

be allocated to some item or class of gross income. See §§ 1.861-8 and 1.863-1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862-1 and 1.863-1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862-1 and 1.863-1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863-2 to 1.863-5, inclusive.

(4) *Exceptions.* An owner of certain aircraft or vessels first leased on or before December 28, 1980, may elect to treat income in respect of these aircraft or vessels as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861-9. An owner of certain aircraft, vessels, or spacecraft first leased after December 28, 1980, must treat income in respect of these craft as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861-9A.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States,

together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7928, 48 FR 55845, Dec. 16, 1983]

§ 1.861-2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States. See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

(2) The term "resident of the United States", as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

(4) For purposes of this section, the term “interest” includes all amounts treated as interest under section 483, and the regulations thereunder. It also includes original issue discount, as defined in section 1232(b)(1), whether or not the underlying bond, debenture, note, certificate, or other evidence of indebtedness is a capital asset in the hands of the taxpayer within the meaning of section 1221.

(5) If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident’s capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States.

(6) In the case of interest received by a nonresident alien individual or foreign corporation this paragraph (a) applies whether or not the interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual or corporation.

(7) A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive a substantially identical securities from the transferee in the future in exchange for cash. A substitute interest payment shall be sourced in the same manner as the interest accruing on the transferred security for purposes of this section and § 1.862-1. See also §§ 1.864-5(b)(2)(iii), 1.871-7(b)(2), 1.881-2(b)(2) and for the character of such payments and § 1.894-1(c) for the application tax treaties to these transactions.

(b) *Interest not derived from U.S. sources.* Notwithstanding paragraph (a) of this section, interest shall be treated as income from sources without the United States to the extent provided

by subparagraphs (A) through (H), of section 861(a)(1) and by the following subparagraphs of this paragraph.

(1) *Interest on bank deposits and on similar amounts.* (i) Interest paid or credited before January 1, 1977, to a nonresident alien individual or foreign corporation on—

(a) Deposits with persons, including citizens of the United States or alien individuals and foreign or domestic partnerships or corporations, carrying on the banking business in the United States,

(b) Deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, or

(c) Amounts held by an insurance company under an agreement to pay interest thereon, shall be treated as income from sources without the United States if such interest is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation. If such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation, it shall be treated as income from sources within the United States under paragraph (a) of this section unless it is treated as income from sources without the United States under another subparagraph of this paragraph. For a special rule for determining whether such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States, see paragraph (c)(1)(ii) or § 1.864-4.

(ii) Paragraph (b)(1)(i)(b) of this section applies to interest on deposits or withdrawable accounts described therein only to the extent that the interest paid or credited by the savings institution described therein is deductible under section 591 in determining the taxable income of such institution; and, for this purpose, whether an amount is deductible under section 591 shall be determined without regard to section 265, relating to deductions allocable to tax-exempt income. Thus, for example, such subdivision does not

apply to amounts paid by a savings and loan or similar association on or with respect to its nonwithdrawable capital stock or on or with respect to funds held in restricted accounts which represent a proprietary interest in such association. Paragraph (b)(1)(i)(b) of this section also applies to so-called dividends paid or credited on deposits or withdrawable accounts if such dividends are deductible under section 591 without reference to section 265.

(iii) For purposes of paragraph (b)(1)(i)(c) of this section, amounts held by an insurance company under an agreement to pay interest thereon include policyholder dividends left with the company to accumulate, prepaid insurance premiums, proceeds of policies left on deposit with the company, and overcharges of premiums. Such subdivision does not apply to (a) the so-called "interest element" in the case of annuity or installment payments under life insurance or endowment contracts or (b) interest paid by an insurance company to its creditors on notes, bonds, or similar evidences of indebtedness, if the debtor-creditor relationship does not arise by virtue of a contract of insurance with the insurance company.

(iv) For purposes of paragraph (b)(1)(i) of this section, interest received by a partnership shall be treated as received by each partner of such partnership to the extent of his distributive share of such item.

(2) *Interest from a resident alien individual or domestic corporation deriving substantial income from sources without the United States.* Interest received from a resident alien individual or a domestic corporation shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 863, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such individual or corporation preceding its taxable year in which such interest is paid or cred-

ited, or for such part of such period as may be applicable. If 20 percent or more of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as so determined, for such 3-year period (or part thereof), the entire amount of the interest from such individual or corporation shall be treated as income from sources within the United States.

(3) *Interest from a foreign corporation not deriving major portion of its income from a U.S. business.* (i) Interest from a foreign corporation which, at any time during the taxable year, is engaged in trade or business in the United States shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that (a) less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864-3, or (b) such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct of a trade or business in the United States.

(ii) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, see section 861(a)(1)(D) and paragraph (c)(1) of this section for determining the portion of interest from such corporation which is treated as income from sources within the United States.

(iii) For purposes of this paragraph the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e) and the regulations thereunder, is treated as income which is effectively connected

with the conduct of a trade or business in the United States.

