

Example 3. Assume the same facts as in example (1) except that on each day beginning on January 1, 1966 (the date controlled foreign corporation G was organized) through January 1, 1968, F owns 80 of the 100 outstanding shares of the only class of G stock. Since, by reason of his ownership of 25 shares of F stock, Green owns within the meaning of section 958(a)(2) the equivalent of 20 shares of G stock ($\frac{25}{100}$ of 80 shares), G is a lower tier corporation referred to in paragraph (c)(5)(i)(a) of this section. If Green had sold the 20 shares of G stock on January 1, 1968, the date he actually sold the block of F stock, the conditions of paragraph (a)(2) of § 1.1248-1 would be satisfied in respect of the G stock, and, accordingly, the conditions of paragraph (c)(5)(ii) of this section must be satisfied. Assume further that such conditions are satisfied, that G uses the calendar year as its taxable year, and that the earnings and profits accumulated by G (computed under paragraph (d) of this section) are \$19,000 for 1966 and \$21,000 for 1967. The earnings and profits of F and of G attributable to the block are \$15,500, determined as follows:

Sum of earnings and profits accumulated by G for period Green owned G stock within the meaning of section 958(a)(2) (\$19,000 plus \$21,000)	\$40,000
Multiplied by:	
Number of G shares deemed owned within the meaning of section 958(a)(2) by Green (20), divided by total number of G shares outstanding (100)	20%
Earnings and profits of G attributable to block	\$8,000
Earnings and profits of F attributable to block, as determined in example (1)	\$7,500
Total earnings and profits attributable to block	\$15,000

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§ 1.1248-3 Earnings and profits attributable to stock in complex cases.

(a) *General*—(1) *Manner of computation.* For purposes of paragraph (a)(1) of § 1.1248-1, if a United States person sells or exchanges stock in a foreign corporation, and if the provisions of § 1.1248-2 do not apply, then the earnings and profits attributable to the stock which were accumulated in taxable years of the corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered to be held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation, shall be computed in accordance with the steps

set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* For each taxable year of the corporation beginning after December 31, 1962, (i) the earnings and profits accumulated for such taxable year by the corporation shall be computed in the manner prescribed in paragraph (b) of this section, (ii) the person's *tentative ratable share* of such earnings and profits shall be computed in the manner prescribed in paragraph (c) or (d) (whichever is applicable) of this section, and (iii) the person's *ratable share* of such earnings and profits shall be computed by adjusting the tentative ratable share in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If the provisions of paragraph (f) of this section (relating to earnings and profits of *lower tier* foreign corporations) apply, the amount of the person's ratable share of the earnings and profits accumulated by each *lower tier* corporation attributable to any such taxable year (i) shall be computed in the manner prescribed by paragraph (f) of this section, and (ii) shall be added to such person's ratable share for such taxable year determined in step 1.

(4) *Step 3.* The amount of earnings and profits attributable to the share shall be the sum of the ratable shares computed for each such taxable year in the manner prescribed in steps 1 and 2.

(5) *Share or block.* In general, the computation under this paragraph shall be made separately for each share of stock sold or exchanged, except that if a group of shares constitute a block of stock the computation may be made in respect of the block. For purposes of this section, the term *block of stock* means a group of shares sold or exchanged in one transaction, but only if (i) the amount realized, basis, and holding period are identical for each such share, and (ii) the adjustments (if any) under paragraphs (e) and (f)(5) of this section of the tentative ratable shares would be identical for each such share if such adjustments were computed separately for each such share.

(6) *Deficit in earnings and profits.* For purposes of this section and §§ 1.1248-4 through 1.1248-7, in respect of a taxable year, the term *earnings and profits accumulated* for a taxable year (but only if

computed under paragraph (b) of this section) includes a deficit in earnings and profits accumulated for such taxable year. Similarly, a tentative ratable share, or a ratable share, may be a deficit.

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

Example 1. On December 31, 1967, Brown sells 10 shares of stock in foreign corporation X, which uses the calendar year as its taxable year. The 10 shares constitute a block of stock under subparagraph (5) of this paragraph. Under step 1, Brown's ratable shares of the earnings and profits of X attributable to the block are as follows:

Taxable year of X	Ratable shares
1963	\$100
1964	150
1965	150
1966	50
1967	100
Sum	350

¹ Deficit.

The amount of the earnings and profits attributable to such block under step 3 is \$350.

Example 2. Assume the same facts as in example (1), except that in respect of X there are *lower tier* corporations Y and Z to which the provisions of paragraph (f) of this section apply. Brown's ratable shares of the earnings and profits of X, Y, and Z attributable to the block under steps 1 and 2 for each taxable year of X are as follows:

Taxable year of X	Ratable shares			
	X	Y	Z	Total
1963	\$100	\$40	\$20	\$160
1964	150	40	-60	130
1965	-50	30	50	30
1966	50	50	30	130
1967	100	-40	40	100
Sum	350	120	80	550

The amount of the earnings and profits attributable to such block under step 3 is \$550.

