for taxable years beginning after December 31, 2002. The Gulf Opportunity Zone Act of 2005 (GOZA) permits taxpayers to elect to defer the effective date of the AJCA amendments until taxable years beginning after December 31, 2004. The final regulations provide guidance needed to comply with these changes and affect corporations claiming foreign tax credits.

DATES: *Effective Date:* These regulations are effective on June 11, 2009.

Applicability Dates: For dates of applicability, see §§ 1.861-9(k), 1.861-12(c)(5), 1.902-1(g), 1.904-2(h)(1) and (2), 1.904-4(n), 1.904-5(o)(2), 1.904-7(f)(10), 1.904(f)-12(g)(5), and 1.964-1(d).

FOR FURTHER INFORMATION CONTACT: Richard Chewning at (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION**Paperwork Reduction Act**

The collections of information contained in the final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork and Reduction Act (44 U.S.C. 3507(d)) under control number 1545-2014. The collections of information in the final regulations are in §§ 1.904-7(f)(9)(ii)(C) and 1.964-1(c)(3). This information is required, with respect to § 1.904-7(f)(9)(ii)(C), to notify the IRS that taxpayer has made the election to defer the applicability of the provisions of section 403 of the AJCA. With respect to § 1.964-1(c)(3), this information is required to notify the IRS and domestic shareholders of a foreign corporation of

elections made to adopt or change a method of accounting or taxable year of the foreign corporation.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

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

Background

On April 20, 2006, a notice of proposed rulemaking by cross-reference to temporary regulations (REG-144784-02) under sections 861, 902, 904, and 964 of the Code and temporary regulations (TD 9260) (the 2006 temporary regulations) were filed with the Office of the Federal Register. On April 25, 2006, the notice of proposed rulemaking by cross-reference to temporary regulations and the 2006 temporary regulations were published in the **Federal Register** (71 FR 24543 and 71 FR 24516, respectively). Corrections to the 2006 temporary regulations were published on August 21, 2006, and December 26, 2006, in the **Federal Register** (71 FR 48474 and 71 FR 77264, respectively). Comments were received. A public hearing was not requested and none was held. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation and Summary of Comments

The IRS and the Treasury Department received written comments on the 2006 temporary regulations. Those comments are discussed in this preamble. These new regulations make several changes to the 2006 temporary regulations to take into account comments received, while adopting without amendment most of the temporary regulations. The significant comments and revisions are described in this preamble.

I. Interest Expense Apportionment**A. Interest Expense of a 10/50 Corporation**

Section 904(d)(4)(A), as amended by the AJCA, provides that any dividend paid by a noncontrolled section 902 corporation (10/50 corporation) shall be treated as income in a separate category based on the separate category of the underlying earnings and profits being distributed (look-through treatment),

effective for taxable years beginning after December 31, 2002 (post-2002 taxable years), without regard to when the distributed earnings were accumulated. For purposes of apportioning interest expense of a 10/50 corporation in order to apply the dividend look-through rule, § 1.861-9T(f)(4) of the 2006 temporary regulations generally applies the same principles as § 1.861-9T(f)(3) (apportionment of interest expense of a controlled foreign corporation). Under these rules, interest expense of a 10/50 corporation may be apportioned using either the asset method or the modified gross income method. Regardless of the interest expense apportionment methods used by its majority domestic corporate shareholders, the 10/50 corporation (or the majority domestic corporate shareholders on behalf of the 10/50 corporation) may elect to use any of the methods described in § 1.861-9T or § 1.861-9 (that is, the modified gross income, tax book value, alternative tax book value or fair market value method) to apportion the 10/50 corporation's interest expense.

Section 1.861-9T(j)(1) provides a rule for "tiering up" the income of tiers of controlled foreign corporations (CFCs) that use the modified gross income method to apportion interest expense. Under that rule, the lowest-tier CFC's interest expense is allocated and apportioned based on its gross income, and its gross income reduced by such allocated and apportioned interest expense is then treated as gross income of the next-higher-tier CFC for purposes of apportioning the higher-tier CFC's interest expense. These steps are then essentially repeated, moving up the tiers. A commenter requested that the IRS and the Treasury Department clarify the mechanics of apportioning interest expense when tiered corporations elect different apportionment methods. This commenter raises issues that are beyond the scope of this regulation project and therefore are not addressed in this document.

B. Definition of "10 Percent Owned Corporation"

Prior to revision by the 2006 temporary regulations, § 1.861-12T(c)(2) required an affiliated group using the tax book value method in apportioning its interest expense to adjust the basis of stock in any "10 percent owned corporation" that is held directly by members of the group to reflect each member's pro rata share of such 10 percent owned corporation's earnings and profits (or deficit in earnings and profits). The rule, as revised by the 2006 temporary regulations, applies to stock

of a 10 percent owned corporation not only where its stock is held directly by members of the affiliated group, but also where its stock is held indirectly through a partnership or other pass-through entity. The revision was effective on April 25, 2006, and applied prospectively. The IRS and the Treasury Department stated in the preamble to the 2006 temporary regulations that the revision was a clarification.

A commenter questioned why the regulations include a prospective, rather than a retroactive, effective date, if the revision clarified existing law. The IRS and the Treasury Department maintain that the revision is a clarification of existing law but continue to believe a prospective effective date is appropriate because the prior regulations were ambiguous.

II. Carryover of Unused Foreign Taxes Under Section 904(c)

In the case of unused foreign taxes attributable to dividends from a 10/50 corporation with respect to which the taxpayer was no longer a qualifying shareholder as of the first day of the taxpayer's first taxable year ending after the first day of the 10/50 corporation's first post-2002 taxable year, § 1.904-2T(h)(1) provides that the unused foreign taxes are allocated among the taxpayer's separate categories in the same percentages as the earnings in the 10/50 corporation's non-look-through pool or pre-1987 accumulated profits "would have been assigned had they been distributed in the last taxable year in which the taxpayer was a domestic shareholder in such corporation." In response to a comment, § 1.904-2(h)(1) of the final regulations clarifies that such taxes will be allocated as if look-through treatment applied in the year of the hypothetical distribution.

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

A. General Application of Look-Through

With respect to applying the look-through rule to any dividend paid by a 10/50 corporation in a post-2002 taxable year, § 1.904-5T(c)(4)(iii) of the 2006 temporary regulations provides that any dividends paid in a post-2002 taxable year to a domestic corporation by a 10/50 corporation with respect to which the domestic corporation meets the stock ownership requirements of section 902(a) are treated as income in a separate category in proportion to the ratio of the portion of earnings and profits of the 10/50 corporation attributable to income in such category to the total amount of earnings and profits of the 10/50 corporation.

A commenter expressed concern that in some cases, where a domestic shareholder meets the stock ownership requirements of section 902(a) but has a relatively small ownership interest, the administrative burden on both the taxpayer and the IRS of applying look-through to earnings and foreign taxes in a 10/50 corporation's look-through pools could be significant. The commenter asserted that the process of obtaining and analyzing multiple years of historical financial data to ascertain the exact portion of distributions that relate to specific categories of income can be challenging, particularly where distributions relate to earnings from certain historical periods (for example, those during which the taxpayer did not own stock in the 10/50 corporation). The commenter indicated that the reconstruction and safe harbor methods provided in § 1.904-7T(f)(4)(i) and (ii) of the 2006 temporary regulations, respectively, reduce difficulties in reconstructing historical accumulated earnings and taxes accounts of a 10/50 corporation, but those rules apply only to undistributed earnings and taxes accumulated in non-look-through periods and do not apply to distributions of earnings accumulated in look-through pools. The commenter suggested that the IRS and the Treasury Department consider providing an elective safe harbor approach for domestic shareholders who own a relatively small interest, such as 15 percent or less, in the 10/50 corporation, which would characterize a dividend paid by a 10/50 corporation as income in a separate category by reference to the gross revenue of the 10/50 corporation for the last three years or a similar abbreviated period, with anti-abuse rules to address distortions.

The IRS and the Treasury Department recognize that in some circumstances a domestic shareholder of a 10/50 corporation (as well as a noncontrolling shareholder of a controlled foreign corporation (CFC)) may face difficulties in substantiating accumulated earnings and taxes accounts of the 10/50 corporation (or CFC) on a look-through basis. However, the IRS and the Treasury Department believe use of a safe harbor is appropriate only as a limited rule for reconstructing earnings and taxes accumulated during prior year periods when the look-through rules did not apply to dividends from 10/50 corporations. An ongoing safe harbor is not appropriate because the statutory look-through rules, which apply to all domestic shareholders meeting the stock ownership requirements of section 902(a) (that is, 10 percent), generally

require substantiation, and if the look-through treatment of a dividend from a 10/50 corporation has not been adequately substantiated, section 904(d)(4)(C)(ii) requires that such dividend be treated as passive income. See also § 1.904-5T(c)(4)(iii) of the 2006 temporary regulations.

B. Substantiation of Look-Through Treatment

Section 1.904-5T(c)(4)(iii) of the 2006 temporary regulations provides that a dividend from a 10/50 corporation is treated as passive income if the look-through characterization of the dividend is not substantiated to the satisfaction of the Commissioner.

A commenter expressed concern that if a 10/50 corporation has high-taxed income outside the general and passive categories a taxpayer may intentionally fail to substantiate the look-through characterization of a dividend from the 10/50 corporation in order to achieve cross-crediting. The commenter suggested that the final regulations include an anti-abuse rule for situations where the Commissioner determines that a taxpayer deliberately failed to substantiate the look-through characterization of the dividend. The commenter suggested that the anti-abuse rule could provide that in such a situation the earnings and associated taxes would be placed in a separate sub-basket to prevent cross-crediting. Alternatively, the commenter suggested that the final regulations could apply rules similar to the rules of section 907. Finally, the commenter suggested that the inadequate substantiation rule in § 1.904-5T(c)(4)(iii) should be revised to conform to the rule in § 1.904-7T(f)(4)(iii), which provides that the Commissioner will allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's passive category only if the Commissioner determines that the look-through characterization of such earnings and taxes cannot reasonably be determined based on the available information. The IRS and the Treasury Department agree with this latter suggestion, and the rule in § 1.904-5(c)(4)(iii) of the final regulations adopts this comment.

C. Application of Section 904(h) to 10/50 Corporations

For purposes of the section 904 foreign tax credit limitation, section 904(h) (section 904(g) prior to redesignation in the AJCA) provides that certain income derived from a United States-owned foreign corporation which would be treated as foreign source income under other Code provisions is

treated as U.S. source income. This resourcing rule applies to certain payments of interest and dividends by a United States-owned foreign corporation as well as inclusions in gross income under sections 951(a) and 1293 to the extent the payments or inclusions are attributable to income of the United States-owned foreign corporation from sources within the United States. Section 904(h)(6) generally defines a United States-owned foreign corporation as any foreign corporation if United States persons (as defined in section 7701(a)(30)) hold 50 percent or more of either the total combined voting power of all classes of voting stock or the total value of the stock.

Section 1.904-5(m) provides rules for the resourcing of certain amounts received or accrued (or treated as received or accrued) by a United States shareholder (as defined in section 951(b)) from a United States-owned foreign corporation. Section 1.904-5T(m)(1) of the 2006 temporary regulations clarified that the resourcing rule applies not only to CFCs but also to 10/50 corporations that meet the definition of a United States-owned foreign corporation, and § 1.904-5T(m)(2)(ii) and (4) provide rules for resourcing interest and dividend payments from 10/50 corporations.

In the preamble to the 2006 temporary regulations, the IRS and the Treasury Department stated that this revision clarified that the rules for resourcing interest and dividends also apply to a 10/50 corporation that meets the definition of a United States-owned foreign corporation.

