(c)(5) of this section, the $24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section is applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* See §1.865–2(e)(3) for examples illustrating an applicability date provision similar to the applicability date provided in this paragraph (f).

[T.D. 8973, 66 FR 67083, Dec. 28, 2001]

§1.865–2 Loss with respect to stock.

(a) *General rules for allocation of loss with respect to stock*—(1) *Allocation against gain.* Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). For purposes of this section, loss includes loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) *Stock attributable to foreign office.* Except as otherwise provided in paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*—(i) *In general.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(ii) *Bona fide residents of Puerto Rico.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income. If gain from a sale of such stock would give rise to income exempt from tax under section 933, the loss with respect to such stock shall be allocated to amounts that are excluded from gross income under section 933(1) and therefore shall not be allowed as a deduction from gross income. See section 933(1) and §1.933–1(c).

(4) *Stock constituting a United States real property interest.* Loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States

real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) *Allocation for purposes of section 904*. For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general*. If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts*. Paragraph (b)(1)(i) of this section shall not apply to a loss recognized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts (other than dividend recapture amounts eligible for the exception described in paragraph (b)(1)(iii) of this section (passive limitation dividends)) included in income by the taxpayer (or a person described in section 1059(c)(3)(C)) with respect to such stock during the recapture period is less than 10 percent of the recognized loss.

(iii) *Exception for passive limitation dividends*. Paragraph (b)(1)(i) of this section shall not apply to the extent of a dividend recapture amount that is treated as income in the separate category for passive income described in section 904(d)(2)(A) (without regard to section 904(d)(2)(A)(iii)(III)). The exception provided for in this paragraph (b)(1)(iii) shall not apply to any dividend recapture amount that is treated as income in the separate category for financial services income described in section 904(d)(2)(C).

(iv) *Examples*. The application of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On May 5, 1998, *N* distributes a dividend to *P* in the amount of $100. The dividend gives rise to a $5 foreign withholding tax, and *P* is deemed to have paid an additional $45 of foreign income tax with respect to the dividend under section 902. Under the look-through rules of section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 2000, *P* sells its shares of *N* and recognizes a $110 loss. In 2000, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) $1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I);

(B) $1,000 of foreign source capital gain from the sale of stock in a foreign affiliate that is sourced under section 865(f) and is passive income described in section 904(d)(1)(A); and

(C) $1,000 of U.S. source income.

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The *de minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) *P*'s remaining $10 loss on the disposition of the *N* stock is allocated to U.S. source income under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *P*'s foreign source taxable income in 2000 consists of $900 of foreign source general limitation income and $1,000 of foreign source passive income.

Example 2. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*, which owns all of the stock of *N3*. *N1*, *N2*, and *N3* are controlled foreign corporations. All of the corporations use the calendar year as their taxable year. On February 5, 1997, *N3* distributes a dividend to *N2*. The dividend is foreign personal holding company income of *N2* under section 954(c)(1)(A) that results in an inclusion of $100 in *P*'s income under section 951(a)(1)(A)(i) as of December 31, 1997. Under section 904(d)(3)(B) the inclusion is general limitation income described in section 904(d)(1)(I). The income inclusion to *P* results in a corresponding increase in *P*'s basis in the stock of *N1* under section 961(a).

(ii) On March 5, 1999, *P* sells its shares of *N1* and recognizes a $110 loss. The $100 1997 subpart F inclusion is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N1* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend recapture amount was assigned (general limitation income). The remaining $10 loss is allocated to U.S. source income under paragraph (a)(1) of this section.

Example 3. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*. *N1* and *N2* are controlled foreign corporations. All the corporations use the calendar year as their taxable year and the U.S. dollar as their functional currency. On May 5, 1998, *N2* pays a dividend of $100 to *N1* out of general limitation earnings and profits.

(ii) On February 5, 2000, *N1* sells its *N2* stock to an unrelated purchaser. The sale results in a loss to *N1* of $110 for U.S. tax purposes. In 2000, *N1* has the following current earnings and profits, excluding the loss on the sale of *N2*:

(A) $1,000 of non-subpart F foreign source general limitation earnings and profits described in section 904(d)(1)(I);

(B) $1,000 of foreign source gain from the sale of stock that is taken into account in determining foreign personal holding company income under section 954(c)(1)(B)(i) and which is passive limitation earnings and profits described in section 904(d)(1)(A);

(C) $1,000 of foreign source interest income received from an unrelated person that is foreign personal holding company income under section 954(c)(1)(A) and which is passive limitation earnings and profits described in section 904(d)(1)(A).