(iv) This paragraph does not apply to interest paid or credited after December 31, 1969, by a branch in the United States of a foreign corporation if, at the time of payment or crediting, such branch is engaged in the commercial banking business in the United States; furthermore, such interest is treated under paragraph (a) of this section as income from sources within the United States unless it is treated as income from sources without the United States under paragraph (b) (1) or (4) of this section.

(4) *Bankers' acceptances.* Interest derived by a foreign central bank of issue from bankers' acceptances shall be treated as income from sources without the United States. For this purpose, a foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose laws it is organized.

(5) *Foreign banking branch of a domestic corporation or partnership.* Interest paid or credited on deposits with a branch outside the United States (as defined in section 7701(a)(9)) of a domestic corporation or of a domestic partnership shall be treated as income from sources without the United States, if, at the time of payment or crediting, such branch is engaged in the commercial banking business. For purposes of applying this paragraph, it is immaterial (i) whether the domestic corporation or domestic partnership is carrying on a banking business in the United States, (ii) whether the recipient of the interest is a citizen or resident of the United States, a foreign corporation, or a foreign partnership, (iii) whether the interest is effectively connected with the conduct of a trade or business in the United States by the recipient, or (iv) whether the deposits with the branch located outside the United States are payable in the currency of a foreign country. Notwithstanding the provisions of §1.863-6, interest to which this paragraph applies shall be treated as income from sources

within the foreign country, possession of the United States, or other territory in which the branch is located.

(6) *Section 4912(c) debt obligations—* (i) *In general.* Under section 861(a)(1)(G), interest on a debt obligation shall not be treated as income from sources within the United States if—

(a) The debt obligation was part of an issue of debt obligations with respect to which an election has been made under section 4912(c) (relating to the treatment of such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax),

(b) The debt obligation had a maturity not exceeding 15 years (within the meaning of paragraph (b)(6)(ii) of this section) on the date it is originally issued or on the date it is treated under section 4912(c)(2) as issued by reason of being assumed by a certain domestic corporation,

(c) The debt obligation, when originally issued, was purchased by one or more underwriters (within the meaning of paragraph (b)(6)(iii) of this section) with a view to distribution through resale (within the meaning of paragraph (b)(6)(iv) of this section), and

(d) The interest on the debt obligation is attributable to periods after the effective date of an election under section 4912(c) to treat such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax.

(ii) *Maturity not exceeding 15 years.* The date the debt obligation is issued or treated as issued is not included in the 15 year computation, but the date of maturity of the debt, obligation is included in such computation.

(iii) *Purchased by one or more underwriters.* For purposes of this paragraph, the debt obligation when originally issued will not be treated as purchased by one or more underwriters unless the underwriter purchases the debt obligation for his own account and bears the risk of gain or loss on resale. Thus, for example, a debt obligation, when originally issued, will not be treated as purchased by one or more underwriters if the underwriter acts only in the capacity of an agent of the issuer. Neither will a debt obligation, when originally issued, be treated as purchased by one

or more underwriters if the agreement between the underwriter and issuer is merely for a “best efforts” underwriting, for the purchase by the underwriter of all or a portion of the debt obligations remaining unsold at the expiration of a fixed period of time, or for any other arrangement under the terms of which the debt obligations are not purchased by the underwriter with a view to distribution through resale. The fact that an underwriter is related to the issuer will not prevent the underwriter from meeting the requirements of this paragraph. In determining whether a related underwriter meets the requirements of this paragraph consideration shall be given to whether the purchase by the underwriter of the debt obligation from the issuer for resale was effected by a transaction subject to conditions similar to those which would have been imposed between independent persons.

(iv) *With a view to distribution through resale.* (a) An underwriter who purchased a debt obligation shall be deemed to have purchased it with a view to distribution through resale if the requirements of paragraph (b)(6)(iv) (b) or (c) of this section are met.

(b) The requirements of this paragraph (b) is that—

(1) The debt obligation is registered, approved, or listed for trading on one or more foreign securities exchanges or foreign established securities markets within 4 months after the date on which the underwriter purchases the debt obligation, or by the date of the first interest payment on the debt obligation, whichever is later, or

(2) The debt obligation, or any substantial portion of the issue of which the debt obligation is a part, is actually traded on one or more foreign securities markets on or within 15 calendar days after the date on which the underwriter purchases the debt obligation.

For purposes of this paragraph (b)(6)(iv), a foreign established securities market includes any foreign over-the-counter market as reflected by the existence of an inter-dealer quotation system for regularly disseminating to brokers and dealers quotations of obligations by identified brokers or dealers, other than quotations prepared

and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(c) The requirements of this paragraph (c) are that, except as provided in paragraph (b)(6)(iv)(d) of this section, the underwriter is under no written or implied restriction imposed by the issuer with respect to whom he may resell the debt obligation and either—

(1) Within 30 calendar days after he purchased the debt obligation the underwriter or underwriters either (i) sold it or (ii) sold at least 95 percent of the face amount of the issue of which the debt obligation is a part, or

(2)(i) The debt obligation is evidenced by an instrument which, under the laws of the jurisdiction in which it is issued, is either negotiable or transferable by assignment (whether or not it is registered for trading), and (ii) it appears from all the relevant facts and circumstances, including any written statements or assurances made by the purchasing underwriter or underwriters, that such debt obligation was purchased with a view to distribution through resale.

