

deemed paid or accrued in 1963 of H's unused foreign tax of \$500 for 1961 and of the unabsorbed part (\$150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. The unabsorbed part (\$50) of W's unused foreign tax for 1964 is then absorbed by W's excess limitation of \$100 for 1965. No part of W's unused foreign tax for 1964 is absorbed by W's excess limitation for 1962, since that excess limitation must first be reduced from \$200 to \$0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964.

(f) No part of H's unused foreign tax of \$400 for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from \$650 to \$0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of \$500 for 1961 and of a part (\$150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. Moreover, no part of H's unused foreign tax of \$400 for 1964 is absorbed by W's part of the joint excess limitation for 1963, since W's part of that excess must first be reduced from \$300 to \$0 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part (\$100) of W's unused foreign tax for 1961 and of the unabsorbed part (\$100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of a part (\$100) of W's unused foreign tax of \$150 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part (\$400) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of \$500 for 1965.

*Example 2.* (a) Assume the same facts as those in example 1 except that for 1964 W's unused foreign tax is \$20, instead of \$150. The carrybacks and carryovers absorbed are the same as in example 1 except as indicated in paragraphs (b) and (c) of this example.

(b) No part of W's unused foreign tax of \$20 for 1964 is absorbed by W's excess limitation for 1962, since that excess must first be reduced from \$200 to \$0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964. W's unused foreign tax of \$20 for 1964 is absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from \$300 to \$100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part (\$100) of W's unused foreign tax for 1961 and the unabsorbed part (\$100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964.

(c) For the reason given in paragraph (f) of example 1, no part of H's unused foreign tax of \$400 for 1964 is absorbed by H's part of the joint excess limitation for 1963. H's unused foreign tax of \$400 for 1964 is first absorbed (to the extent of \$80) by W's part of the joint excess limitation for 1963, which must first

be reduced from \$300 to \$80 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part (\$100) of W's unused foreign tax for 1961 and of the unabsorbed part (\$100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of W's unused foreign tax of \$20 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part (\$320) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of \$500 for 1965.

*Example 3.* The facts are the same as in example 1 except that the per-country limitation applies to both spouses for all taxable years involved in the example and that excess limitations and the unused foreign taxes relate to a single foreign country. The carryovers and carrybacks are the same as in example 1.

[T.D. 6789, 29 FR 19246, Dec. 31, 1964, as amended by T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7961, 49 FR 26225, June 27, 1984]

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

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive income), (B) (high withholding tax interest), (C) (financial services income), (D) (shipping income), (E) (dividends from each noncontrolled section 902 corporation), (F) (dividends from a DISC or former DISC), (G) (foreign trade income), (H) (distributions from a FSC or former FSC), or (I) (general limitation income).

(b) *Passive income*—(1) *In general*—(i) *Rule.* The term “passive income” means any—

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 551 or section 1293. Passive income does not include any income that is also described in section 904(d)(1)(B) through (H), any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this

section), any high taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section, or, for taxable years beginning before January 1, 1993, any foreign oil and gas extraction income (as defined in section 907(c)). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the lookthrough rules. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d) (5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related person factoring income may be eligible for the exception for export financing interest.

(ii) *Example.* The following example illustrates the application of paragraph (b)(1)(i) of this section:

*P* is a domestic corporation with a branch in foreign country *X*. *P* does not have any financial services income. For 1988, *P* has a net foreign currency gain that would not constitute foreign personal holding company income if *P* were a controlled foreign corporation because the gain is directly related to the business needs of *P*. The currency gain is, therefore, general limitation income to *P* because it is not income of a kind that would be foreign personal holding company income.

(2) *Active rents or royalties—(i) In general.* Passive income does not include any rents or royalties that are derived in the active conduct of a trade or business and received from a person who is an unrelated person. Except as provided in paragraph (b)(2)(ii) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term “taxpayer” shall be substituted for the term “controlled foreign corporation” if the recipient of the rents or royalties is not a controlled foreign corporation.

(ii) *Exception for certain rents and royalties.* Rents or royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a) without regard to section 1504(b)(3)) of which the recipient is a member.

(iii) *Unrelated person.* For purposes of this paragraph (b)(2), a person is considered to be an unrelated person if the person is not a related person within the meaning of section 954(d)(3), without regard to whether the relationship described in section 954(d)(3) is between a controlled foreign corporation and another person or between two persons neither one of which is a controlled foreign corporation.

(iv) *Example.* The following example illustrates the application of paragraph (b)(2)(ii) of this section.

*Example.* Controlled foreign corporation *S* is a wholly-owned subsidiary of *P*, a domestic corporation. *S* is regularly engaged in the restaurant franchise business. *P* licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which *S* pays *P* an arm’s length royalty. *P* is regularly engaged in the development and licensing of such property. The royalties received by *P* for the use of its property are allocable under the look-through rules of § 1.904-5 to the royalties *S* receives from the franchisees. All of the franchisees are unrelated to *S* or *P* and operate in *S*’s country of incorporation. *S* does not satisfy, but *P* does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by *S* with regard to its franchisees is foreign personal holding company income that is general limitation income, and the royalties paid to *P* are general limitation income to *P*.

(c) *High-taxed income—(1) In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the

United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under § 1.904-6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general limitation income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section. This paragraph (c)(1) is applicable for taxable years beginning after March 12, 1999.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective dates*—(A) *In general*. For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3)(i) and (ii), (c)(4), and (c)(5) of this section apply to taxable years beginning after December 31,

1987. Except as provided in paragraph (c)(2)(i)(B) of this section, the rules of paragraph (c)(3)(iii) apply to taxable years beginning after December 31, 1987, and ending before December 31, 1998, and the rules of paragraph (c)(3)(iv) apply to taxable years ending on or after December 31, 1998. See Notice 87-6 (1987-1 C.B.417) for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. Paragraph (c)(2)(ii) of this section is applicable for taxable years beginning after March 12, 1999.