A commenter suggested that the inclusion of 10/50 corporations within the resourcing rule of § 1.904-5T(m) was not simply a clarification and that the combination of referring to this provision as only a clarification and the prospective application of the rule is confusing. In addition, the commenter requested guidance on the appropriate treatment of dividends from 10/50 corporations for 2003 through 2006 under section 904(h) (section 904(g) as applicable for those years). The commenter suggested that § 1.904-5T(m) be made retroactive to 2003 (or 2005 for taxpayers electing to apply the pre-AJCA section 904(d) rules to assign dividends paid by 10/50 corporations in their 2003 and 2004 taxable years to a single separate category for dividends from all 10/50 corporations) to match the retroactive effective date of the statutory changes to the look-through rules for 10/50 corporations and of the § 1.904-7T rules for reconstructing non-look-through pools.

This comment is not adopted. The IRS and the Treasury Department continue to believe that the revision is a clarification of existing law. A retroactive effective date is unnecessary, however, because the statute provides the applicable rule.

A commenter suggested that, because section 904(h) applies exactly the same rule to both section 951(a) and section 1293 inclusions, § 1.904-5(m)(5) (other than the special rules for related person interest expense which are incorporated by cross-reference) should also reference section 1293 inclusions from United States-owned 10/50 corporations. The IRS and the Treasury Department agree, and § 1.904-5(m)(5) of the final regulations adopts this comment.

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

i. Reconstruction Method

Section 1.904-7T(f)(2) of the 2006 temporary regulations provides that any undistributed earnings and foreign income taxes in the non-look-through pools of a 10/50 corporation that were accumulated and paid as of the end of the 10/50 corporation's last pre-2003 taxable year are treated as if they were accumulated and paid during a period in which a distribution would have been eligible for look-through treatment. Section 1.904-7T(f)(4)(i) of the 2006 temporary regulations provides that in order to substantiate the look-through characterization of the earnings and taxes in the non-look-through pools, the taxpayer must make a reasonable, good-faith effort to reconstruct the non-look-through pools of earnings and taxes for each year in the non-look-through period, beginning with the first year in which earnings were accumulated in the non-look-through pool. Section 1.904-7T(f)(4)(i) further provides that reconstruction will be based on reasonably available books and records and other relevant information, and must take into account earnings distributed and taxes deemed paid in the non-look-through period as if they were distributed and deemed paid pro rata from the amounts that were added to the non-look-through pools during the non-look-through period.

In recognition of the difficulty in reconstructing the pools, the IRS and the Treasury Department stated in the preamble to the 2006 temporary regulations that a reasonable approximation of the amounts properly included in the look-through pools, based on available records obtained through reasonable, good-faith efforts by the taxpayer, will adequately

substantiate the reconstruction required by the statute.

A commenter suggested that clarification of what constitutes other relevant information would be helpful. The IRS and the Treasury Department do not adopt this comment because the substantiation requirement requires evaluation of the facts and circumstances of each situation.

With respect to earnings accumulated and foreign taxes paid in the 2003 through 2006 taxable years, a commenter suggested that the rules in the 2006 temporary regulations concerning the look-through characterization and reconstruction of earnings and taxes in the non-look-through pools need to be clarified to provide that taxpayers are required to determine the sub-characterization of earnings and taxes, if relevant. As an example, the commenter stated that if a 10/50 corporation conducts a financing business but does not itself qualify as a financial services entity within the meaning of § 1.904-4(e)(3)(i), a qualifying shareholder of the 10/50 corporation must (if the shareholder does not elect the safe harbor method) determine what portion of the non-look-through earnings qualify as active financing income as defined in § 1.904-4(e)(2)(i). Such a determination would be necessary in order to determine whether the income would be placed in the separate category for financial services income upon distribution to an upper-tier financial services entity. The IRS and the Treasury Department agree with this comment that sub-characterization of earnings and taxes is required, if relevant, in determining the look-through characterization of earnings and taxes in the non-look-through pools and in reconstructing such pools. However, the IRS and the Treasury Department believe that the 2006 temporary regulations already require reconstruction as if look-through applied for all section 904 purposes, including any relevant sub-characterization of the earnings and taxes pools. Accordingly, the final regulations adopt the rule in the 2006 temporary regulations without change.

ii. Safe Harbor

Section 1.904-7T(f)(4)(ii) of the 2006 temporary regulations provides a safe harbor in reconstructing the non-look-through pools under which a taxpayer may allocate the earnings and taxes in the non-look-through pools ratably to the look-through pools on the first day of the 10/50 corporation's first post-2002 taxable year in the same percentages as the taxpayer (or the qualified group member that owns the

10/50 corporation) properly characterizes the stock of the 10/50 corporation in the separate categories for purposes of apportioning the taxpayer's (or qualified group member's) interest expense in its first taxable year ending after the first day of the 10/50 corporation's first post-2002 taxable year. If a taxpayer elects to use the safe harbor method with respect to a 10/50 corporation that uses the modified gross income method to apportion interest expense for the 10/50 corporation's first post-2002 taxable year, earnings and taxes in the non-look-through pools are allocated to the look-through pools based on an average of the 10/50 corporation's modified gross income ratios for its taxable years beginning in 2003 and 2004. The IRS and the Treasury Department stated in the preamble to the 2006 temporary regulations that the two-year base period rule is necessary to avoid potential distortions associated with allocating earnings and taxes from the non-look-through pool to the look-through pools based on the 10/50 corporation's modified gross income for just one taxable year.

A commenter suggested that other potential distortions are not addressed in § 1.904-7T(f)(4)(ii), such as instances in which a material change in the foreign corporation's operations (or asset composition) would distort the characterization of the non-look-through earnings and taxes under the safe harbor method. The commenter suggested that conditioning the use of the safe harbor method on the lack of any material change in the foreign corporation's operations, structure, assets or income from the non-look-through period would reduce the likelihood of a distortion.

The IRS and the Treasury Department acknowledge that the safe harbor method does not address all potential distortions. However, the purpose of the safe harbor method is to provide certainty and to minimize administrative burdens. The IRS and the Treasury Department believe that revising the safe harbor method to reflect the commenter's suggestion would diminish these benefits of the safe harbor method.

A commenter also suggested that the regulations should include guidance on how the safe harbor method election is to be made and the time frame for making the election. The commenter suggested that taxpayers should be allowed to elect the safe harbor method retroactively, on an amended return or during audit.

The IRS and the Treasury Department agree with this comment. The final

regulations provide that taxpayers may choose to use the safe harbor method on either timely filed or amended tax returns or during audit. However, if a taxpayer chooses to use the safe harbor method on an amended return or in the course of an audit, the taxpayer must make appropriate adjustments to eliminate any duplicate benefits arising from application of the safe harbor method to taxable years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by simply employing the method. No separate statement need be filed.

In addition, the final regulations clarify that the safe harbor method is only available as a transition rule for taxpayers who were required to characterize the stock of the foreign corporation for purposes of apportioning interest expense in the taxpayer's first taxable year ending after the first day of the foreign corporation's first post-2002 taxable year. The safe harbor is not available to determine the look-through treatment of earnings accumulated by a foreign corporation that did not have a shareholder that was entitled to look-through treatment in such a year.

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

Section 1.904-7T(f)(5) of the 2006 temporary regulations provides that if there is an accumulated deficit in the non-look-through pool of a 10/50 corporation or a CFC as of the end of the foreign corporation's last pre-2003 taxable year, the deficit and associated taxes, if any, are treated as if they had been accumulated and paid during a look-through period. The earnings and deficits in earnings making up the accumulated deficit are assigned to the look-through pools based on where the foreign corporation's income and expenses or losses would have been assigned had they been incurred during a look-through period, or, if the taxpayer uses the safe harbor method, the deficit is allocated based on how the stock of the foreign corporation is properly characterized for interest expense apportionment purposes.

A commenter suggested that the regulations should clarify that, for shareholders not using the safe harbor method, one or more separate income categories could have positive earnings, while one or more separate income categories could have a greater deficit. Thus, for example, if a 10/50 corporation had a \$100 deficit accumulated in its non-look-through pool as of the end of its last pre-2003 taxable year, the deficit could consist of

a \$200 deficit in general limitation income and \$100 earnings in the separate category for shipping income.

The IRS and the Treasury Department believe that § 1.904-7T(f)(5) of the 2006 temporary regulations is clear that, as part of reconstruction of a non-look-through pool that contains an accumulated deficit, one or more separate income categories could have positive earnings, while one or more separate income categories could have a greater deficit, and that therefore, the rule does not need to be revised to reflect the comment.

iv. Section 952(c) Recapture Accounts

In response to a comment, § 1.904-7(f)(7) of the final regulations provides that section 952(c)(2) recapture accounts maintained by a CFC with respect to dividends received from a 10/50 corporation that were subject to the earnings and profits limitation of section 952(c)(1) are allocated to separate categories in the same manner as the associated post-1986 undistributed earnings.

v. GOZA Election

Conforming changes are made to the transition rules at § 1.904-7(f)(9) for taxpayers electing to defer the applicability of the look-through rules for two years to reflect changes in response to comments made with respect to the general transition rules of § 1.904-7(f)(7).

E. Pre-Acquisition E&P

Section 904(d)(4)(C)(i)(II), as amended by the AJCA, provides that the Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits of a 10/50 corporation for periods before the taxpayer's acquisition of the stock to which the distributions relate (pre-acquisition E&P). Such distributions may be out of post-1986 undistributed earnings accumulated by a 10/50 corporation before the specific shareholder acquired its stock or out of pre-1987 accumulated profits accumulated before the 10/50 corporation had any qualifying shareholder. The 2006 temporary regulations extend look-through treatment to dividends out of earnings and profits accumulated in non-look-through periods during which a 10/50 corporation or a CFC had no qualifying shareholder and do not restrict look-through treatment of dividends paid to a new qualifying shareholder of an existing 10/50 corporation. The preamble to the 2006 temporary regulations stated that the IRS and the Treasury Department believe that look-

through treatment of pre-acquisition earnings is the more appropriate policy result than passive category treatment, if look-through characterization can be adequately substantiated under §§ 1.904–5T(c)(4)(iii) and 1.904–7T(f)(4).

A commenter suggested that the extension of look-through treatment to pre-acquisition E&P is inappropriate because the liberalized cross-crediting of foreign taxes permitted by this treatment may encourage tax-motivated acquisitions in order to traffic in excess foreign taxes. The commenter suggested that the IRS and the Treasury Department exercise the regulatory authority under section 904(d)(4)(C)(i)(II) to create new separate categories for pre-acquisition earnings and profits.

This comment is not adopted. The IRS and the Treasury Department continue to believe that look-through treatment of pre-acquisition earnings, where the earnings and taxes are substantiated, is the more appropriate policy result. Moreover, denying look-through treatment to dividends of earnings of a 10/50 corporation accumulated prior to a specific shareholder's acquisition of stock entails unacceptable administrative complexity associated with maintaining multiple sets of look-through pools starting on different dates for different shareholders. Accordingly, the final regulations adopt the rule in the 2006 temporary regulations without change.

IV. Recapture of an Overall Foreign Loss or Separate Limitation Loss Incurred in a Separate Category for Dividends From a 10/50 Corporation

Section 1.904(f)–12T(g)(1) of the 2006 temporary regulations provides that where a taxpayer had an overall foreign loss (OFL) or separate limitation loss (SLL) in a separate category for dividends from a 10/50 corporation, the OFL or SLL account is recaptured in subsequent taxable years out of income in the same separate categories in which the stock of the 10/50 corporation is properly characterized for purposes of apportioning the taxpayer's interest expense in its first taxable year in which dividends from the 10/50 corporation are eligible for look-through treatment (that is, its first taxable year ending after the first day of the 10/50 corporation's first post-2002 taxable year).

A commenter suggested that a rule providing for recapture of the OFL or SLL from the other separate categories in the same proportions that post-OFL or SLL dividends from the 10/50 corporation would have been assigned to such other separate categories had look-through applied would be more

consistent with § 1.904–2T(h)(1) and (2) (carryovers of excess foreign taxes from 10/50 baskets) and § 1.904–7T(f)(2) and (3) (characterization of non-look-through pools as if look-through had applied) that generally take the approach of following the consequences that would have applied if look-through had always been in effect. This comment is not adopted. The IRS and the Treasury Department stated in the preamble to the 2006 temporary regulations and continue to believe that recapturing losses from income earned in subsequent years is a forward-looking concept, and that reallocating OFL and SLL accounts based on the interest expense apportionment ratio (as opposed to, for example, reallocating losses based on reconstructed non-look-through pools) is consistent with that concept.