(b) *Earnings and profits accumulated for a taxable year—(1) General.* For purposes of this section, the earnings and profits accumulated for a taxable year of a foreign corporation shall be the earnings and profits for such year, computed in accordance with the rules prescribed in § 1.964-1 (relating to determination of earnings and profits for a taxable year of a controlled foreign corporation), except that (i) the special

rules of subparagraph (2) of this paragraph shall apply, and (ii) adjustments shall be made under subparagraph (3) of this paragraph for distributions made by the corporation during such taxable year. If the stock in the corporation is sold or exchanged before any action is taken by or on behalf of the corporation under paragraph (c) of § 1.964-1, the computation of earnings and profits under § 1.964-1 for purposes of this section shall be made as if no elections had been made and no accounting method had been adopted. The amount of earnings and profits accumulated for a taxable year of a foreign corporation, as computed under this paragraph, is not necessarily the same amount as the earnings and profits of the taxable year computed under section 316(a)(1) or paragraph (d) of § 1.1248-2. Thus, for example, if a distribution with respect to stock is in excess of the amount of earnings and profits of the taxable year computed under section 316(a)(2), such excess is treated under section 316(a)(2), or paragraph (d) of § 1.1248-2 as made out of any earnings and profits accumulated in prior taxable years, whereas the amount of such excess may create, or increase, a deficit in the earnings and profits accumulated for the taxable year as computed under this paragraph. See subparagraph (3) of this paragraph.

(2) *Special rules.* (i) The earnings and profits of the corporation accumulated:

(a) For any taxable year beginning before January 1, 1967, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b) as gross income derived from sources within the United States, and

(b) For any taxable year beginning after December 31, 1966, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b)(2) as income effectively connected for that year with the conduct by such corporation of a trade or business in the United States, whether derived from sources within or from sources without the United States,

Over any deductions allocable to such item under section 882(c). However, if the sale or exchange of stock in the foreign corporation by the U.S. person

occurs before January 1, 1967, the provisions of (a) of this subdivision apply with respect to such sale or exchange even though the taxable year begins after December 31, 1966. See section 1248(d)(4). Any item which is required to be excluded from gross income, or which is taxed at a reduced rate, under an applicable treaty obligation of the United States shall not be excluded under this subdivision from earnings and profits accumulated for a taxable year.

(ii) If a foreign corporation adopts a plan of complete liquidation in a taxable year of the corporation beginning after December 31, 1962, and if because of the application of section 337(a) gain or loss would not be recognized by the corporation from the sale or exchange of property if the corporation were a domestic corporation, then the earnings and profits of the corporation accumulated for the taxable year shall be determined without regard to the amount of such gain or loss. See section 1248(d)(2). For the nonapplication of section 337(a) to a liquidation by a collapsible corporation (as defined in section 341) and to certain other liquidations, see section 337(c).

(3) *Adjustment for distributions.* (i) The earnings and profits of a foreign corporation accumulated for a taxable year (computed without regard to this subparagraph) shall be reduced (if necessary below zero so as to create a deficit), or a deficit in such earnings and profits shall be increased, by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation in respect of its stock during such taxable year (a) out of such earnings and profits, or (b) out of earnings and profits accumulated for prior taxable years beginning after December 31, 1962 (computed under this paragraph). Except for purposes of applying this subparagraph, the application of the preceding sentence shall not affect the amount of earnings and profits accumulated for any such prior taxable year.

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

Example 1. X Corporation, which uses the calendar year as its taxable year, was orga-

nized on January 1, 1965, and was a controlled foreign corporation on each day of 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is \$400,000, of which \$100,000 is distributed by X as dividends during 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph) is \$300,000 (that is, \$400,000 minus \$100,000). The result would be the same even if X was not a controlled foreign corporation on each day of 1965.

Example 2. Assume the same facts as in example (1). Assume further that the amount of X's earnings and profits accumulated for 1966 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is \$150,000, and that X distributes the amount of \$260,000 as dividends during 1966. Since \$150,000 of the distribution is from earnings and profits accumulated for 1966 (computed without regard to the adjustment for distributions under this subparagraph), and since \$110,000 is from earnings and profits accumulated for 1965, the earnings and profits of X accumulated for 1966 are a deficit of \$110,000 (that is, \$150,000 minus \$260,000). However, the earnings and profits accumulated for 1965 are still \$300,000 for purposes of computing in the manner prescribed in paragraph (c) of this section a person's tentative ratable share.

(c) *Tentative ratable share if earnings and profits accumulated for a taxable year not less than zero—(1) General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if the amount of the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section), beginning after December 31, 1962, is not less than zero, then the person's tentative ratable share for such taxable year shall be equal to:

(i)(a) Such amount (if the computation is made in respect of a block, multiplied by the number of shares in the block), divided by (b) the number of shares in the corporation outstanding, or deemed under subparagraph (2) of this paragraph to be outstanding, on each day of such taxable year, multiplied by

(ii) The percentage that (a) the number of days in such taxable year of the corporation during the period the person held (or was considered to have held by reason of the application of section 1223) the share (or block) while

the corporation was a controlled foreign corporation, bears to (b) the total number of days in such taxable year.

