

is entitled to credits only if they are attributable to effectively connected income. See paragraph (a)(2) of this section for the requirement that a return be filed. Except as provided by section 906, a foreign corporation shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a foreign corporation claiming deductions from gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States or credits which are attributable to that income must furnish at the place designated pursuant to §301.7605-1(a) information sufficient to establish that the corporation is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a foreign corporation fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part. For additional filing requirements and for penalties for failure to provide information, see also section 6038A.

[T.D. 8322, 55 FR 50830, Dec. 11, 1990, as amended by T.D. 8981, 67 FR 4175, Jan. 29, 2002]

§ 1.882-4T Allowance of deductions and credits to foreign corporations (temporary).

(a) through (a)(3)(i) For further guidance, see § 1.882-4(a) through (a)(3)(i).

(a)(3)(ii) The filing deadlines set forth in § 1.882-4(a)(3)(i) may be waived if the foreign corporation establishes to the satisfaction of the Commissioner or his or her delegate that the corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in § 1.882-4(a)(3)(vi))). For this purpose, a foreign corporation shall not be considered to have acted reasonably

and in good faith if the foreign corporation knew that it was required to file the return and chose not to file the return. In addition, a foreign corporation shall not be granted a waiver unless the foreign corporation cooperates in the process of determining its income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the foreign corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return:

(A) Whether the corporation voluntarily identifies itself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(B) Whether the corporation did not become aware of its ability to file a protective return (as described in § 1.882-4(a)(3)(vi)) by the deadline for filing a protective return;

(C) Whether the corporation had not previously filed a U.S. income tax return;

(D) Whether the corporation failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the corporation was unaware of the necessity for filing the return;

(E) Whether the corporation failed to file a U.S. income tax return because of intervening events beyond the corporation's control; and

(F) Whether other mitigating or exacerbating factors existed.

(iii) The following examples illustrate the provisions of this section. In all examples, FC is a foreign corporation and uses the calendar year as its taxable year. The examples are as follows:

Example 1. Foreign corporation discloses own failure to file. In Year 1, FC became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, FC incurred losses with respect to FC's U.S. partnership interest. FC's foreign tax director incorrectly concluded that because FC was a limited partner and

had only losses from FC's partnership interest, FC was not required to file a U.S. income tax return. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In Year 5, FC began realizing a profit, rather than a loss, with respect to the partnership interest, and, for this reason, engaged a U.S. tax advisor to handle FC's responsibility to file U.S. income tax returns. In preparing FC's income tax return for Year 5, FC's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in § 1.882-4(a)(3)(i) were not met, FC would be barred by § 1.882-4(a)(2) from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and would have been available as loss carryforwards in subsequent years. At FC's direction, FC's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in § 1.882-4(a)(3)(i).

Example 2. Foreign corporation refuses to cooperate. Same facts as in *Example 1*, except that while FC's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, FC refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which an income tax return was not timely filed, FC is not granted a waiver as described in paragraph (a)(3)(ii) of this section of any applicable filing deadlines in § 1.882-4(a)(3)(i).

Example 3. Foreign corporation fails to file a protective return. Same facts as in *Example 1*, except that in Year 1 through Year 4, FC's tax director also consulted a U.S. tax advisor, who advised FC's tax director that it was uncertain whether U.S. income tax returns were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing protective returns under § 1.882-4(a)(3)(vi). FC did not file U.S. income tax returns or protective returns for those years. FC did not present evidence that intervening events beyond FC's control prevented FC from filing an income tax return, and there were no

other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in § 1.882-4(a)(3)(i).

Example 4. Foreign corporation with effectively connected income. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file U.S. income tax returns for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that FC should have filed U.S. income tax returns for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor, at FC's direction, who promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in § 1.882-4(a)(3)(i).

Example 5. IRS discovers foreign corporation's failure to file. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. Despite FC's extensive experience conducting similar business activities in other countries, FC made no effort to seek advice in connection with FC's U.S. tax obligations. FC failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In January of Year 4, an Internal Revenue Service examiner asked FC for an explanation of FC's failure to file U.S. income tax returns. FC immediately engaged X, a U.S. tax advisor, and cooperated with

the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond FC's control prevented FC from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in § 1.882-4(a)(3)(i) of this section.

Example 6. Foreign corporation with prior filing history. FC began a U.S. trade or business in Year 1. FC's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a U.S. income tax return for any year from Year 7 through Year 10, although FC had effectively connected income for those years. FC's management was aware of FC's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted FC and asked FC's chief financial officer for an explanation of its failure to file U.S. income tax returns after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond FC's control prevented FC from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in § 1.882-4(a)(3)(i).

(iv) Paragraphs (a)(3)(ii) and (iii) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

(a)(3)(v) through (b)(2) For further guidance, see § 1.882-4(a)(3)(v) through (b)(2).

[T.D. 8981, 67 FR 4175, Jan. 29, 2002]

§ 1.882-5 Determination of interest deduction.

(a) *Rules of general application—(1) Overview—(i) In general.* The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the

interest paid or accrued by the foreign corporation on its liabilities booked in the United States, as adjusted under the three-step process set forth in paragraphs (b), (c), and (d) of this section and the specially allocated interest expense determined under section (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation. Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on liabilities booked in the United States, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S.-booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) *Direct allocations—(A) In general.* A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of § 1.861-10T (b) and (c), as limited by § 1.861-10T(d)(1), may directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in § 1.861-10T. For purposes of paragraph (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of § 1.861-10T (b) and (c) by the principal amount of the indebtedness that meets the requirements of § 1.861-10T (b) and (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of § 1.861-10T (b) and (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section, and shall not take into account any interest expense paid or accrued