V. Regulations Under Section 964

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

The 2006 temporary regulations at § 1.964–1T(c)(2) and (3) provide rules allowing the majority domestic corporate shareholders of a 10/50 corporation to make an election, adopt a method of accounting or taxable year, or change a method of accounting or taxable year on behalf of the 10/50 corporation. The 2006 temporary regulations also allow the controlling United States shareholders of a CFC to make an election, adopt a method of accounting or taxable year, or change a method of accounting or taxable year on behalf of the CFC. Section 1.964–1T(c)(2) provides that for the first taxable year of a foreign corporation beginning after April 25, 2006, in which such foreign corporation first qualifies as a CFC or 10/50 corporation, any method of accounting or taxable year allowable under this section may be adopted or elected by such foreign corporation or on its behalf notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. Section 1.964–1T(c)(6) further provides that such actions may be deferred until the first year in which the computation of the foreign corporation's earnings and profits is significant for U.S. tax purposes, and includes a nonexclusive list of significant events for taxable years beginning after April 25, 2006.

Section 1.964–1T(c)(4) of the 2006 temporary regulations acknowledges that a 10/50 corporation may have had a significant event in taxable years beginning on or before April 25, 2006, such as a distribution with respect to which the corporation's shareholder could claim a deemed-paid foreign tax credit under section 902. In order to determine the allowable foreign tax credit, at the time of the distribution the 10/50 corporation's domestic corporate shareholder would have had to compute the 10/50 corporation's earnings and profits, even though no procedure was then available for the controlling domestic shareholders to adopt or elect accounting methods on the 10/50 corporation's behalf. Section 1.964–1T(c)(4) provides that in this situation the 10/50 corporation's earnings and profits shall be computed as if no accounting method elections were made and any permissible accounting method not requiring an election and reflected in the books of account regularly maintained by the 10/50 corporation for purposes of accounting to its shareholders had been adopted. Thereafter, in taxable years beginning after April 25, 2006, the 10/50 corporation, or its controlling domestic shareholders, must obtain the consent of the Commissioner in order to change a particular accounting method or methods (or its taxable year) pursuant to the applicable revenue procedure. A commenter suggested that in post-2006 years the controlling domestic shareholders of a 10/50 corporation should be permitted to change accounting methods on its behalf without obtaining the consent of the Commissioner or making adjustments to the 10/50 corporation's earnings and profits under the principles of section 481 to prevent the duplication or omission of amounts attributable to previous years. This comment is not adopted. The IRS and the Treasury Department believe that it would be inappropriate to give the controlling domestic shareholders of a 10/50 corporation this type of "fresh start."

A commenter recommended simplifying the procedures in § 1.964–1T(c)(3) of the 2006 temporary regulations by which controlling domestic shareholders may make an election or adopt or change a method of accounting or taxable year on behalf of a foreign corporation. Specifically, the commenter suggested that § 1.964–1T(c)(3)(i) and (ii) be revised to provide that where a United States shareholder changes a method of accounting on behalf of a CFC of which it is the sole shareholder, such shareholder need file

only the original Form 3115 with its tax return, and need not file the statement (described in § 1.964–1T(c)(3)(ii)) that is required to be filed with each controlling domestic shareholder's tax return. The IRS and the Treasury Department agree with the comment and believe it is equally applicable to changes in the taxable year of the CFC. Accordingly, § 1.964–1(c)(3)(ii) of the final regulations provides that in the case of a controlling domestic shareholder that is the sole shareholder of a CFC, no separate statement need be filed if the information described in § 1.964–1(c)(3)(ii) is included on Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) and Form 3115 (Application for Change in Accounting Method) or Form 1128 (Application to Adopt, Change or Retain a Tax Year), as applicable, filed with respect to the CFC with the shareholder's return for such taxable year.

B. Section 481(a) Adjustments

Prior to its expiration, § 1.964–1T(g)(5) provided that adjustments to the appropriate separate category of earnings and profits and income of the controlled foreign corporation was required using the principles of section 481(a) to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any election or adoption of a method of accounting. This provision was cross-referenced in § 1.964–1T(c)(4) of the 2006 temporary regulations. Commenters requested clarification regarding the mechanics of making the adjustments according to the principles of section 481(a), such as the period over which the section 481(a) adjustment is spread and whether a correlative section 481(a) adjustment should be made at the domestic shareholder level in order to capture an increased subpart F inclusion that would have been generated had earnings and profits initially been determined using the method subsequently elected or adopted. One commenter suggested that the regulations state specifically that the applicable domestic principles should apply so that the section 481 adjustment would be taken into account in determining the current earnings and profits of the CFC or 10/50 corporation beginning with the year of change and for the same period as the adjustment is taken into account for purposes of computing taxable income.

In response to the comment, § 1.964–1(c)(2) of the final regulations provides that adjustments to the appropriate separate category (as defined in § 1.904–

5(a)(1)) of earnings and profits and income of the foreign corporation shall be required under section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any change in a method of accounting. The details concerning the section 481 adjustment are addressed in applicable revenue procedures. See, for example, Rev. Proc. 2008–52, 2008–36 IRB 587.

C. Miscellaneous Cross-References

The 2006 temporary regulations included in § 1.964–1T(c)(4) cross-references to expired § 1.964–1T(g) that are updated in the final regulations. In addition, § 1.964–1(c)(2) of the final regulations adds cross-references to §§ 1.985–5, 1.985–6, and 1.986–7, which provide that a qualified business unit must make adjustments to its earnings and profits when it changes its functional currency or begins to use the dollar approximate separate transactions method of accounting.

Section 1.964–1(b)(1)(v) includes a cross-reference to “paragraph (d) of this section.” Because of revisions to § 1.964–1, that cross-reference and a similar cross-reference in § 1.989(b)–1 were no longer effective. The final regulations replace the cross-references to paragraph (d) with the appropriate cross-reference to section 988 and the regulations under that section.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of 5 U.S.C. chapter 5 does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act, 5 U.S.C. chapter 6, does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation and temporary regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal authors of the final regulations are Richard Chewning and Jeffrey Parry of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

■ **Par. 2.** Section 1.861–9 is amended by removing paragraphs (h)(5)(iii) and (i)(4), revising paragraphs (a), (b), (c), (d), (e), (f), and (g)(1)(i), and adding paragraph (k), to read as follows:

1.861–9 Allocation and apportionment of interest expense.

(a) through (f)(3)(i) [Reserved]. For further guidance, see § 1.861–9T(a) through (f)(3)(i).

(f)(3)(ii) *Manner of election.* The election shall be made by filing the statement and providing the written notice described in § 1.964–1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein. For further guidance, see § 1.861–9T(f)(3)(ii).

(f)(3)(iii) and (iv) [Reserved]. For further guidance, see § 1.861–9T(f)(3)(iii) and (iv).

(4) *Noncontrolled section 902 corporations—(i) In general.* For purposes of computing earnings and profits of a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)) for Federal tax purposes, the interest expense of a noncontrolled section 902 corporation may be apportioned using either the asset method described in § 1.861–9T(g) or the modified gross income method described in § 1.861–9T(j). A noncontrolled section 902 corporation that is not a controlled foreign corporation may elect to use a different method of apportionment than that elected by one or more of its shareholders. A noncontrolled section 902 corporation must use the same method of apportionment with respect to all its domestic corporate shareholders.

(ii) *Manner of election.* The election to use the asset method described in § 1.861–9T(g) or the modified gross income method described in § 1.861–9T(j) may be made either by the

noncontrolled section 902 corporation or by the majority domestic corporate shareholders (as defined in § 1.964-1(c)(5)(ii)) on behalf of the noncontrolled section 902 corporation. The election shall be made by filing the statement and providing the written notice described in § 1.964-1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein. For further guidance, see § 1.861-9T(f)(4)(ii).

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

(f)(5) through (g)(1)(i) [Reserved]. For further guidance, see § 1.861-9T(f)(5) through (g)(1)(i).

* * * * *

(k) *Effective/applicability date.* Paragraph (h)(5) of this section applies to taxable years beginning after December 31, 1989. Paragraph (i) of this section applies to taxable years beginning on or after March 26, 2004. Paragraphs (f)(3)(ii) and (4) of this section apply to taxable years of shareholders ending on or after April 20, 2009. See 26 CFR 1.861-9T(f)(3)(ii)(last sentence) and (4) (revised as of April 1, 2009) for rules applicable to taxable years of shareholders ending after the first day of the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009.

■ **Par. 3.** Section 1.861-9T is amended as follows:

- 1. Remove paragraph (b)(6)(viii).
- 2. Revise the last sentence of paragraph (f)(3)(ii) and paragraph (f)(4).
- 3. Add paragraph (k).

The revisions and additions read as follows:

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

* * * * *

(f) * * *

(3) * * *

(ii) * * * For guidance relating to the time and manner of this election, see § 1.861-9(f)(3)(ii).

* * * * *

(4) * * * For further guidance, see § 1.861-9(f)(4).

* * * * *

(k) *Effective/applicability dates.* Paragraph (b)(6) of this section applies to losses on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988. Paragraph (b)(6) of this section also applies to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after August 11, 1989. Taxpayers may also apply paragraph (b)(6) of this section to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988, and on or before August 11, 1989, if the taxpayer can demonstrate to the satisfaction of the Commissioner that substantially all of the arrangements described in paragraph (b)(6)(i) of this section to which the taxpayer became a party during that interim period were identified on the taxpayer's books and records with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses and expenses that are subject to the rules of paragraph (b)(6) of this section were treated in the same manner as interest expense. For this purpose, arrangements that were identified in a substantially contemporaneous manner with the taxpayer's assets shall be ignored. For further guidance, see § 1.861-9(k).

■ **Par. 4.** Section 1.861-12 is added as follows:

§ 1.861-12 Characterization rules and adjustments for certain assets.

(a) through (c)(1) [Reserved]. For further guidance, see § 1.861-12T(a) through (c)(1).

(2) *Basis adjustment for stock in nonaffiliated 10 percent owned corporations—* (i) *Taxpayers using the tax book value method—*(A) *General rule.* For purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned by the taxpayer either directly or, for taxable years beginning after April 25, 2006, indirectly through a partnership or other pass-through entity shall be—

(1) Increased by the amount of the earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock and accumulated during the period the taxpayer or other members of its affiliated group held 10 percent or more of such stock; or

(2) Reduced (but not below zero) by any deficit in earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock for such period.

(c)(2)(i)(B) through (c)(3) [Reserved] For further guidance, see § 1.861-12T(c)(2)(i)(B) through (c)(3).

(4) *Characterization of stock of noncontrolled section 902 corporations—*(i) *General rule.* The principles of § 1.861-12T(c)(3) shall apply to stock in a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)). Accordingly, stock in a noncontrolled section 902 corporation shall be characterized as an asset in the various separate limitation categories on the basis of either the asset method described in § 1.861-12T(c)(3)(ii) or the modified gross income method described in § 1.861-12T(c)(3)(iii). Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of assets shall be characterized in the hands of its domestic shareholders (as defined in § 1.902-1(a)(1)) under the asset method described in § 1.861-12T(c)(3)(ii). Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of gross income shall be characterized in the hands of its domestic shareholders under the gross income method described in § 1.861-12T(c)(3)(iii).

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

(5) *Effective/applicability date.* Paragraphs (c)(2)(i)(A) and (4) of this section apply to taxable years of shareholders ending on or after April 20, 2009. See 26 CFR § 1.861-12T(c)(2)(i) introductory text, (2)(i)(A), (2)(i)(B), and (4) (revised as of April 1, 2009) for rules applicable to taxable years of shareholders ending after the first day of the first taxable year of the

noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009.

(d) through (j) [Reserved]. For further guidance, see § 1.861-12T(d) through (j).

■ **Par. 5.** Section 1.861-12T is amended as follows:

■ 1. Paragraph (c)(2)(i) introductory text is removed.

■ 2. Paragraph (c)(2)(i)(A) is revised.