(2) *Shares deemed outstanding for a taxable year.* For purposes of this section and §§1.1248-4 through 1.1248-7, if the number of shares of stock in a foreign corporation outstanding on each day of a taxable year of the corporation is not constant, then the number of such shares deemed outstanding on each such day shall be the sum of the fractional amounts in respect of each share outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing (i) the number of days in the taxable year during which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by (ii) the total number of days in such taxable year.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. On each day of 1964, S owns a block consisting of 30 of the 100 shares of the only class of stock outstanding in F Corporation, and on each such day F is a controlled foreign corporation. F uses the calendar year as its taxable year and F's earnings and profits accumulated for 1964 (computed under paragraph (b) of this section) are \$10,000. S's tentative ratable share with respect to the block is \$3,000, computed as follows:

Earnings and profits accumulated for taxable year	\$10,000
Multiplied by:	
Number of shares in block (30), divided by number of shares outstanding (100)	30%
Multiplied by:	
Number of days in 1964 S held block while F was a controlled foreign corporation (365), divided by number of days in 1964 (365)	100%
Tentative ratable share for block	\$3,000

Example 2. On December 31, 1964, X Corporation, a controlled foreign corporation which uses the calendar year as its taxable year, had 100 shares of one class of stock outstanding, 15 of which were owned by T. T's 15 shares were redeemed by X on March 14, 1965. On December 31, 1965, in addition to the remaining 85 shares, 10 new shares of stock (which were issued on May 26, 1965) were outstanding. Thus, during 1965, 15 shares were outstanding for 73 days, 10 for 219 days, and 85 for 365 days. The earnings and profits (computed under paragraph (b) of this section) accumulated for X's taxable year ending on December 31, 1965, are \$18,800. T's ten-

tative ratable share with respect to one share of stock is \$40, computed as follows:

Earnings and profits accumulated for taxable year	\$18,800
Divided by:	
Number of shares deemed outstanding each day of 1965:	
15 for 73 days (15×73/365)	3
10 for 219 days (10×219/365)	6
85 for 365 days (85×365/365)	85
Total number of shares deemed outstanding each day of 1965	94
Earnings and profits accumulated per share	\$200
Multiplied by:	
Number of days in 1965 T held his share while X was a controlled foreign corporation (73), divided by number of days in 1965 (365)	20%
T's tentative ratable share per share of stock	\$40

Example 3. Assume the same facts as in example (2) except that X was not a controlled foreign corporation after January 31, 1965. T's tentative ratable share with respect to one share of stock for 1965 is \$17, computed as follows:

Earnings and profits accumulated per share, determined in example (2)	\$200
Multiplied by:	
Number of days in 1965 T held X stock while X was a controlled foreign corporation (31), divided by number of days in 1965 (365)	8.5%
Tentative ratable share	\$17

(4) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraphs (1) and (2) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of §1.951-1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(d) *Tentative ratable share if deficit in earnings and profits accumulated for taxable year—(1) General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if there is a deficit in the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section) beginning after December 31, 1962, the person's tentative

ratable share for such taxable year shall be an amount equal to the sum of the partial tentative ratable shares computed under subparagraphs (2) and (3) of this paragraph.

(2) *Operating deficit.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year. Second, compute the partial tentative ratable share in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if such deficit were the amount referred to in paragraph (c)(1)(i)(a) of this section.

(3) *Deficit from distributions.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute and treat as a deficit only that portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under subparagraph (4) of this paragraph to distributions out of earnings and profits accumulated during prior taxable years of the corporation beginning after December 31, 1962, during the period or periods the corporation was a controlled foreign corporation and the share (or block) of stock was owned by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share for such taxable year in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if (i) such deficit were the amount referred to in paragraph (c)(1)(i)(a) of this section, and (ii) the corporation were a controlled foreign corporation on each day of such taxable year.

(4) *Order of distributions.* For purposes of applying subparagraph (3) of this paragraph only, the adjustment for distributions under paragraph (b)(3) of this section for a taxable year of a foreign corporation shall be treated as attributable first to distributions of earnings and profits for the taxable year (computed under paragraph (b) of

this section without regard to such adjustment) to the extent thereof, and then to distributions out of the most recent of earnings and profits accumulated during prior taxable years beginning after December 31, 1962 (computed under paragraph (b) of this section). If the foreign corporation was a controlled foreign corporation during a prior taxable year for a period or periods which was only part of such prior taxable year, then for purposes of the preceding sentence (i) such taxable year shall be divided into periods the corporation was or was not a controlled foreign corporation, (ii) distributions of the earnings and profits accumulated during such prior taxable year shall be considered made from the most recent period first, and (iii) the earnings and profits accumulated during such prior taxable year shall be allocated to a period during such year in the same proportion as the number of days in the period bears to the number of days in such year. Except for purposes of applying subparagraph (3) of this paragraph, the application of this subparagraph shall not affect the amount of earnings and profits accumulated for any such prior taxable year (computed under paragraph (b) of this section).