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *N1*'s income within the recapture period preceding the disposition of the *N2* stock. The *de minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation earnings and profits).

(iv) *N1*'s remaining $10 loss on the disposition of the *N2* stock is allocated to foreign source passive limitation earnings and profits under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *N1*'s current earnings and profits for 1998 consist of $900 of foreign source general limitation earnings and profits and $1,990 of foreign source passive limitation earnings and profits.

(vi) After allocation of the stock loss, *N1*'s subpart F income for 2000 consists of $1,000 of foreign source interest income that is foreign personal holding company income under section 954(c)(1)(A) and $890 of foreign source net gain that is foreign personal holding company income under section 954(c)(1)(B)(i). *P* includes $1,890 in income under section 951(a)(1)(A)(i) as passive income under sections 904(d)(1)(A) and 904(d)(3)(B).

Example 4. *P*, a foreign corporation, has two wholly-owned subsidiaries, *S*, a domestic corporation, and *B*, a foreign corporation. On January 1, 2000, *S* purchases a one-percent interest in *N*, a foreign corporation, for $100. On January 2, 2000, *N* distributes a $20 dividend to *S*. The $20 dividend is foreign source financial services income. On January 3, 2000, *S* sells its *N* stock to *B* for $80 and recognizes a $20 loss that is deferred under section 267(f). On June 10, 2008, *B* sells its *N* stock to an unrelated person for $55. Under section 267(f) and §1.267(f)–1(c)(1), *S*'s $20 loss is deferred until 2008. Under this paragraph (b)(1), the $20 loss is allocated to reduce foreign source financial services income in 2008 because the loss was recognized (albeit deferred) within the 24-month recapture period following the receipt of the dividend. See §§1.267(f)–1(a)(2)(i)(B) and 1.267(f)–1(c)(2).

Example 5. The facts are the same as in *Example 4*, except *P*, *S*, and *B* are domestic corporations and members of the *P* consolidated group. Under the matching rule of §1.1502–13(c)(1), the separate entity attributes of *S*'s intercompany items and *B*'s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if *S* and *B* were divisions of a single corporation and the intercompany transaction was a transaction between divisions. If *S* and *B* were divisions of a single corporation, the transfer of *N* stock on January 3, 2000 would be ignored for tax purposes, and the corporation would be treated as selling that stock only in 2008. Thus, the corporation's entire $45 loss would have been allocated against U.S. source income under paragraph (a)(1) of this section because a dividend recapture amount was not received during the corporation's recapture period. Accordingly, *S*'s $20 loss and *B*'s $25 loss are allocated to reduce U.S. source income.

Example 6. (i) On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for $1,000. On March 1, 1998, *P* causes *N* to sell its operating assets, distribute a $400 general limitation dividend to *P*, and invest its remaining $600 in short-term government securities. *P* converted the *N* assets into low-risk investments with a principal purpose of holding the *N* stock without significant risk of loss until the recapture period expired. *N* earns interest income from the securities. The income constitutes subpart F income that is included in *P*'s income under section 951, increasing *P*'s basis in the *N* stock under section 961(a). On March 1, 2002, *P* sells *N* and recognizes a $400 loss.

(ii) Pursuant to paragraph (d)(3) of this section, the recapture period is increased by the period in which *N*'s assets were held as low-risk investments because *P* caused *N*'s assets to be converted into and held as low-risk investments with a principal purpose of enabling *P* to hold the *N* stock without significant risk of loss. Accordingly, under paragraph (b)(1)(i) of this section the $400 loss is allocated against foreign source general limitation income.

(2) *Exception for inventory*. This section does not apply to loss recognized with respect to stock described in section 1221(1).

(3) *Exception for stock in an S corporation*. This section does not apply to loss recognized with respect to stock in an S corporation (as defined in section 1361).