■ 3. Paragraph (c)(2)(i)(B) is removed.

■ 4. A paragraph heading is added to the undesignated text following paragraph (c)(2), which is designated as new paragraph (c)(2)(i)(B).

■ 5. Paragraph (c)(4) is revised.

■ 6. A new paragraph (c)(5) is added.

The revisions and additions read as follows:

§ 1.861-12T Characterization rules and adjustments for certain assets (temporary).

* * * * *

(c) * * *

(2)(i)(A) [Reserved]. For further guidance, see § 1.861-12(c)(2)(i)(A).

(B) *Computational rules.* * * *

(4) [Reserved]. For further guidance, see § 1.861-12(c)(4).

(5) [Reserved]. For further guidance, see § 1.861-12(c)(5).

* * * * *

■ **Par. 6.** Section 1.902-1 is amended by revising paragraphs (a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), (c)(8), (d)(1), (d)(2)(i), and (g) to read as follows:

§ 1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) * * *

(4) * * *

(ii) *Fourth-, fifth-, or sixth-tier corporation.* In the case of dividends paid to a third-, fourth-, or fifth-tier corporation by a foreign corporation in a taxable year beginning after August 5, 1997, the foreign corporation is a fourth-, fifth-, or sixth-tier corporation, respectively, if at the time the dividend is paid, the corporation receiving the dividend owns at least 10 percent of the foreign corporation's voting stock, the chain of foreign corporations that includes the foreign corporation is connected through stock ownership of at least 10 percent of their voting stock, the domestic shareholder in the first-tier corporation in such chain indirectly owns at least 5 percent of the voting stock of the foreign corporation through such chain, such corporation is a controlled foreign corporation (as defined in section 957) and the domestic shareholder is a United States shareholder (as defined in section 951(b)) in the foreign corporation. Taxes paid by a fourth-, fifth-, or sixth-tier

corporation shall be taken into account in determining post-1986 foreign income taxes only if such taxes are paid with respect to taxable years beginning after August 5, 1997, in which the corporation was a controlled foreign corporation.

* * * * *

(6) *Upper- and lower-tier corporations.* In the case of a sixth-tier corporation, the term *upper-tier corporation* means a first-, second-, third-, fourth-, or fifth-tier corporation. In the case of a fifth-tier corporation, the term *upper-tier corporation* means a first-, second-, third-, or fourth-tier corporation. In the case of a fourth-tier corporation, the term *upper-tier corporation* means a first-, second-, or third-tier corporation. In the case of a third-tier corporation, the term *upper-tier corporation* means a first- or second-tier corporation. In the case of a second-tier corporation, the term *upper-tier corporation* means a first-tier corporation. In the case of a first-tier corporation, the term *lower-tier corporation* means a second-, third-, fourth-, fifth-, or sixth-tier corporation. In the case of a second-tier corporation, the term *lower-tier corporation* means a third-, fourth-, fifth-, or sixth-tier corporation. In the case of a third-tier corporation, the term *lower-tier corporation* means a fourth-, fifth-, or sixth-tier corporation. In the case of a fourth-tier corporation, the term *lower-tier corporation* means a fifth- or sixth-tier corporation. In the case of a fifth-tier corporation, the term *lower-tier corporation* means a sixth-tier corporation.

(7) *Foreign income taxes.* The term *foreign income taxes* means income, war profits, and excess profits taxes as defined in § 1.901-2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See section 901(f) and (i) and paragraph (c)(5) of this section. Foreign income, war profits, and excess profits taxes also shall not include taxes for which a credit is disallowed under section 901 and the regulations under section 901. See section 901(j), (k), and (l), and paragraphs (c)(4) and (8) of this section.

(8) *Post-1986 foreign income taxes—*
(i) *In general.* Except as provided in

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

the term *year* means that accounting period. See sections 441(b)(3) and 443.

* * * * *

(c) * * *

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

(ii) *Example.* The following examples illustrate the application of this paragraph (c)(8):

Example. P, a domestic corporation, has owned 100 percent of the voting stock of foreign corporation S at all times since January 1, 1987. Until June 30, 2002, S owned 100 percent of the voting stock of foreign corporation T, T owned 100 percent of the voting stock of foreign corporation U, and U owned 100 percent of the voting stock of foreign corporation V. P, S, T, U, and V each use the calendar year as their U.S. taxable year. Thus, beginning in 1998 V was a fourth-tier controlled foreign corporation, and its foreign taxes paid or accrued in 1998 and later taxable years were eligible to be deemed paid. On June 30, 2002, T was liquidated, causing S to acquire 100 percent of the stock of U. As a result, V became a third-tier controlled foreign corporation. In

2003, V paid a dividend to U. Under paragraph (c)(8) of this section, foreign taxes paid by V in taxable years beginning before 1998 are not taken into account in computing the foreign taxes deemed paid with respect to the dividend paid by V to U.

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

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

(ii) A domestic shareholder from a first-tier corporation that is a noncontrolled section 902 corporation;

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

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

(2) *Look-through*—(i) *Dividends.* Any dividend distribution by a controlled foreign corporation or noncontrolled section 902 corporation to a domestic shareholder or a foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1) shall be deemed paid pro rata out of each separate category of income. Any dividend distribution by a controlled foreign corporation to a controlled foreign corporation that is a related look-through entity within the meaning of § 1.904-5(i)(3) shall also be deemed to be paid pro rata out of each separate category of income. See §§ 1.904-5(c)(4) and (i), and 1.904-7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

$$\frac{\text{Foreign taxes deemed paid by domestic shareholder or upper-tier corporation with respect to a separate category}}{\text{Post-1986 foreign income taxes of first-tier or lower-tier corporation allocated and apportioned to the separate category under § 1.904-6}} \times \frac{\text{Dividend amount attributable to the separate category}}{\text{Post-1986 undistributed earnings of first-tier or lower-tier corporation in the separate category}}$$

(g) *Effective/applicability dates.* This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987, except that the provisions of paragraphs (a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), and (c)(8) of this section and, except as provided in § 1.904-7(f)(9), the provisions of paragraph (d) of this section apply to distributions made in taxable years of foreign corporations ending on or after April 20, 2009. See 26 CFR 1.902-1T(a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), and (c)(8) (revised as of April 1, 2009) for rules applicable to distributions made in taxable years of foreign corporations beginning after

April 25, 2006, and ending before April 20, 2009, and 26 CFR 1.902-1T(d), except as provided in 26 CFR 1.904-7T(f)(9) (revised as of April 1, 2009), for rules applicable to distributions made in taxable years of foreign corporations beginning after December 31, 2002, and ending before April 20, 2009.

§ 1.902-1T [Removed]

■ **Par. 7.** Section 1.902-1T is removed.

■ **Par. 8.** Section 1.904-0 is amended by revising the section heading and the entries for §§ 1.904-5(m), (m)(5), and (n), and 1.904-7(f) to read as follows:

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

* * * * *

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

* * * * *

(m) Application of section 904(h).

* * * * *

(5) *Treatment of inclusions under sections 951(a)(1)(A) and 1293.*

* * * * *

(n) Order of application of sections 904(d) and (h).

§ 1.904-7 Transition rules.

* * * *

(f) * * *

- (1) Definition of non-look-through pools.
- (2) Treatment of non-look-through pools of a noncontrolled section 902 corporation.
- (3) Treatment of non-look-through pools of a controlled foreign corporation.
- (4) Substantiation of look-through character of undistributed earnings and taxes in a non-look-through pool.
- (i) Reconstruction of earnings and taxes pools.
- (ii) Safe harbor method.
- (iii) Inadequate substantiation.
- (iv) Examples.
- (5) Treatment of a deficit accumulated in a non-look-through pool.
- (6) Treatment of pre-1987 accumulated profits.
- (7) Treatment of post-1986 undistributed earnings or a deficit of a controlled foreign corporation attributable to dividends from a noncontrolled section 902 corporation paid in taxable years beginning before January 1, 2003.
- (i) Look-through treatment of post-1986 undistributed earnings at controlled foreign corporation level.
- (ii) Look-through treatment of deficit in post-1986 undistributed earnings at controlled foreign corporation level.
- (iii) Substantiation required for look-through treatment.
- (8) Treatment of distributions received by an upper-tier corporation from a lower-tier noncontrolled section 902 corporation, including when the corporations do not have the same taxable years.
- (i) Rule.
- (ii) Example.
- (9) Election to apply pre-AJCA rules to 2003 and 2004 taxable years.
- (i) Definition.
- (ii) Time, manner, and form of election.
- (iii) Treatment of non-look-through pools in taxable years beginning after December 31, 2004.
- (iv) Carryover of unused foreign tax.
- (v) Carryback of unused foreign tax.
- (vi) Recapture of overall foreign loss or separate limitation loss in the single category for dividends from all noncontrolled section 902 corporations.
- (vii) Recapture of separate limitation losses in other separate categories.
- (viii) Treatment of undistributed earnings in an upper-tier corporation-level single category for dividends from lower-tier noncontrolled section 902 corporations.
- (ix) Treatment of a deficit in the single category for dividends from lower-tier noncontrolled section 902 corporations.
- (10) Effective/applicability date.

■ **Par. 9.** Section 1.904-2 is amended by revising paragraphs (a) and (h) to read as follows:

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

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under

that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(c). However, the taxes so deemed paid or accrued shall not be allowed as a deduction under section 164(a). Paragraphs (b) through (g) of this section and § 1.904-3, providing rules for the computation of carryovers and carrybacks, do not reflect a number of intervening statutory amendments, including the redesignation of section 904(d) as section 904(c) for taxable years beginning after 1975, amendments to sections 904(d) and (f) regarding the application of separate limitations in taxable years beginning after 1986, the limitation of the carryback period to one year for unused foreign taxes arising in taxable years beginning after October 22, 2004, and the extension of the carryover period to ten years for unused foreign taxes that may be carried to any taxable year ending after October 22, 2004. However, the principles of paragraphs (b) through (g) of this section and § 1.904-3(b) through (g) shall apply in determining carrybacks and carryovers of unused foreign taxes, modified so as to take into account the effect of statutory amendments. For transition rules relating to the carryover and carryback of unused foreign tax paid with respect to dividends from noncontrolled section 902 corporations, see paragraph (h) of this section. For special rules regarding these computations in case of taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907(f) and the regulations under that section.

* * * *

(h) *Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations—(1) Carryover of unused foreign tax.* Except as provided in §§ 1.904-7(f)(9)(iv) and 1.904(f)-12(g)(3), the rules of this paragraph (h)(1) apply to reallocate to the taxpayer's other separate categories any unused foreign taxes (as defined in paragraph (b)(2) of this section) that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation beginning before January 1, 2003, which taxes were subject to a separate limitation for dividends from that noncontrolled section 902 corporation. To the extent any such

unused foreign taxes are carried forward to a taxable year of a domestic shareholder beginning on or after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002, such taxes shall be allocated among the taxpayer's separate categories in the same proportions as the related dividend would have been assigned had such dividend been eligible for look-through treatment when paid. Accordingly, the taxes shall be allocated in the same percentages as the reconstructed earnings in the noncontrolled section 902 corporation's non-look-through pool and pre-1987 accumulated profits that were accumulated in taxable years beginning before January 1, 2003, out of which the dividend was paid, in accordance with the rules of § 1.904-7(f), or, if the taxpayer uses the safe harbor method of § 1.904-7(f)(4)(ii), in the same percentages as the taxpayer properly characterizes the stock of the noncontrolled section 902 corporation for purposes of apportioning its interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. See § 1.904-7(f)(2) and (4). In the case of unused foreign taxes allocable to dividends from a noncontrolled section 902 corporation with respect to which the taxpayer was no longer a domestic shareholder (as defined in § 1.902-1(a)) as of the first day of such taxable year, such taxes shall be allocated among the taxpayer's separate categories in the same percentages as the earnings in the noncontrolled section 902 corporation's non-look-through pool or pre-1987 accumulated profits would have been assigned had they been distributed and eligible for look-through treatment in the last taxable year in which the taxpayer was a domestic shareholder in such corporation. The unused foreign taxes that are carried forward shall be treated as allocable to general limitation income to the extent that such taxes would otherwise have been allocable to passive income, either on a look-through basis or as a result of inadequate substantiation under the rules of § 1.904-7(f)(4).