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

Example 1. On each day of 1965 X Corporation, which uses the calendar year as its taxable year, was a controlled foreign corporation having 100 shares of one class of stock outstanding, a block of 25 of which were owned by T, who acquired them in 1962 and sold them in 1967. The deficit in X's earnings and profits accumulated for 1965 (computed under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) is \$100,000, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is a deficit of \$25,000 (that is, $\$100,000 \times 25/100$). During 1965 X does not make any distributions in respect of its stock, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (3) of this paragraph is zero. Accordingly, T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of \$25,000. If, however, X was a controlled foreign corporation for only 292 days during 1965, T's tentative ratable share in respect of the block for 1965 would be a deficit of \$20,000 (that is, $\$25,000 \times 292/365$).

Example 2. (i) Assume the same facts as in example (1) except that at no time during 1965 is X a controlled foreign corporation and that during 1965 X distributes \$80,000 with respect to its stock. Assume further that X was a controlled foreign corporation on each day of 1964, but only for the first 146 days of 1963, and that X's earnings and profits accumulated for prior taxable years computed under paragraph (b) of this section are \$70,000 for 1964 and \$20,000 for 1963.

(ii) Since X was not a controlled foreign corporation on any day of 1965, in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is zero.

(iii) The partial tentative ratable share under subparagraph (3) of this paragraph is computed in the following manner: For 1965 the adjustment for distributions under paragraph (b)(3) of this section is \$80,000. Under subparagraph (4) of this paragraph \$70,000 of such adjustment is attributable to the distribution of all of the earnings and profits accumulated during 1964, on every day of which X was a controlled foreign corporation, and \$10,000 of the adjustment is attributable to the distribution of \$10,000 of the earnings and profits accumulated for 1963. The portion of the earnings and profits accumulated by X in 1963 attributable to the first 146 days in 1963 during which X was a controlled foreign corporation is \$8,000 (that is, $\$20,000 \times 146/365$), and the portion attributable to the period in 1963 during which X was not a controlled foreign corporation is \$12,000 (that is, $\$20,000 \times 219/365$). Under subparagraph (4)(ii) of this paragraph, the distribution in 1965 of \$10,000 of earnings and profits accumulated during 1963 is attributable to the more recent period in 1963, that is, the period X was not a controlled foreign corporation. Accordingly, the portion of the adjustment for distributions under paragraph (b)(3) of this section attributable to earnings and profits accumulated during periods X was a controlled foreign corporation is \$70,000, and in respect of the block T's partial tentative ratable share under subparagraph (3) of this paragraph is a deficit of \$17,500 (that is, $\$70,000 \times 25/100$).

(iv) T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of \$17,500 (that is, the sum of the partial tentative ratable share for the block computed under subparagraph (2) of this paragraph, zero, plus the partial tentative ratable share for the block computed under subparagraph (3) of this paragraph, a deficit of \$17,500).

(v) Assume that X had 100 shares of one class of stock outstanding on each day of 1964 and 1963. Notwithstanding the distributions in 1965 of earnings and profits accumulated during 1964 and 1963 (computed under paragraph (b) of this section), nevertheless, in respect of the block T's tentative ratable share for 1964 is \$17,500 (that is, earnings and

profits accumulated during 1964 so computed of \$70,000, multiplied by 25 shares/100 shares) and in respect of the block T's tentative ratable share for 1963 is \$2,000 (that is, earnings and profits accumulated during 1963 so computed of \$20,000, multiplied by 25 shares/100 shares, and multiplied by the percentage that the number of days in 1963 on which X was a controlled foreign corporation bears to the total number of days in 1963, 146/365).

Example 3. Assume the same facts as in example (2) except that X was a controlled foreign corporation on each day of 1965. The tentative ratable share with respect to the block of stock for 1965 is a deficit of \$42,500, that is, the sum of the partial tentative ratable share under subparagraph (2) of this paragraph (as determined in example (1)), a deficit of \$25,000, plus the partial tentative ratable share under subparagraph (3) of this paragraph (as determined in example (2)), a deficit of \$17,500.

(6) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951-1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(e) *Ratable share of earnings and profits accumulated for a taxable year—(1) In general.* For purposes of paragraph (a)(2)(iii) of this section, in respect of a share (or block) of stock in a foreign corporation, the person's ratable share of the earnings and profits accumulated for a taxable year beginning after December 31, 1962, shall be an amount equal to the tentative ratable share computed under paragraph (c) or (d) (as the case may be) of this section, adjusted in the manner prescribed in subparagraphs (2) through (6) of this paragraph.