(4) *Anti-abuse rules*—(i) *Transactions involving built-in losses*. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock by transferring the stock to another person, qualified business unit (within the meaning of section 989(a)), office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized with respect to the stock by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to stock, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock (or other personal property) by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, or transfers to or from a qualified business unit, office or other fixed place of business. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions*. If a taxpayer recognizes loss with respect to stock and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such stock with a principal purpose of recognizing foreign source income and United States source loss, the loss will be allocated and apportioned against such foreign source income. For purposes of this paragraph (b)(4)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule*. If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to stock (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. This paragraph (b)(4)(iii) applies to any portion of a loss that is not allocated under paragraph (b)(1)(i) of this section (dividend recapture rule), including a loss in excess of the dividend recapture amount and a loss that is related to a dividend recapture amount described in paragraph (b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) of this section.

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Example 1. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, owns all of the stock of *N1*, a controlled foreign corporation, which owns all of the stock of *N2*, a controlled foreign corporation. *N1*'s basis in the stock of *N2* exceeds its fair market value, and any loss recognized by *N1* on the sale of *N2* would be allocated under paragraph (a)(1) of this section to reduce foreign source passive limitation earnings and profits of *N1*. In contemplation of the sale of *N2* to an unrelated purchaser, *P* causes *N1* to liquidate with principal purposes of recognizing the loss on the *N2* stock and allocating the loss against U.S. source income. *P* sells the *N2* stock and *P* recognizes a loss.

(ii) *Loss allocation.* Because one of the principal purposes of the liquidation was to transfer the stock to *P* in order to change the allocation of the built-in loss on the *N2* stock, under paragraph (b)(4)(i) of this section the loss is allocated against *P*'s foreign source passive limitation income.

Example 2. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, forms *N* and *F*, foreign corporations, and contributes $1,000 to the capital of each. *N* and *F* enter into offsetting positions in financial instruments that produce financial services income. Holding the *N* stock substantially diminishes *P*'s risk of loss with respect to the *F* stock (and vice versa). *P* holds *N* and *F* with a principal purpose of recognizing foreign source income and U.S. source loss. On March 31, 2000, when the financial instrument held by *N* is worth $1,200 and the financial instrument held by *F* is worth $800, *P* sells its *F* stock and recognizes a $200 loss.

(ii) *Loss allocation.* Because *P* held an offsetting position with respect to the *F* stock with a principal purpose of recognizing foreign source income and U.S. source loss, the $200 loss is allocated against foreign source financial services income under paragraph (b)(4)(ii) of this section.

Example 3. (i) *Facts.* On January 1, 2002, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. *P* contributes $900 to *R* in exchange for a 90-percent partnership interest and *Q* contributes $100 to *R* in exchange for a 10-percent partnership interest. *R* purchases a dance studio in Country *X* for $1,000. On January 2, 2002, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2003. These contracts are prepaid by the dance studio customers on December 31, 2002, and *R* recognizes foreign source taxable income of $500 from the prepayments (*R*'s only income in 2002). *P* takes into income its $450 distributive share of partnership taxable income. On January 1, 2003, *P*'s basis in its partnership interest is $1,350 ($900 from its contribution under section 722, increased by its $450 distributive share of partnership income under section 705). On September 22, 2003, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P*'s basis in *S* is $1,350. On December 1, 2003, *P* sells *S* to an unrelated party for $1050 and recognizes a $300 loss.

(ii) *Loss allocation.* *P* recognized foreign source income for tax purposes before the income had economically accrued, and the accelerated recognition of income increased *P*'s basis in *R* without increasing its value by a corresponding amount, which resulted in the creation of a built-in loss with respect to the *S* stock. Under paragraph (b)(4)(iii) of this section the $300 loss is allocated against foreign source income if *P* had a principal purpose of recognizing foreign source income and corresponding loss.

(c) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(d) *Definitions*—(1) *Terms defined in §1.861–8.* See §1.861–8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

(2) *Dividend recapture amount.* A dividend recapture amount is a dividend

(except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B).

(3) *Recapture period.* A recapture period is the 24-month period ending on the date on which a taxpayer recognized a loss with respect to stock. For example, if a taxpayer recognizes a loss on March 15, 2002, the recapture period begins on and includes March 16, 2000, and ends on and includes March 15, 2002. A recapture period is increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss (or are converted into and held as low-risk investments) with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. In the case of a loss recognized after a dividend is declared but before such dividend is paid, the recapture period is extended through the date on which the dividend is paid.