(2) *Carryback of unused foreign tax.* The rules of this paragraph (h)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation ending on or after April 20, 2009, which dividends were eligible for look-through

treatment. See 26 CFR § 1.904-2T(h)(2) (revised as of April 1, 2009) for rules applicable to such unused foreign taxes with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002 and ending before April 20, 2009, which dividends were eligible for look-through treatment. To the extent any such unused foreign taxes are carried back to a prior taxable year of a domestic shareholder, a credit for such taxes shall be allowed only to the extent of the excess limitation in the same separate category or categories to which the related look-through dividend was assigned and not in any separate category for dividends from noncontrolled section 902 corporations.

* * * * *

■ **Par. 10.** Section 1.904-2T is amended by revising paragraphs (a), (b), (c), (d), (e), (f), (g), and (h) to read as follows:

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

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

* * * * *

■ **Par. 11.** Section 1.904-4 is amended as follows:

- 1. Remove paragraph (c)(2)(i).
- 2. Redesignate paragraphs (c)(2)(ii)(A) and (c)(2)(ii)(B) as paragraphs (c)(2)(i) and (c)(2)(ii), respectively.
- 3. Remove the language “§ 1.904-6(a)(iii)” from the second sentence in newly-designated paragraph (c)(2)(i) and add the language “§ 1.904-6(a)(1)(iii)” in its place.
- 4. Remove the language “paragraph (c)(2)(ii)(B)” from the last sentence in newly-designated paragraph (c)(2)(i) and add the language “paragraph (c)(2)(ii)” in its place.
- 5. Remove the language “paragraph (c)(2)(ii)(A)” from the first sentence in newly-designated paragraph (c)(2)(ii) and add the language “paragraph (c)(2)(i)” in its place.
- 6. Revise paragraphs (c)(3) and (c)(4) introductory text.
- 7. Add paragraph (n).

The revisions and addition read as follows:

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

* * * * *

(c) * * *

(3) *Amounts received or accrued by United States persons.* Except as otherwise provided in paragraph (c)(5) of this section, all passive income received by a United States person shall be subject to the rules of this paragraph

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

- (i) All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.
- (ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.
- (iii) All passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income.
- (iv) All passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) *Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled section 902 corporations, and income of foreign QBUs.* Except as provided in paragraph (c)(5) of this section, all dividends and all amounts included in gross income of a United States shareholder under section 951(a)(1) with respect to the foreign corporation that (after application of the look-through rules of section 904(d)(3) and § 1.904-5) are attributable to passive income received or accrued by a controlled foreign corporation, all dividends from a noncontrolled section 902 corporation that are received or accrued by a domestic corporate shareholder meeting the stock ownership requirements of section 902(a) that (after application of

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

* * * * *

(n) *Effective/applicability dates.* For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3) and (4) of this section apply in taxable years ending on or after April 20, 2009. See 26 CFR § 1.904-4T(c)(3) and (4) (revised as of April 1, 2009) for grouping rules applicable to taxable years beginning after December 31, 2002, and ending before April 20, 2009. For corresponding rules applicable to taxable years beginning before January 1, 2003, see 26 CFR § 1.904-4(c)(2)(i) (revised as of April 1, 2006).

■ **Par. 12.** Section 1.904-4T is amended by revising paragraphs (c), (d), (e), (f), (g), (h)(1), and (h)(2) to read as follows:

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

* * * * *

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

* * * * *

■ **Par. 13.** Section 1.904-5 is amended by revising paragraphs (a) introductory text, (a)(1), (a)(4), (b), (c)(2)(iii), (c)(4)(iii), (i)(1), (i)(3), (i)(4), (i)(5) *Examples 4 and 5*, (m)(1), (m)(2)(ii), (m)(4)(i), (m)(5)(i), (n), and (o)(2) to read as follows:

§ 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 (4) and the

regulations under section 904, the following definitions apply:

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1)(A) and (B) (or section 904(d)(1)(A), (B), (C), (D), (F), (G), (H), or (I) for taxable years beginning before January 1, 2007) and in § 1.904-4T(b) (or § 1.904-4(e) for taxable years beginning before January 1, 2007), any category of income described in § 1.904-4(m), or any category of earnings and profits to which income described in such provisions is attributable.

(4) 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, with respect to a lower-tier foreign corporation, the taxpayer meets the requirements of section 902(b). Except as provided in section 902 and the regulations under that section and paragraphs (i)(3) and (i)(4) of this section, a controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902(a) or (b) will be made with respect to the taxpayer's indirect ownership, and not the partnership's direct ownership, in the foreign corporation. See section 902(c)(7).

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

(c) * * *

(2) * * *

(iii) *Allocating and apportioning expenses of a noncontrolled section 902 corporation.* Expenses of a noncontrolled section 902 corporation shall be allocated and apportioned in the same manner as expenses of a controlled foreign corporation under paragraph (c)(2)(ii) of this section, except that the related person interest

rule of paragraphs (c)(2)(ii)(C) and (D) of this section shall not apply.

* * * * *

(4) * * *

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

* * * * *

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

more than 50 percent of the total voting power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 318 and the regulations under that section.

* * * * *

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

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

(5) * * *

Example 4. P, a domestic corporation, owns all of the voting stock of S, a controlled foreign corporation. S owns 5 percent of the voting stock of T, a controlled foreign corporation. The remaining 95 percent of the stock of T is owned by P. In 2006, T pays a \$50 dividend to S and a \$950 dividend to P. The dividend to S is not eligible for look-through treatment under paragraph (i)(4) of this section, and S is not eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are not members of the same qualified group (S owns less than 10 percent of the

voting stock of T). See section 902(b) and § 1.902-1(a)(3). However, the dividend is eligible for look-through treatment under paragraph (i)(3) of this section because P owns at least 10 percent of the voting power of all classes of stock of both S and T. The dividend is subpart F income of S that is taxable to P.

Example 5. P, a domestic corporation, owns 50 percent of the voting stock of S, a controlled foreign corporation. S owns 10 percent of the voting stock of T, a controlled foreign corporation. The remaining 50 percent of the stock of S and the remaining 90 percent of the stock of T are owned, respectively, by X and Y. X and Y are each United States shareholders of T but are not related to P, S, or each other. In 2006, T pays a \$100 dividend to S. The dividend is not eligible for look-through treatment under paragraph (i)(3) of this section because no United States shareholder owns at least 10 percent of the voting power of all classes of stock of both S and T (P and X each own only 5 percent of T). However, the dividend is eligible for look-through treatment under paragraph (i)(4) of this section, and S is eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are members of the same qualified group. See section 902(b) and § 1.902-1(a)(3). The dividend is subpart F income of S that is taxable to P and X.

* * * * *

(m) *Application of section 904(h)*—(1) *In general.* This paragraph (m) applies to certain amounts derived from controlled foreign corporations and noncontrolled section 902 corporations that are treated as United States-owned foreign corporations as defined in section 904(h)(6). For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation or noncontrolled section 902 corporation from sources within the United States under section 904(h)(3), the rules in paragraph (m)(2) of this section apply. For purposes of determining the portion of a dividend (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) paid or accrued by a controlled foreign corporation or noncontrolled section 902 corporation that is treated as from sources within the United States under section 904(h)(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)(1)(A) or 1293 that is attributable to income of the controlled foreign corporation or noncontrolled section 902 corporation from sources within the United States under section 904(h)(2), the rules in paragraph (m)(5) of this section apply. In order to determine whether section 904(h) applies, section 904(h)(5) (exception if a United States-

owned foreign corporation has a *de minimis* amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation or noncontrolled section 902 corporation for a taxable year without regard to the characterization of those earnings under section 904(d).

(2) * * *

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

* * * * *

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

* * * * *

(5) *Treatment of inclusions under sections 951(a)(1)(A) and 1293*—(i) *Rule.* Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a)(1)(A) or in the gross income of domestic corporate shareholders that meet the stock ownership requirements of section 902(a) with respect to a noncontrolled section 902 corporation that is a qualified electing fund under section 1293 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 or qualified electing fund, respectively, 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. In order to determine a qualified electing fund's 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, except that the related person interest rule of paragraph (m)(2) of this section shall not apply.

* * * * *

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

(o) * * *

(2) *Rules for noncontrolled section 902 corporations.* Paragraphs (a), (a)(1), (a)(4), (b), (c)(2)(iii), (c)(4)(iii), (i)(1), (i)(3), (i)(4), (i)(5), *Examples 4 and 5*, (m)(1), (m)(2)(ii), (m)(4)(i), (m)(5)(i), and (n) of this section apply to distributions from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation ending on or after April 20, 2009. See 26 CFR 1.904-5T(a), (a)(1), (a)(4), (b), (c)(2)(iii), (c)(4)(iii), (i)(1), (i)(3), (i)(4), (i)(5), *Examples 4 and 5*, and 26 CFR 1.904-7T(f)(9) (revised as of April 1, 2009) for rules applicable to distributions from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009. See 26 CFR 1.904-

5T(m)(1), (m)(2)(ii), (m)(4)(i), and (n) (revised as of April 1, 2009) for rules applicable to distributions from a noncontrolled section 902 corporation paid in taxable years of such corporation beginning after April 25, 2006, and ending before April 20, 2009. For corresponding rules applicable to taxable years beginning before January 1, 2003, see 26 CFR 1.904-5 (revised as of April 1, 2006).

* * * * *

■ **Par. 14.** Section 1.904-5T is amended by revising paragraphs (a), (b), (c), (d), (e), (f), (g), (h)(1), (h)(2), (i), (j), (k), (l), (m), (n), (o)(1), and (o)(2) to read as follows:

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

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

* * * * *

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

* * * * *

■ **Par. 15.** Section 1.904-7 is amended by revising paragraph (f) to read as follows:

§ 1.904-7 Transition rules.

* * * * *

(f) *Treatment of non-look-through pools of a noncontrolled section 902 corporation or a controlled foreign corporation in post-2002 taxable years—*

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

(2) *Treatment of non-look-through pools of a noncontrolled section 902 corporation.* Any undistributed earnings in the non-look-through pool that were accumulated in taxable years beginning before January 1, 2003, by a noncontrolled section 902 corporation as of the last day of the corporation's last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning after December 31, 2002, as if they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation to a domestic shareholder

would have been eligible for look-through treatment under section 904(d)(4) and § 1.904-5. Post-1986 foreign income taxes paid, accrued or deemed paid with respect to such earnings shall be treated as if they were paid, accrued or deemed paid during a period when the related earnings were eligible for look-through treatment. Any such earnings and taxes in the non-look-through pools shall constitute the opening balance of the noncontrolled section 902 corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes on the first day of the foreign corporation's first taxable year beginning after December 31, 2002, in accordance with the rules of paragraph (f)(4) of this section.

(3) *Treatment of non-look-through pools of a controlled foreign corporation.* A controlled foreign corporation may have non-look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes that were accumulated and paid in a taxable year beginning before January 1, 2003, in which it was a noncontrolled section 902 corporation. Any such undistributed earnings in the non-look-through pool as of the last day of the controlled foreign corporation's last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning on or after January 1, 2003, as if they were accumulated during a period when a dividend paid by the controlled foreign corporation out of such earnings, or an amount included in the gross income of a United States shareholder under section 951 that is attributable to such earnings, would have been eligible for look-through treatment. Any post-1986 foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated in taxable years beginning on or after January 1, 2003, as if they were paid, accrued, or deemed paid during a period when a dividend or inclusion out of such earnings would have been eligible for look-through treatment. Any such undistributed earnings and taxes in the non-look-through pools shall be added to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the controlled foreign corporation in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning after December 31, 2002, in accordance with the rules of paragraph (f)(4) of this section. Similar rules shall apply to characterize any previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to earnings in the non-look-through pool.