(2) *Amounts included in gross income under section 951.* (i) In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the excess of (a) the amount, if any, included (in respect of such corporation for such taxable year)

under section 951 in the gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such share (or block), over (b) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1) (relating to exclusion from gross income of distributions of previously taxed earnings and profits). See section 1248(d)(1). This subdivision shall apply notwithstanding an election under section 962 by such person to be subject to tax at corporate rates.

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

Example: On December 31, 1975, Brown sells one share of stock in X Corporation, a controlled foreign corporation which has never been a less developed country corporation (as defined in section 902(d)). Both Brown and X use the calendar year as the taxable year. In respect of his share, Brown's tentative ratable share for 1971 (computed under paragraph (c) of this section) is \$35. In respect of his share, Brown included \$4 in his gross income for 1971 under section 951, and the amount of \$3, which was distributed to him by X on January 15, 1972, is excluded from Brown's gross income under section 959(a)(1). In respect of the stock, Brown's ratable share for 1971 is \$34, determined as follows:

Tentative ratable share	\$35
Minus:	
Excess of amount of tentative ratable share included in Brown's gross income under section 951 (\$4), over portion thereof which resulted in exclusion under section 959(a)(1) (\$3)	1
Ratable share	34

(3) *Amounts included in gross income under section 551.* In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551 in the gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section

1223) in the gross income of any other person who held such share (or block).

(4) *Less developed country corporations.*

(i) If the foreign corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, and if the person who sold or exchanged a share (or block) of stock in such corporation satisfies the requirements of paragraph (a) of §1.1248-5 in respect of such stock, then his ratable share for such taxable year shall be zero. See section 1248(d)(3).

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

Example: Assume the same facts as in the example in subparagraph (2)(ii) of this paragraph except that X was a less developed country corporation for 1971. Assume further that Brown satisfies the requirements of paragraph (a) of §1.1248-5. Brown's ratable share in respect of the stock for 1971 is zero.

(5) *Qualified shareholder of foreign investment company.* In respect of a share (or block) of stock in a foreign corporation which was a foreign investment company described in section 1246(b)(1), if the election under section 1247(a) to distribute income currently was in effect for a taxable year of the company, and if the person who sold or exchanged the stock (or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223 to the person who sold or exchanged the stock) was a qualified shareholder (as defined in section 1247(c)) for his taxable year in which or with which such taxable year of the company ends, then the ratable share in respect of the share (or block) for such taxable year of the company shall be zero. See section 1248(d)(5). In case gain is recognized under section 1246 in respect of a share (or block), see section 1248(f)(3)(B).

(6) *Adjustment for certain distributions.* If (i) the person who sold or exchanged the share or block (or another person who actually owned the share or block and whose holding of the share or block is attributed by reason of the application of section 1223 to such person) received a distribution during a taxable year of the corporation, and (ii) such distribution was not included in the

gross income of such person (or such other person) by reason of the application of section 959(a)(1) to amounts which were included under section 951(a)(1) in the gross income of a United States shareholder whose holding of the share or block is not attributed by reason of the application of section 1223 to such person (or such other person), then the amount of such distribution shall be added to such person's tentative ratable share for such taxable year. Thus, for example, such tentative ratable share may be increased, or a deficit reduced, by the amount of such distribution.

(f) *Earnings and profits of subsidiaries of foreign corporations*—(1) *Application of paragraph.* (i) In respect of a person who sells or exchanges stock in a foreign corporation (referred to as a *first tier* corporation), the provisions of this paragraph shall apply if the following 3 conditions exist:

(a) The conditions of paragraph (a)(2) of § 1.1248-1 are satisfied by the person in respect of such stock;

(b) By reason of his ownership of such stock, on the date of such sale or exchange such person owned, within the meaning of section 958(a)(2), stock in another foreign corporation (referred to as a *lower tier* corporation); and

(c) The conditions of paragraph (a)(2) of § 1.1248-1 would be satisfied by such person in respect of such stock in the lower tier corporation if such person were deemed to have sold or exchanged such stock in the lower tier corporation on the date he actually sold or exchanged such stock in the first tier corporation.

(ii) If the provisions of this paragraph apply, (a) the person's tentative ratable share (or shares) of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (2) or (4) of this paragraph, whichever is applicable, and (b) such person's ratable share (or shares) for the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (5) of this paragraph. For the manner of taking into account the ratable share for a lower tier corporation, see paragraph (a)(3) of this section.

(iii) The application of this subparagraph may be illustrated by the following example:

Example: On each day of 1964 and 1965 corporations X and Y are controlled foreign corporations, and each has outstanding 100 shares of one class of stock. On January 15, 1965, T, a United States person, owns one share of stock in X and X directly owns 20 shares of stock in Y. Thus, T owns, within the meaning of section 958(a)(2), stock in Y. On that date, T sells his share in X and satisfies the conditions of paragraph (a)(2) of § 1.1248-1 in respect of his stock in X. Assuming that the conditions of paragraph (a)(2) of § 1.1248-1 would be satisfied by T in respect of the stock he indirectly owns in Y if, on January 15, 1965, he were deemed to have sold such stock in Y, the provisions of this paragraph apply.