(4) *United States resident.* See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) *Effective date*—(1) *In general.* This section is applicable to loss recognized on or after January 11, 1999, except that paragraphs (a)(3)(ii), (b)(1)(iv) *Example 6*, (b)(4)(iii), (b)(4)(iv) *Example 3*, and (d)(3) of this section are applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples:

Example 1. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1985, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1985 and is carried over to the 1990 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7). In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years.

(ii) Allocation of the loss on the sale of *N* is not affected by the rules of this section because the loss was recognized in a taxable year that did not begin after December 31, 1986.

Example 2. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1988, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1988 and is carried back to the 1985 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P*'s federal income tax return for 1985 and increases an overall foreign loss account under §1.904(f)-1.

(ii) In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years. Consequently, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income reduces *P's* overall foreign loss account and increases *P's* tax liability in 2 years: 1990, a year that will not be open for assessment on June 30, 1999, and 1997, a year that will be open for assessment on June 30, 1999. Pursuant to paragraph (e)(2)(i) of this section, *P* must file an amended federal income tax return that reflects the rules of this section for 1997, but not for 1990.

Example 3. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1989, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P's* federal income tax return for 1989 and results in excess foreign tax credits for that year. The excess credit is carried back to 1988, pursuant to section 904(c). In 1999, *P* chooses to apply this section to all losses recognized in its 1989 taxable year and in all subsequent years. On June 30, 1999, *P's* 1988 taxable year is closed for assessment, but *P's* 1989 taxable year is open with respect to claims for refund.

(ii) Because *P* chooses to apply this section to its 1989 taxable year, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income would have permitted the foreign tax credit to be used in 1989, reducing *P's* tax liability in 1989. Nevertheless, under paragraph (e)(2)(ii) of this section, because the credit was carried back to 1988, *P* may not claim the foreign tax credit in 1989.

[T.D. 8805, 64 FR 1511, Jan. 11, 1999, as amended by T.D. 8973, 66 FR 67085, Dec. 28, 2001; 67 FR 3812, Jan. 28, 2002]

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871–1 Classification and manner of taxing alien individuals.

(a) *Classes of aliens.* For purposes of the income tax, alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident alien individuals are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. See §1.1–1(b). Nonresident alien individuals are taxable only on certain income from sources within the United States and on the income described in section 864(c)(4) from sources without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States. However, nonresident alien individuals may elect, under section 6013 (g) or (h), to be treated as U.S. residents for purposes of determining their income tax liability under Chapters 1, 5, and 24 of the code. Accordingly, any reference in §§1.1–1 through 1.1388–1 and §§1.1491–1 through 1.1494–1 of this part to non-resident alien individuals does not include those with respect to whom an election under section 6013 (g) or (h) is in effect, unless otherwise specifically provided. Similarly, any reference to resident aliens or U.S. residents includes those with respect to whom an election is in effect, unless otherwise specifically provided.

(b) *Classes of nonresident aliens*—(1) *In general.* For purposes of the income tax, nonresident alien individuals are divided into the following three classes:

(i) Nonresident alien individuals who at no time during the taxable year are engaged in a trade or business in the United States,

(ii) Nonresident alien individuals who at any time during the taxable year are, or are deemed under §1.871–9 to be, engaged in a trade or business in the United States, and

(iii) Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

An individual described in subdivision (i) or (ii) of this subparagraph is subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder. See §§1.871–7 and 1.871–8. The provisions of subpart A do not apply to individuals described in subdivision (iii) of this subparagraph, but such individuals, except as provided in section 933 with respect to Puerto Rican source income, are subject to the tax imposed by section 1 or section 1201(b). See §1.876–1.

(2) *Treaty income.* If the gross income of a nonresident alien individual described in subparagraph (1) (i) or (ii) of this paragraph includes income on which the tax is limited by tax convention, see §1.871–12.

(3) *Exclusions from gross income.* For rules relating to the exclusion of certain items from the gross income of a nonresident alien individual, including annuities excluded under section 871(f), see §§1.872–2 and 1.894–1.

(4) *Expatriation to avoid tax.* For special rules applicable in determining the tax of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877.

(5) *Adjustment of tax of certain nonresident aliens.* For the application of