(4) *Substantiation of look-through character of undistributed earnings and taxes in a non-look-through pool—*(i) *Reconstruction of earnings and taxes pools.* In order to substantiate the look-through characterization of undistributed earnings and taxes in a non-look-through pool under section 904(d)(4) and § 1.904-5, the taxpayer shall make a reasonable, good-faith effort to reconstruct the non-look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes (and previously-taxed earnings and profits, if any) on a look-through basis for each year in the non-look-through period, beginning with the first taxable year in which post-1986 undistributed earnings were accumulated in the non-look-through pool. Reconstruction shall be based on reasonably available books and records and other relevant information, and it must account for earnings distributed and taxes deemed paid in these years as if they were distributed and deemed paid pro rata from the amounts that were added to the non-look-through pools during the non-look-through period.

(ii) *Safe harbor method.* A taxpayer that was eligible for look-through treatment with respect to a distribution from the foreign corporation in the taxpayer's first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002, may allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in other separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2002, in the same percentages as the taxpayer properly characterizes the stock of the foreign corporation in the separate categories for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002, under § 1.861-12T(c)(3) or § 1.861-12(c)(4), as the case may be. If the modified gross income method described in § 1.861-9T(j) is used to apportion interest expense of the foreign corporation in its first taxable year beginning after December 31, 2002, the taxpayer must allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes based on an average of the foreign corporation's

modified gross income ratios for the foreign corporation's taxable years beginning in 2003 and 2004. A taxpayer may also use the safe harbor method described in this paragraph (f)(4)(ii) to allocate to separate categories any previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to the non-look-through pool. A taxpayer may choose to use the safe harbor method on either a timely filed or amended tax return or during an audit. However, a taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any duplicate benefits arising from application of the safe harbor method to taxable years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(iii) *Inadequate substantiation.* If a taxpayer does not use, or is ineligible to use, the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of earnings and taxes in the non-look-through pools cannot reasonably be determined based on the available information, the Commissioner shall allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's passive category.

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

Example 1. P, a domestic corporation, has owned 50 percent of the voting stock of S, a foreign corporation, at all times since January 1, 1987, and S has been a noncontrolled section 902 corporation with respect to P since that date. P and S use the calendar year as their U.S. taxable year. The first year in which post-1986 undistributed earnings were accumulated in the non-look-through pool of S was 1987. As of December 31, 2002, S had 200u of post-1986 undistributed earnings and \$100 of post-1986 foreign income taxes in its non-look-through pools. P does not use the safe harbor method under paragraph (f)(4)(ii) of this section to allocate the earnings and taxes in the non-look-through pools to S's other separate categories and does not attempt to substantiate the look-through characterization of S's non-look-through pools. The Commissioner, however, reasonably determines, based on information used to characterize S's stock for purposes of apportioning P's interest expense in P's 2003 and 2004 taxable years, that 100u of the earnings and all \$100 of the taxes in the non-look-through pools are properly assigned on a look-through basis to the general limitation category, and 100u of earnings and no taxes are properly assigned on a look-through basis

to the passive category. Therefore, in accordance with the Commissioner's look-through characterization of the earnings and taxes in S's non-look-through pools, on January 1, 2003, S has 100u of post-1986 undistributed earnings and \$100 of post-1986 foreign income taxes in the general limitation category and 100u of post-1986 undistributed earnings and no post-1986 foreign income taxes in the passive category.

Example 2. The facts are the same as in *Example 1*, except that the Commissioner cannot reasonably determine, based on the available information, the proper look-through characterization of the 200u of undistributed earnings and \$100 of taxes in S's non-look-through pools. Accordingly, the Commissioner will assign such earnings and taxes to the passive category, so that as of January 1, 2003, S has 200u of post-1986 undistributed earnings and \$100 of post-1986 foreign income taxes in the passive category, and the Commissioner will treat S as a passive category asset for purposes of apportioning P's interest expense.

(5) *Treatment of a deficit accumulated in a non-look-through pool.* Any deficit in the non-look-through pool of a noncontrolled section 902 corporation or a controlled foreign corporation as of the end of its last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning after December 31, 2002, as if the deficit had been accumulated during a period in which a dividend paid by the foreign corporation would have been eligible for look-through treatment. In the case of a noncontrolled section 902 corporation, the deficit and taxes, if any, in the non-look-through pools shall constitute the opening balance of the look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the noncontrolled section 902 corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. In the case of a controlled foreign corporation, the deficit and taxes, if any, in the non-look-through pools shall be added to the balance of the look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the controlled foreign corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(4) of this section. If a taxpayer does not use the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the deficit and taxes cannot reasonably be determined based on the available information, the

Commissioner shall allocate the deficit and taxes, if any, in the non-look-through pools to the foreign corporation's passive category. If, as of the end of a taxable year beginning after December 31, 2002, in which it pays a dividend, the foreign corporation has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), the deficit in post-1986 undistributed earnings shall be carried back to reduce pre-1987 accumulated profits, if any, on a last-in first-out basis. *See* § 1.902-2(a)(1). If, as of the end of a taxable year beginning after December 31, 2002, in which the foreign corporation pays a dividend out of current earnings and profits, it has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), and the sum of current plus accumulated earnings and profits is zero or less than zero, no foreign taxes shall be deemed paid with respect to the dividend. *See* § 1.902-1(b)(4).

(6) *Treatment of pre-1987 accumulated profits.* Any pre-1987 accumulated profits (as defined in § 1.902-1(a)(10)) of a controlled foreign corporation or noncontrolled section 902 corporation shall be treated in taxable years beginning after December 31, 2002, as if they were accumulated during a period in which a dividend paid by the foreign corporation would have been eligible for look-through treatment. Any pre-1987 foreign income taxes (as defined in § 1.902-1(a)(10)(iii)) shall be treated as if they were paid, accrued or deemed paid during a year when a dividend out of the related pre-1987 accumulated profits would have been eligible for look-through treatment. The taxpayer must substantiate the look-through characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes in accordance with the rules of paragraph (f)(4) of this section. If a taxpayer does not use, or is ineligible to use, the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes cannot reasonably be determined based on the available information, the pre-1987 accumulated profits and pre-1987 foreign income taxes shall be allocated to the foreign corporation's passive category.

(7) *Treatment of post-1986 undistributed earnings or a deficit of a controlled foreign corporation*

attributable to dividends from a noncontrolled section 902 corporation paid in taxable years beginning before January 1, 2003—(i) Look-through treatment of post-1986 undistributed earnings at controlled foreign corporation level. Dividends paid by a noncontrolled section 902 corporation to a controlled foreign corporation in post-1986 taxable years of the noncontrolled section 902 corporation beginning before January 1, 2003, were assigned to a separate category for dividends from that noncontrolled section 902 corporation. Beginning on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002, any post-1986 undistributed earnings, or previously-taxed earnings and profits described in section 959(c)(1) or (2), of the controlled foreign corporation in such a separate category shall be treated as if they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation would have been eligible for look-through treatment. Any post-1986 foreign income taxes in such a separate category shall also be treated as if they were paid, accrued or deemed paid during a period when such a dividend would have been eligible for look-through treatment. Any such post-1986 undistributed earnings and post-1986 foreign income taxes in a separate category for dividends from a noncontrolled section 902 corporation shall be added to the opening balance of the controlled foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002. Any section 952(c)(2) recapture account with respect to such a separate category shall be allocated in the same manner as the associated post-1986 undistributed earnings. The taxpayer must substantiate the look-through characterization of such earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section.

(ii) *Look-through treatment of deficit in post-1986 undistributed earnings at controlled foreign corporation level.* If a controlled foreign corporation has a deficit in a separate category for dividends from a lower-tier noncontrolled section 902 corporation that is a member of the controlled

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

(iii) *Substantiation required for look-through treatment.* The taxpayer must substantiate the look-through characterization of post-1986 undistributed earnings, previously-taxed earnings and profits, or a deficit in post-1986 undistributed earnings in a separate category for dividends paid by a noncontrolled section 902 corporation in taxable years beginning before January 1, 2003, by making a reasonable, good-faith effort to reconstruct the earnings (or deficit) and taxes in the separate category at the level of the controlled foreign corporation on a look-through basis, in accordance with the principles of paragraph (f)(4)(i) of this section. Alternatively, the taxpayer may allocate the earnings (or deficit) and taxes to the controlled foreign corporation's look-through pools under the safe harbor method described in paragraph (f)(4)(ii) of this section at the level of the controlled foreign corporation. If the taxpayer uses the safe harbor method, the earnings (or deficit) and taxes shall be allocated to the controlled foreign corporation's look-through pools in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after

December 31, 2002. The allocation shall be made in the same percentages as the controlled foreign corporation would properly characterize the stock of the lower-tier noncontrolled section 902 corporation in the separate categories for purposes of apportioning the controlled foreign corporation's interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. Under § 1.861-12T(c)(3), the apportionment ratios properly used by the controlled foreign corporation are in turn based on the apportionment ratios properly used by the noncontrolled section 902 corporation to apportion its interest expense in its first taxable year beginning after December 31, 2002. In the case of a taxpayer that uses the safe harbor method where the lower-tier noncontrolled section 902 corporation uses the modified gross income method described in § 1.861-9T(j) to apportion interest expense for its first taxable year beginning after December 31, 2002, earnings (or a deficit) and taxes in the separate category for dividends from the noncontrolled section 902 corporation shall be allocated to the look-through pools based on the average of the noncontrolled section 902 corporation's modified gross income ratios for its taxable years beginning in 2003 and 2004. In the case of a controlled foreign corporation that has in its qualified group a chain of lower-tier noncontrolled section 902 corporations, the safe harbor applies first to characterize the stock of the third-tier corporation and then to characterize the stock of the second-tier corporation. Where a taxpayer uses the safe harbor method with respect to a lower-tier noncontrolled section 902 corporation with respect to which the taxpayer did not meet the requirements of section 902(a) as of the end of the upper-tier controlled foreign corporation's last taxable year beginning before January 1, 2003, the earnings (or deficit) and taxes in the separate category for dividends from the lower-tier corporation shall be allocated to the upper-tier corporation's look-through pools in the separate categories in the same percentages as the stock of the lower-tier corporation would have been characterized for purposes of apportioning the upper-tier corporation's interest expense in the last year the taxpayer met the ownership requirements of section 902(a) with respect to the lower-tier corporation if the look-through rules had applied in that year. If a taxpayer does not use the safe harbor method described in this paragraph (f)(7)(iii), and the

Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the Commissioner shall allocate the earnings (or deficit) and associated foreign income taxes to the controlled foreign corporation's passive category.

(8) *Treatment of distributions received by an upper-tier corporation from a lower-tier noncontrolled section 902 corporation, including when the corporations do not have the same taxable years*—(i) *Rule.* In the case of dividends paid by a lower-tier noncontrolled section 902 corporation to an upper-tier corporation where both are members of the same qualified group as defined in section 902(b)(2), the following rules apply. Dividends paid by the lower-tier corporation in taxable years beginning before January 1, 2003, are assigned to a separate category for dividends from that corporation, regardless of whether the corresponding taxable year of the recipient corporation began after December 31, 2002. Post-1986 undistributed earnings, previously-taxed earnings and profits, and post-1986 foreign income taxes in such a separate category shall be treated, beginning on the first day of the upper-tier corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002, as if they were accumulated during a period when a dividend paid by the lower-tier corporation would have been eligible for look-through treatment under section 904(d)(4) and § 1.904-5. Dividends paid by a lower-tier corporation in taxable years beginning after December 31, 2002, are eligible for look-through treatment when paid, without regard to whether the corresponding taxable year of the recipient upper-tier corporation began after December 31, 2002.