(2) *Tentative ratable share (of lower tier corporation attributable to a taxable year of first tier corporation) not less than zero.* If the provisions of this paragraph apply to a sale or exchange by a United States person of a share (or block) of stock in a first tier corporation, and if the amount of earnings and profits accumulated (computed under paragraph (b) of this section) for a taxable year (beginning after December 31, 1962) of the lower tier corporation is not less than zero, then in respect of the share (or block) such person's tentative ratable share of the earnings and profits accumulated for such taxable year of the lower tier corporation attributable to any taxable year (beginning after December 31, 1962) of such first tier corporation shall be an amount equal to:

(i)(a) Such amount of earnings and profits accumulated for such taxable year of the lower tier corporation (if the computation is made in respect of a block in the first tier corporation, multiplied by the number of shares in the block), divided by (b) the number of shares in the first tier corporation outstanding, or deemed under paragraph (c)(2) of this section to be outstanding, on each day of such taxable year of the first tier corporation, multiplied by

(ii) The percentage that (a) the number of days during the period or periods in such taxable year of the first tier corporation on which such person held (or was considered to have held by reason of the application of section 1223) the share (or block) in the first tier

corporation while the first tier corporation owned (within the meaning of section 958(a)) stock of such lower tier corporation at times while such lower tier corporation was a controlled foreign corporation, bears to (b) the total number of days in such taxable year of the first tier corporation, multiplied by

(iii) The percentage that (a) the average number of shares in the lower tier corporation which were owned within the meaning of section 958(a) by the first tier corporation during such period or periods (referred to in subdivision (ii)(a) of this subparagraph), bears to (b) the total number of such shares outstanding, or deemed under the principles of paragraph (c)(2) of this section to be outstanding, during such period or periods, multiplied by

(iv) The percentage that (a) the number of days in such taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (b) the total number of days in such taxable year of the lower tier corporation.

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

Example 1. In a year subsequent to 1969, Brown, a United States person, sells 5 of his shares of stock in X Corporation in a transaction as to which the provisions of this paragraph apply. Brown had purchased the 5 shares prior to 1969. On each day of 1969 X Corporation actually had 100 shares of one class of stock outstanding. On each such day X Corporation directly owned all of the shares of stock in Y Corporation, and Y Corporation directly owned all of the shares of stock in Z Corporation. Z Corporation on each such day was a controlled foreign corporation. Both X and Z use the calendar year as the taxable year. Z's earnings and profits accumulated for 1969 (computed under paragraph (b) of this section) are \$2,000. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is \$20 per share, computed as follows:

(i) Z's earnings and profits for 1969 (\$2,000), divided by the number of shares in X deemed outstanding each day of 1969 (100)	\$20
Multiplied by:	
(ii) Since on each day of 1969 Brown (by reason of owning directly his shares in X) owned, within the meaning of section 958(a)(2), stock in Z while Z was a controlled foreign corporation, the percentage determined under subparagraph (2)(ii) of this paragraph equals	100%

Multiplied by:	
(iii) Since on each day of 1969 X owned 100 percent of the stock of Y while Y owned 100 percent of the stock in Z, the percentage determined under subparagraph (2)(iii) of this paragraph equals	100%
Multiplied by:	
(iv) Since X and Z each use the same taxable year, the percentage determined under subparagraph (2)(iv) of this paragraph equals	100%
Total	\$20

Example 2. Assume the same facts as in example (1), except that Brown sold his stock in X on October 19, 1969. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is \$16 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	\$20
Multiplied by:	
(ii) The number of days in the period during 1969 Brown (by reason of owning directly his stock in X) owned, within the meaning of section 958(a)(2), his stock in Z while Z was a controlled foreign corporation (292), divided by the number of days in 1969 (365), equals	80%
Multiplied by:	
(iii) The percentage determined in subdivision (iii) of example (1)	100%
Multiplied by:	
(iv) The percentage determined in subdivision (iv) of example (1)	100%
Total	\$16

Example 3. Assume the same facts as in examples (1) and (2), except that on each day during 1969 Y owned (within the meaning of section 958(a)(2)) 81 of the 100 shares of Z's outstanding stock. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is \$12.96 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	\$20
Multiplied by:	
(ii) The percentage determined in subdivision (ii) of example (2)	80%
Multiplied by:	
(iii) The average number of shares in Z which were owned (within the meaning of section 958(a)) by X during the applicable period (81), divided by the total number of shares in Z during such period (100) ...	81%
Multiplied by:	
(iv) The percentage determined in subdivision (iv) of example (1)	100%
Total	\$12.96

The result would be the same if X owned (within the meaning of section 958(a)(2)) 81 percent of the stock in Y while Y so owned 100 percent of the stock in X, or if X so owned 90 percent of the stock in Y while Y so owned 90 percent of the stock in Z.