(d) The requirements of paragraph (b)(6)(iv)(c) of this paragraph may be met whether or not the underwriter is restricted from reselling the debt obligations—

(1) To a United States person (as defined in section 7701(a)(30)) or

(2) To any particular person or persons pursuant to a restriction imposed by, or required to be met in order to comply with, United States or foreign securities or other law.

(v) *Statement with return.* Any taxpayer who is required to file a tax return and who excludes from gross income interest of the type specified in this subparagraph must comply with the requirements of paragraph (d) of this section.

(vi) *Effect of termination of IET.* If the interest equalization tax expires, the provisions of section 861(a)(1)(G) and this subparagraph shall apply to interest paid on debt obligations only with respect to which a section 4912(c) election was made.

(vii) *Definition of term underwriter.* For purposes of section 861(a)(1)(G) and

this paragraph, the term “underwriter” shall mean any underwriter as defined in section 4919(c)(1).

(c) *Special rules*—(1) *Proration of interest from a foreign corporation deriving major portion of its income from a U.S. business.* If, after applying the first sentence of paragraph (b)(3) of this section to interest to which that paragraph applies, it is determined that the interest may not be treated as income from sources without the United States, the amount of the interest from the foreign corporation which at some time during the taxable year is engaged in trade or business in the United States which is to be treated as income from sources within the United States shall be the amount that bears the same ratio to such interest as the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(2) *Payors having no gross income for period preceding taxable year of payment.* If the resident alien individual, domestic corporation, or foreign corporation, as the case may be, paying interest has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (b) (2) or (3) of this section, or paragraph (c)(1) of this section, the 20-percent test or the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of the payor in which the interest is paid or credited. This paragraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the payor, from the fact that the payor is a corporation which is newly created or organized, or from any other cause.

(3) *Transitional rule.* For purposes of applying paragraph (b)(3) of this section, and paragraph (c)(1) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after De-

cember 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89-809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business in the United States by such foreign corporation.

(4) *Gross income determinations.* In making determinations under paragraph (b) (2) or (3) of this section, or paragraph (c) (1) or (3) of this section—

(i) The gross income of a domestic corporation or a resident alien individual is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(d) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude an amount of interest from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the obligor of the interest, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the obligor setting forth such information and indicating the amount of interest to be treated as income from sources without the United States may be used for this purpose. See §§ 1.6012-1(b)(1)(i) and 1.6012-2(g)(1)(i).

(e) *Effective dates.* Except as otherwise provided, this section applies with respect to taxable years beginning

after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (a)(7) of this section is applicable to payments made after November 13, 1997.

[T.D. 7378, 40 FR 45429, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8735, 62 FR 53500, Oct. 14, 1997]

§ 1.861-3 Dividends.

(a) *General*—(1) *Dividends included in gross income.* Gross income from sources within the United States includes a dividend described in subparagraph (2), (3), (4), or (5) of this paragraph. For purposes of subparagraphs (2), (3), and (4) of this paragraph, the term “dividend” shall have the same meaning as set forth in section 316 and the regulations thereunder. See subparagraph (5) of this paragraph for special rules with respect to certain dividends from a DISC or former DISC. See also paragraph (a)(6) of this section for special rules concerning substitute dividend payments received pursuant to a securities lending transaction.

(2) *Dividend from a domestic corporation.* A dividend described in this subparagraph is a dividend from a domestic corporation other than a domestic corporation entitled to the benefits of section 931, and other than a domestic corporation less than 20 percent of the gross income of which is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividend, or for such part of such period as the corporation has been in existence. See subparagraph (5) of this paragraph for the treatment of certain dividends from a DISC or former DISC.

(3) *Dividend from a foreign corporation*—(i) *In general.* (a) A dividend described in this subparagraph is a dividend from a foreign corporation (other than a dividend to which subparagraph (4) of this paragraph applies) unless

less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the taxable year in which occurs the declaration of such dividend (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864-3. Thus, no portion of a dividend from a foreign corporation shall be treated as income from sources within the United States under section 861(a)(2)(B) if less than 50 percent of the gross income of such foreign corporation from all sources for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States or if such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct by such corporation of a trade or business in the United States.

(b) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, the amount of the dividend which is to be treated as income from sources within the United States under section 861(a)(2)(B) shall be the amount that bears the same ratio to such dividend as the gross income of such foreign corporation for such 3-year period (or part thereof) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(c) For purposes of this subdivision (i), the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e), is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(ii) *Rule applicable in applying limitation on amount of foreign tax credit.* For purposes of determining under section 904 the limitation upon the amount of the foreign tax credit—