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

Example. M, a domestic corporation, has directly owned 50 percent of the stock of foreign corporation X, and X has directly owned 50 percent of the stock of foreign corporation Y, at all times since X and Y were organized on January 1, 1990. Accordingly, X and Y are noncontrolled section 902 corporations with respect to M, and X and Y are members of the same qualified group. M and Y use the calendar year as their U.S. taxable year, and X uses a taxable year beginning on July 1. Under § 1.904-4(g) and paragraph (f)(10) of this section, a dividend paid to M by X on January 15, 2003 (during X's last pre-2003 taxable year) is not eligible for look-through treatment in 2003. However, under § 1.861-

12(c)(4), M will characterize the stock of X on a look-through basis for purposes of interest expense apportionment in its 2003 taxable year. Under § 1.904-2(h)(1), any unused foreign taxes in M's separate category for dividends from X will be carried over to M's other separate categories on a look-through basis for M's taxable years beginning on and after January 1, 2004. Under paragraph (f)(2) of this section, any undistributed earnings and taxes in X's non-look-through pools will be allocated to X's other separate categories on July 1, 2003. Under § 1.904-5(i)(4) and paragraphs (f)(8)(i) and (f)(10) of this section, a dividend paid to X by Y on January 15, 2003 (during Y's first post-2002 taxable year) is eligible for look-through treatment when paid, notwithstanding that it is received in a pre-2003 taxable year of X.

(9) *Election to apply pre-AJCA rules to 2003 and 2004 taxable years*—(i)

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

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

(A) The taxpayer's tax liability as shown on an original or amended tax return for each of its affected taxable years is consistent with the rules of this paragraph (f)(9), the guidance set forth in Notice 2003-5 (2003-1 CB 294) (see § 601.601(d)(2) of this chapter), and the principles of § 1.861-12(c)(4) for each such year for which the statute of limitations does not preclude the filing of an amended return;

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

(C) The taxpayer attaches a statement to its next tax return for which the due date (with extensions) is more than 90 days after April 25, 2006, indicating that the taxpayer elects not to apply the provisions of section 403 of the AJCA to taxable years of its noncontrolled section 902 corporations beginning in 2003 and 2004, and that the taxpayer

has filed original returns or will file amended returns reflecting tax liabilities for each affected year that satisfy the requirements described in this paragraph (f)(9)(ii).

(iii) *Treatment of non-look-through pools in taxable years beginning after December 31, 2004.* Undistributed earnings (or a deficit) and taxes in the non-look-through pools of a controlled foreign corporation or a noncontrolled section 902 corporation as of the end of its last taxable year beginning before January 1, 2005, shall be treated in taxable years beginning after December 31, 2004, as if they were accumulated and paid during a period in which a distribution out of earnings in the non-look-through pool would have been eligible for look-through treatment. Such earnings (or deficit) and taxes shall be added to the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2004. In accordance with the principles of paragraph (f)(4) of this section, the taxpayer must reconstruct the non-look-through pools or, if the taxpayer chooses to use the safe harbor method, allocate the earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools in the appropriate separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2004. Under the safe harbor method, this allocation is made in the same percentages as the taxpayer properly characterized the stock of the foreign corporation for purposes of apportioning the taxpayer's interest expense in the taxpayer's first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002. See § 1.861-12T(c)(3) and § 1.861-12(c)(4). If a taxpayer does not use the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the earnings (or deficit) and taxes shall be allocated to the foreign corporation's passive category.

(iv) *Carryover of unused foreign tax.* To the extent that a taxpayer has unused foreign taxes in the single category for dividends from all noncontrolled section 902 corporations, such taxes shall be carried forward to the appropriate separate categories in the taxpayer's taxable years beginning on or after the first day of the relevant

noncontrolled section 902 corporation's first taxable year beginning after December 31, 2004. Such unused taxes shall be carried forward in the same manner as § 1.904-2(h)(1) provides that unused foreign taxes in the separate categories for dividends from each noncontrolled section 902 corporation are carried over to taxable years beginning on or after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002, in the case of a taxpayer that does not make the election under this paragraph (f)(9). The electing taxpayer shall determine which noncontrolled section 902 corporations paid the dividends to which the unused foreign taxes are attributable and assign the taxes to the appropriate separate categories as if such dividends had been eligible for look-through treatment when paid. Accordingly, the taxpayer must substantiate the look-through characterization of the unused foreign taxes in accordance with paragraph (f)(4) of this section by reconstructing the non-look-through pools or, if the taxpayer uses the safe harbor method, by allocating the unused foreign taxes to other separate categories in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. The rule described in this paragraph (f)(9)(iv) shall apply only to unused foreign taxes attributable to dividends out of earnings that were accumulated by noncontrolled section 902 corporations in taxable years of such corporations beginning before January 1, 2003, because only unused foreign taxes attributable to distributions out of pre-2003 earnings are included in the single category for dividends from all noncontrolled section 902 corporations. To the extent that unused foreign taxes carried forward to the single category for dividends from all noncontrolled section 902 corporations under the rules of Notice 2003-5 were either absorbed by low-taxed dividends paid by noncontrolled section 902 corporations out of the non-look-through pool in taxable years of such corporations beginning in 2003 or 2004, or expired unused, the amount of taxes carried forward to the separate categories on a look-through basis will be smaller than the aggregate amount of taxes initially carried forward to the single category for dividends from all noncontrolled

section 902 corporations. In this case, the unused foreign taxes arising in each taxable year shall be deemed attributable to each noncontrolled section 902 corporation in the same ratio as the dividends included in the separate category that were paid by such corporation in such year bears to all such dividends paid by all noncontrolled section 902 corporations in such year. Unused foreign taxes carried forward from the separate categories for dividends from each noncontrolled section 902 corporation to the single category for dividends from all noncontrolled section 902 corporations will similarly be deemed to have been utilized on a pro rata basis. The remaining unused foreign taxes are then assigned to the appropriate separate categories under the rules of paragraph (f)(4) of this section. Unused foreign taxes shall be treated as allocable to general category income to the extent that such taxes would otherwise have been allocable to passive income (based on reconstructed pools or the safe harbor method), or to the extent that, under paragraph (f)(4)(iii) of this section, the Commissioner determines that the look-through characterization cannot reasonably be determined based on the available information.

(v) *Carryback of unused foreign tax.* To the extent that a taxpayer has unused foreign taxes attributable to a dividend paid by a noncontrolled section 902 corporation that was eligible for look-through treatment under section 904(d)(4) and § 1.904-5, any such unused foreign taxes shall be carried back to prior taxable years within the same separate category and not to the single category for dividends from all noncontrolled section 902 corporations or any separate category for dividends from a noncontrolled section 902 corporation. See Notice 2003-5 for rules relating to the carryback of unused foreign taxes in the single category for dividends from all noncontrolled section 902 corporations.

(vi) *Recapture of overall foreign loss or separate limitation loss in the single category for dividends from all noncontrolled section 902 corporations.* To the extent that a taxpayer has a balance in a separate limitation loss or overall foreign loss account in the single category for dividends from all noncontrolled section 902 corporations under section 904(d)(1)(E) (prior to its repeal by the AJCA), at the end of the taxpayer's last taxable year beginning before January 1, 2005 (or a later taxable year in which the taxpayer received a dividend subject to the separate limitation for dividends from all noncontrolled section 902 corporations),

the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's other separate categories. The amount of such balance that is attributable to each noncontrolled section 902 corporation shall be allocated in the same percentages as the taxpayer properly characterized the stock of such corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under § 1.861-12T(c)(3) or § 1.861-12(c)(4), as the case may be. To the extent that a taxpayer has a balance in a separate limitation loss account for the single category for dividends from all noncontrolled section 902 corporations with respect to another separate category, and the separate limitation loss account would otherwise be assigned to that other category under this paragraph (f)(9)(vi), such balance shall be eliminated.

(vii) *Recapture of separate limitation losses in other separate categories.* To the extent that a taxpayer has a balance in any separate limitation loss account in a separate category with respect to the single category for dividends from all noncontrolled section 902 corporations at the end of the taxpayer's last taxable year with or within which ends the last taxable year of the relevant noncontrolled section 902 corporation beginning before January 1, 2005, such loss shall be recaptured in subsequent taxable years as income in the appropriate separate category. The separate limitation loss account shall be deemed attributable on a pro rata basis to those noncontrolled section 902 corporations that paid dividends out of earnings accumulated in taxable years beginning before January 1, 2003, in the years in which the separate limitation loss in the other separate category arose. The ratable portions of the separate limitation loss account shall be recaptured as income in the taxpayer's separate categories in the same percentages as the taxpayer properly characterized the stock of the relevant noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under § 1.861-12T(c)(3) or § 1.861-12(c)(4), as the case may be. To the extent that a taxpayer has a balance in any separate limitation loss account in any separate category that would have been recaptured as income in that same

category under this paragraph (f)(9)(vii), such balance shall be eliminated.

(viii) *Treatment of undistributed earnings in an upper-tier corporation-level single category for dividends from lower-tier noncontrolled section 902 corporations.* Where a controlled foreign corporation or noncontrolled section 902 corporation has a single category for dividends from all noncontrolled section 902 corporations containing earnings attributable to dividends paid by one or more lower-tier corporations, the following rules apply. The post-1986 undistributed earnings, previously-taxed earnings and profits described in section 959(c)(1) or (2), if any, and associated post-1986 foreign income taxes shall be allocated to the upper-tier corporation's other separate categories in the same manner as earnings and taxes in a separate category for dividends from each noncontrolled section 902 corporation maintained by the upper-tier corporation are allocated under paragraph (f)(7) of this section. Accordingly, post-1986 undistributed earnings, previously-taxed earnings and profits, if any, and post-1986 foreign income taxes in the single category for dividends from all noncontrolled section 902 corporations shall be treated as if they were accumulated and paid, accrued or deemed paid during a period when a dividend paid by each lower-tier corporation that paid dividends included in the single category would have been eligible for look-through treatment. If the taxpayer uses the safe harbor method described in paragraph (f)(7)(iii) of this section, the earnings and taxes shall be allocated based on the apportionment ratios properly used by the lower-tier corporation to apportion its interest expense for its first taxable year beginning after December 31, 2002. Any section 952(c)(2) recapture account with respect to the single category shall be allocated in the same manner as the associated post-1986 undistributed earnings. The taxpayer must substantiate the look-through characterization of the earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section. If the taxpayer does not use the safe harbor method and the Commissioner determines that the look-through characterization of the earnings cannot reasonably be determined based on the available information, the earnings and taxes shall be assigned to the upper-tier corporation's passive category.

(ix) *Treatment of a deficit in the single category for dividends from lower-tier noncontrolled section 902 corporations.* Where a controlled foreign corporation or noncontrolled section 902 corporation had an aggregate deficit in

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

(10) *Effective/applicability date.* This paragraph (f) shall apply to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation ending on or after April 20, 2009. See 26 CFR § 1.904-7T(f) (revised as of April 1, 2009) for rules applicable, except in the case of a taxpayer that makes the election under paragraph (f)(9) of that section, to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009. See 26 CFR 1.904-7T(f) (revised as of April 1, 2009) for rules applicable, in the case of a taxpayer that makes the election under paragraph (f)(9) of that section, to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2004, and ending before April 20, 2009. However, taxpayers may choose to apply paragraph (f) of this section in its entirety in lieu of 26 CFR 1.904-7T(f) to

all dividends paid in periods covered by the temporary regulations, provided that appropriate adjustments are made to eliminate duplicate benefits arising from application of paragraph (f) to taxable years that are not open for assessment.

■ **Par. 16.** Section 1.904-7T is amended by revising paragraphs (a), (b), (c), (d), (e), and (f) to read as follows:

§ 1.904-7T Transition rules (temporary).

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

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■ **Par. 17.** Section 1.904(f)-0 is amended by adding the entries for § 1.904(f)-12(g)(1), (g)(2), (g)(3), (g)(4), and (g)(5) as follows:

§ 1.904(f)-0 Outline of regulation provisions.

* * * * *

§ 1.904(f)-12 Transition rules.

* * * * *

(g) * * *

(1) Recapture of separate limitation loss or overall foreign loss in a separate category for dividends from a noncontrolled section 902 corporation.

(2) Recapture of separate limitation loss in another separate category.

(3) Exception.

(4) Examples.

(5) Effective/applicability date.

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■ **Par. 18.** Section 1.904(f)-12 is amended by revising paragraph (g) to read as follows:

§ 1.904(f)-12 Transition rules.