Example 4. Assume the same facts as in example (3), except that Z Corporation uses a fiscal year ending June 30 as its taxable year. Assume further that Z's earnings and profits accumulated for its fiscal year ending June 30, 1969, and for its fiscal year ending June 30, 1970, are \$3,000 and \$2,000, respectively. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is \$16.17 per share, computed as follows:

	In respect of Z's tax- able year ending	
	June 30, 1969	June 30, 1970
(i) Z's earnings and profits, divided by the number of shares in X deemed outstanding on each day of 1969:		
\$3,000/100	\$30	
\$2,000/100		\$20
Multiplied by:		
(ii) The percentage determined in subdivision (ii) of example (2)	80%	80%
Multiplied by:		
(iii) The percentage determined in subdivision (iii) of example (3)	81%	81%
Multiplied by:		
(iv) Number of days in Z's taxable year which fall within 1969, divided by total number of days in Z's taxable year:		
181/365	49.6%	
184/365		50.4%
Totals	\$9.64	\$6.53
(v) Sum of tentative ratable shares of Z attributable to X's 1969 calendar year:		
For Z's taxable year ending		
June 30, 1969		\$9.64
June 30, 1970		\$6.53
Sum		\$16.17

(4) *Deficit in tentative ratable share of lower tier corporation attributable to a taxable year of first tier corporation.* (i) If there is a deficit in the earnings and profits accumulated for a taxable year of a lower tier corporation beginning after December 31, 1962 (computed under paragraph (b) of this section), the person's tentative ratable share for such taxable year of such lower tier corporation attributable to a taxable year of a first tier corporation shall not be computed under subparagraph (2) of this paragraph but shall be an amount equal to the sum of the partial tentative ratable shares computed under subdivisions (ii) and (iii) of this subparagraph.

(ii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustments for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year of such lower tier corporation. Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph.

(iii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute and treat as a deficit the portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under paragraph (d)(4) of this section to distributions of earnings and profits accumulated during prior taxable years of the lower tier corporation beginning after December 31, 1962, during the period or periods such lower tier corporation was a controlled foreign corporation and the percentage of the stock of such lower tier corporation (which the person owns within the meaning of section 958(a)(2)) was owned within the meaning of section 958(a) by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if (a) such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph, and (b) such lower tier corporation were a controlled foreign corporation on each day of such taxable year.

(5) *Ratable share of lower tier corporation attributable to a first tier corporation.* (i) If the provisions of this paragraph apply in respect of a share of stock in a first tier corporation, a person's ratable share of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be an amount equal to the tentative

ratable share computed under subparagraph (2) or (4) of this paragraph, adjusted in the manner prescribed in this subparagraph.

(ii) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the excess of (a) the amount, if any, included (in respect of such lower tier corporation for its taxable year) under section 951 in the gross income of such person or (during the period such stock was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such stock, over (b) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1). For an illustration of the principles in the preceding sentence, see the example in paragraph (e)(2)(ii) of this section.

(iii) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be an excess computed under subdivision (ii) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced (but not below zero) by an amount which bears the same ratio to (a) such excess, as (b) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (c) the total number of days in the taxable year of the first tier corporation.

(iv) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier cor-

poration the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551, by reason of the application of section 555(b), in the gross income of such person or (during the period such share (or block) was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such share (or block).

(v) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be a reduction in the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation by an amount computed under subdivision (iv) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced by an amount which bears the same ratio to (a) such amount, as (b) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (c) the total number of days in the taxable year of the first tier corporation.

(vi) If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, see paragraph (g) of this section.

(g) *Lower tier corporation a less developed country corporation*—(1) *General*. If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of such corporation, and if the person who sold or exchanged a share (or block) of stock in the first tier corporation satisfies on the date of such sale or exchange:

(i) The requirements of paragraph (a)(1) of §1.1248-5 with respect to such stock, and

(ii) The requirements of paragraph (d)(1) of §1.1248-5 with respect to any stock of the lower tier corporation which such person, by reason of his direct ownership of such stock in the first tier corporation, owned within the meaning of section 958(a)(2),

Then such person's ratable share (or a deficit in such ratable share) for such taxable year of the lower tier corporation attributable to a taxable year of the first tier corporation (determined without regard to this paragraph) shall be reduced by an amount computed by multiplying such ratable share (so determined without regard to this paragraph) by the percentage computed under either subparagraph (2) or (4) of this paragraph, whichever is applicable.

(2) *Percentage for second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (hereinafter referred to as a *second tier* corporation) is owned directly by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed by dividing (i) the number of shares of stock of the second tier corporation which the first tier corporation has owned directly for an uninterrupted 10-year period ending on such date, by (ii) the total number of shares of the stock of such second tier corporation owned directly by such first tier corporation on such date.