* * * * *

(g) *Recapture in years beginning after December 31, 2002, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2003, with respect to the separate category for dividends from a noncontrolled section 902 corporation—*(1) *Recapture of separate limitation loss or overall foreign loss in a separate category for dividends from a noncontrolled section 902 corporation.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a separate category for dividends from a noncontrolled section 902 corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108-357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer's last taxable year beginning before January 1, 2003 (or a later taxable year in which the taxpayer received a dividend subject to a separate limitation for dividends from that noncontrolled section 902 corporation), the amount of such balance shall be allocated on the

first day of the taxpayer's next taxable year to the taxpayer's other separate categories. The amount of such balance shall be allocated in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under § 1.861-12T(c)(3) or § 1.861-12(c)(4), as the case may be. To the extent a taxpayer has a balance in a separate limitation loss account in a separate category for dividends from a noncontrolled section 902 corporation with respect to another separate category, and the separate limitation loss would otherwise be assigned to that other category under this paragraph (g)(1), such balance shall be eliminated.

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

(3) *Exception.* Where a taxpayer formerly met the stock ownership requirements of section 902(a) with respect to a foreign corporation, but did not meet the requirements of section 902(a) on December 20, 2002 (or on the first day of the taxpayer's first taxable year beginning after December 31, 2002, in the case of a transaction that was the subject of a binding contract in effect on

December 20, 2002), if the taxpayer has a balance in any separate limitation loss or overall foreign loss account for a separate category for dividends from that foreign corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108-357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer's last taxable year beginning before January 1, 2003, then the amount of such balance shall not be subject to recapture under section 904(f) and this section. If a separate limitation loss or overall foreign loss account for such category is not subject to recapture under this paragraph (g)(3), the taxpayer cannot carry over any unused foreign taxes in such separate category to any other limitation category. However, a taxpayer may elect to recapture the balances of all separate limitation loss and overall foreign loss accounts for all separate categories for dividends from such formerly-owned noncontrolled section 902 corporations under the rules of paragraphs (g)(1) and (2) of this section. If a taxpayer so elects, it may carry over any unused foreign taxes in these separate categories to the appropriate separate categories as provided in § 1.904-2(h).

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

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

Example 2. The facts are the same as in *Example 1*, except that as of December 31, 2002, X had a \$30 balance in its separate limitation loss account in the general limitation category, and a \$20 balance in its separate limitation loss account in the

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

(5) *Effective/applicability date.* This paragraph (g) applies to taxable years ending on or after April 20, 2009. See 26 CFR 1.904(f)-12T(g) (revised as of April 1, 2009) for rules applicable to taxable years beginning after December 31, 2002, and ending before April 20, 2009.

* * * * *

■ **Par. 19.** Section 1.904(f)-12T is amended by revising paragraphs (a), (b), (c), (d), (e), (f), and (g) to read as follows:

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

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

* * * * *

■ **Par. 20.** Section 1.964-1 is amended as follows:

- 1. Revise paragraph (a)(1).
- 2. Remove the last sentence of paragraph (a)(2).
- 3. Revise paragraphs (b)(1)(v), (c)(1)(v), (c)(2), (c)(3), (c)(4), (c)(5), and (c)(6).
- 4. Remove and reserve paragraph (c)(8).
- 5. Add new paragraphs (a)(3) and (d).
- 6. Designate the undesignated text preceding paragraph (c)(1)(vi) as paragraph (c)(1)(vi) and revise it.

The revisions and additions read as follows:

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

(a)(1) *In general.* For rules for determining the earnings and profits (or deficit in earnings and profits) of a foreign corporation for taxable years beginning before January 1, 1987, for purposes of sections 951 through 964, see 26 CFR 1.964-1(a) (revised as of April 1, 2006). For taxable years beginning after December 31, 1986,

except as otherwise provided in the Code and regulations, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall be computed for all Federal income tax purposes substantially as if such corporation were a domestic corporation by—

* * * * *

(3) *Translation into dollars.* In the case of a foreign corporation with a functional currency other than the United States dollar (dollar), see sections 986(b) and 989(b) for rules regarding the time and manner of translating distributions or inclusions of the foreign corporation's earnings and profits into dollars.

(b) * * *

(1) * * *

(v) *Foreign currency.* If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be made in a manner substantially similar to that as prescribed in section 988 and the regulations under that section for the translation of foreign currency amounts into United States dollars.

* * * * *

(c) * * *

(1) * * *

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

(vi) *Applicable requirements.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting or taxable year must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method or taxable year is to be taken into account in the computation of its earnings and profits.

(2) *Adoption or change of method or taxable year.* For the first taxable year of a foreign corporation beginning after April 25, 2006, in which such foreign corporation first qualifies as a controlled foreign corporation (as defined in section 957 or 953) or a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)), any method of accounting or taxable year allowable under this section may be adopted, and any election allowable under this section may be made, by such foreign corporation or on its behalf

notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. Any allowable methods adopted or elections made shall be reflected in the computation of the foreign corporation's earnings and profits for such taxable year, prior taxable years, and (unless the Commissioner consents to a change) subsequent taxable years. However, see section 898 for the rules regarding the taxable year of a specified foreign corporation as defined in section 898(b). Any allowable method of accounting or election that relates to events that first arise in a subsequent taxable year may be adopted or made by or on behalf of the foreign corporation for such year. Adjustments to the appropriate separate category (as defined in § 1.904-5(a)(1)) of earnings and profits and income of the foreign corporation shall be required under section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any change in a method of accounting. See paragraph (c)(3) of this section for the manner in which a method of accounting or a taxable year may be adopted or changed on behalf of the foreign corporation. See paragraph (c)(4) of this section for applicable rules if the amount of the foreign corporation's earnings and profits became significant for United States tax purposes before a method of accounting or taxable year was adopted by the foreign corporation or on its behalf in accordance with the rules of paragraph (c)(3) of this section. See paragraph (c)(6) of this section for special rules postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant for U.S. tax purposes. See also §§ 1.985-5, 1.985-6, and 1.986-7 relating to adjustments to earnings and profits of a QBU required when the QBU changes its functional currency or begins to use the dollar approximate separate transactions method of accounting.

(3) *Action on behalf of corporation—*

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

(A) Satisfy for such corporation any requirements imposed by the Internal Revenue Code or applicable regulations with respect to such election or such adoption or change in method or taxable

year (including the provisions of sections 442 and 446 and the regulations under those sections, as well as any operative provisions), such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner. For purposes of this paragraph (c)(3)(i)(A), the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling domestic shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations under that section in that manner;

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

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

(ii) *Statement required to be filed with a tax return.* The statement required by this paragraph (c)(3)(ii) shall set forth the name, country of organization, and U.S. employer identification number (if applicable) of the foreign corporation, the name, address, stock interests, and U.S. employer identification number of each controlling domestic shareholder (or, if applicable, the shareholder's common parent) approving the action, and the names, addresses, U.S. employer identification numbers, and stock interests of all other domestic shareholders notified of the action taken. Such statement shall describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or its common parent). Each controlling domestic shareholder (or its common parent) shall file the statement with, and on or before the due date (including extensions) of, its own tax return (or information return, if applicable) for its taxable year with or within which ends the taxable year of the foreign corporation for which the election is made or for which the method of accounting or taxable year is adopted or changed. In the case of a controlling domestic shareholder that is the sole shareholder of a controlled foreign corporation, no separate statement need be filed if the information described in this paragraph (c)(3)(ii) is included on Form 5471 and Form 3115 or 1128, as applicable, filed

with respect to the controlled foreign corporation with the shareholder's return for such taxable year.

(iii) *Notice.* On or before the filing date described in paragraph (c)(3)(ii) of this section, the controlling domestic shareholders shall provide written notice of the election made or the adoption or change of method or taxable year effected to all other persons known by them to be domestic shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall set forth the name, country of organization and U.S. employer identification number (if applicable) of the foreign corporation, and the names, addresses, and stock interests of the controlling domestic shareholders. Such notice shall describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or its common parent). However, the failure of the controlling domestic shareholders to provide such notice to a person required to be notified shall not invalidate the election made or the adoption or change of method or taxable year effected.

(4) *Effect of action or inaction by controlling domestic shareholders—(i) In general.* Any election, or adoption or change of method of accounting or taxable year made by the controlling domestic shareholders on behalf of the foreign corporation pursuant to paragraph (c)(3) of this section or any other provision of the regulations (for example, § 1.985–2(c)(2) or (3)) shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the federal income tax liability of the domestic shareholders of the foreign corporation. Any such action shall bind both the foreign corporation and its domestic shareholders as to the computation of the foreign corporation's earnings and profits for the taxable year of the foreign corporation for which the election is made or for which the method of accounting or taxable year is adopted or changed and in subsequent taxable years unless the Commissioner consents to a change. The preceding sentence shall apply regardless of—

- (A) When the action was taken;
- (B) Whether the foreign corporation was a controlled foreign corporation or a noncontrolled section 902 corporation at the time the action was taken;
- (C) When ownership was acquired; or

(D) Whether the domestic shareholder received the written notice required by paragraph (c)(3)(ii) of this section.

(ii) *Inaction or untimely action.* In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in paragraph (c)(6) of this section and such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause, such action may be undertaken during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in paragraph (c)(6) of this section and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, earnings and profits shall be computed as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the foreign corporation for the purpose of accounting to its shareholders had been adopted. Accordingly, if the earnings and profits of a noncontrolled section 902 corporation became significant for United States income tax purposes in a taxable year beginning on or before April 25, 2006, the corporation's earnings and profits shall be computed as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the foreign corporation for purposes of accounting to its shareholders had been adopted. Thereafter, any change in a particular accounting method or methods or taxable year may be made by, or on behalf of, the foreign corporation only with the Commissioner's consent.

(iii) *Computation of earnings and profits by a minority shareholder prior to majority election or significant event.* A shareholder of a foreign corporation may be required to compute the foreign corporation's earnings and profits before the foreign corporation or its controlling domestic shareholders make, or are required under this section to make, an election or adopt a method of accounting for federal income tax purposes. In such a case, the shareholder must compute earnings and profits in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the foreign corporation for the purpose of accounting to its

shareholders had been adopted. However, a later, properly filed, and timely election or adoption of method by, or on behalf of, the foreign corporation shall not be treated as a change in accounting method.

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

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

(6) *Action not required until significant.* Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other

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

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

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

(C) An amount is excluded from subpart F income of the foreign corporation or another foreign corporation by reason of section 952(c).

(D) Any event making the foreign corporation subject to tax under section 882.

(E) The use by the foreign corporation's controlling domestic shareholders of the tax book value (or alternative tax book value) method of

allocating interest expense under section 864(e)(4).

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

* * * * *

(d) *Effective/applicability dates.* Paragraphs (c)(1)(v) through (c)(6) of this section apply to taxable years ending on or after April 20, 2009. See 26 CFR §§ 1.964-1T(c)(1)(v) through (c)(6) (revised as of April 1, 2009) for rules applicable to taxable years beginning after April 25, 2006, and ending before April 20, 2009. However, taxpayers may choose to apply paragraphs (c)(1)(v) through (c)(6) of this section in their entirety in lieu of 26 CFR §§ 1.964-1T(c)(1)(v) through (c)(6) for periods covered by the temporary regulations, provided that appropriate adjustments are made to eliminate duplicate benefits arising from the application of paragraphs (c)(1)(v) through (c)(6) of this section to taxable years that are not open for assessment.

§ 1.964-1T [Removed]

■ **Par. 21.** Section 1.964-1T is removed.

§ 1.989(b)-1 [Amended]

■ **Par. 22.** Section 1.989(b)-1 is amended by removing the language "within the meaning of § 1.964-1(d)(5)" and adding the language "described in § 1.988-1(d)(1)" in its place.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 23.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 24.** In § 602.101, paragraph (b) is amended by removing the entry for "§ 1.964-1T" and adding the following entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	* * * * *
1.904-7	1545-2104
* * * * *	* * * * *
1.964-1	1545-2104
* * * * *	* * * * *

Approved: March 24, 2009.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Bernard Knight,

Acting General Counsel of the Treasury.

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