(3) *Examples.* The provisions of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1966, Smith, a United States person, recognizes gain upon the sale of one share of the only class of stock of F Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). On January 1, 1966, F owns directly 60 shares of the 100 outstanding shares of the only class of stock of G Corporation, which F acquired in 1955 and owned continuously until such sale. F uses a taxable year ending June 30, and G uses the calendar year as the taxable year. For 1964, G was a less developed country corporation, and on each day of 1964 G was a controlled foreign corporation. Smith's ratable share

for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (determined without regard to this paragraph) is \$6.00. Since the percentage computed under subparagraph (2) of this paragraph is 100 percent (60 shares divided by 60 shares), Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) of this paragraph) is zero (that is, \$6.00 reduced by 100 percent of \$6.00).

Example 2. Assume the same facts as in example (1) except that of the 60 shares of G Corporation which F Corporation owned on January 1, 1966, 20 shares were acquired in 1961. The percentage computed under subparagraph (2) of this paragraph is 66⅔ percent (40 shares divided by 60 shares). Accordingly, Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) of this paragraph) is \$2.00 (that is, \$6.00 reduced by 66⅔ percent of \$6.00).

(4) *Percentage for lower tier corporations other than second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (other than a second tier corporation) is owned within the meaning of section 958(a)(2) by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed in the following manner:

(i) First, determine the percentage for the second tier corporation in accordance with subparagraph (2) of this paragraph.

(ii) Second, determine a partial percentage for each other lower tier corporation in the same manner as the percentage for the second tier corporation is determined. Thus, for example, the partial percentage for a third tier corporation is determined by dividing (a) the number of shares of stock of the third tier corporation which the second tier corporation has owned directly for an uninterrupted 10-year period ending on the date of the sale or exchange referred to in subparagraph (1) of this paragraph, by (b) the total number of shares of stock of such third tier corporation owned directly by such second tier corporation on such date.

(iii) Third, the percentage for a third tier corporation is the percentage for the second tier corporation multiplied by the partial percentage for the third

tier corporation. The percentage for a fourth tier corporation is the percentage for the third tier corporation (as determined in the preceding sentence) multiplied by the partial percentage for the fourth tier corporation. In a similar manner, the percentage for any other lower tier corporation may be determined.

(5) *Example.* The application of subparagraph (4) of this paragraph may be illustrated by the following example:

Example: On January 1, 1967, Brown, a United States person recognizes gain upon the sale of one share of the only class of stock of W Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). W is the first tier corporation of a chain of foreign corporations W, X, Y, and Z. W and Z each use the calendar year as the taxable year. For 1964, Z was a less developed country corporation and on each day of 1964 Z was a controlled foreign corporation. Additional facts are set forth in the table below:

Corporation—(1)	Shares directly owned by preceding tier—		Column (2) divided by column (3) (percent)—(4)
	For uninterrupted 10-year period ending Jan. 1, 1967—(2)	On Jan. 1, 1967—(3)	
X	40	60	66⅔%
Y	30	40	75%
Z	20	30	66⅔%

For 1964, the percentage referred to in subparagraph (4) of this paragraph for Z is 33⅓ percent (66⅔%×75%×66⅔%).

(6) *Special rule.* For purposes of applying the provisions of this paragraph, a lower tier corporation may be treated as a second tier corporation with respect to any of its stock which is owned directly by a first tier corporation whereas such lower tier corporation may be treated as a lower tier corporation other than a second tier corporation with respect to other stock in such lower tier corporation which is owned (within the meaning of section 958(a)(2)) by such first tier corporation. Thus, for example, if corporations X, Y, and Z are foreign corporations, X is a first tier corporation owning directly 100 percent of the stock of Y and 40 percent of the stock of Z, and in addition Y owns directly 60 percent of the stock

of Z, then the 40 percent of the Z stock (which X owns directly) is considered to be stock in a second tier corporation and the 60 percent of the Z stock (which Y owns directly and which X is considered to own within the meaning of section 958(a)(2)) is considered to be stock in a third tier corporation.

[T.D. 6779, 29 FR 18133, Dec. 22, 1964, as amended by T.D. 7293, 38 FR 32803, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.1248-4 Limitation on tax applicable to individuals.

(a) *General rule—(1) Limitation on tax.* Under section 1248(b), if during a taxable year an individual sells or exchanges stock in a foreign corporation, then in respect of the stock the increase in the individual's income tax liability for such taxable year which is attributable (under paragraph (b) of this section) to the amount included in his gross income as a dividend under section 1248(a) shall not be greater than an amount equal to the sum of:

(i) The excess, computed under paragraph (c) of this section in respect of the stock of the United States taxes which would have been paid by the corporation over the taxes (including United States taxes) actually paid by the corporation, plus.

(ii) An amount equal to the increase in the individual's income tax liability which would be attributable to the inclusion in his gross income for such taxable year, as long-term capital gain, of an amount equal to the excess of (a) the amount included in the individual's gross income as a dividend under section 1248(a) in respect of such stock, over (b) the excess referred to in subdivision (i) of this subparagraph.

(2) *Share or block.* In general, the limitation on tax attributable (under paragraph (b) of this section) to the amount included in an individual's gross income as a dividend under section 1248(a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248-2 or 1.1248-3. See paragraph (b) of § 1.1248-2 and paragraph (a)(5) of § 1.1248-3.