(B) *Application to prior periods*. A taxpayer may apply the rules of paragraph (c)(3)(iv) to any taxable year beginning after December 31, 1991, and all subsequent years, provided that—

(1) 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, 1999; and

(2) 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.

(ii) *Grouping rules*—(A) *Initial allocation and apportionment of deductions and taxes*. For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§ 1.861-8 through 1.861-14T and 1.865-1 through 1.865-2. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of § 1.904-6(a)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A

determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) *Amounts received or accrued by United States persons.* Except as provided in paragraph (c)(5) of this section, all passive income received by a United States person shall be subject to the rules of this paragraph (c)(3). However, subpart F inclusions that are passive income and income that is earned by a United States person through a foreign qualified business unit (foreign QBU) that is passive income shall be subject to the rules of this paragraph only to the extent provided in paragraph (c)(4)(ii) of this section. For purposes of this section, a foreign QBU is a QBU (as defined in section 989(a)) other than a controlled foreign corporation, that has its principal place of business outside the United States. These rules shall apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder or from any other person. For purposes of determining whether passive income is high-taxed income, the following rules apply:

(i) All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.

(ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.

(iii) For taxable years ending before December 31, 1998 (except as provided in paragraph (c)(2)(i)(B) of this section), all passive income received during the taxable year that is subject to no withholding tax shall be treated as one item of income.

(iv) For taxable years ending on or after December 31, 1998, all passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income, and all passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) *Income of controlled foreign corporations and foreign QBUs.* Except as provided in paragraph (c)(5) of this section, all amounts included in gross income of a United States shareholder under section 951(a)(1) for a particular year that (after application of the look-through rules of section 904(d)(3) and § 1.904-5) are attributable to passive income received or accrued by a controlled foreign corporation and all amounts of passive income received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). This paragraph (c)(4) shall be applied separately to inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder. This paragraph (c)(4) also shall be applied separately to income attributable to each QBU of a controlled foreign corporation or any other look-through entity as defined in § 1.904-5(i), except that if the entity subject to the look-through rules is a United States person, then this paragraph (c)(4) shall be applied separately only to each foreign QBU of that United States person.

(i) *Income from sources within the QBU's country of operation.* Passive income from sources within the QBU's country of operation shall be treated as one item of income.

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the tax imposed on that income as provided in paragraphs (c)(3)(i) through (iv) of this section.

(iii) *Determination of the source of income.* For purposes of this paragraph (c)(4), income will be determined to be from sources within or without the QBU's country of operation under the

laws of the foreign country of the payor of the income.

(5) *Special rules*—(i) *Certain rents and royalties.* All items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts.

(ii) *Treatment of partnership income.* A partner's distributive share of income from a foreign or United States partnership that is not subject to the look-through rules and that is treated as passive income under § 1.904-5(h)(2)(i) (generally providing that a less than 10 percent partner's distributive share of partnership income is passive income) shall be treated as a single item of income and shall not be grouped with other amounts. A distributive share of income from a foreign partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(4) of this section. A distributive share of income from a United States partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(3) of this section, except that the portion, if any, of the distributive share of income attributable to income earned by a United States partnership through a foreign QBU shall be grouped under the rules of paragraph (c)(4) of this section.

(iii) *Currency gain or loss*—(A) *Section 986(c).* Any currency gain or loss with respect to a distribution received by a United States shareholder (other than a foreign QBU of that shareholder) of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(A) shall be applied separately for each foreign QBU of a United States shareholder.

(B) *Section 987(3).* Any currency gain or loss with respect to remittances or

transfers of property between QBUs of a United States shareholder that is recognized under section 987(3)(B) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(B) shall be applied separately for each foreign QBU of a United States shareholder.

(C) *Example.* The following example illustrates the provisions of this paragraph (c)(5)(iii).

*Example.* P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that uses x as its functional currency. In 1993, S earns 100x of passive foreign personal holding company income. When included in P's income under subpart F, the exchange rate is 1x equals \$1. Therefore, P's subpart F inclusion is \$100. At the end of 1993, S has previously taxed earnings and profits of 100x and P's basis in those earnings is \$100. In 1994, S has no earnings and distributes 100x to P. The value of the earnings when distributed is \$150. Assume that under section 986(c), P must recognize \$50 of passive income attributable to the appreciation of the previously taxed income. Country X does not recognize any gain or loss on the distribution. Therefore, the section 986(c) gain is not subject to any foreign withholding tax or other foreign tax. Thus, under paragraph (c)(3)(iii) of this section, the section 986(c) gain shall be grouped with other items of P's income that are subject to no withholding tax or other foreign tax.

(iv) *Certain passive dividends.* A dividend from a controlled foreign corporation that is treated as passive income under the look-through rules shall be grouped according to the rules of paragraph (c)(4) of this section.

(v) *Coordination with section 954(b)(4).* For rules relating to passive income of a controlled foreign corporation that is exempt from subpart F treatment because the income is subject to high foreign tax, see section 904(d)(3)(E), § 1.904-4(c)(7)(iii), and § 1.904-5(d)(2).

(6) *Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income*—(i) *Determination made in year of*

*inclusion.* The determination of whether an amount included in gross income under section 951(a) is high-taxed income shall be made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) (hereinafter the “taxable year of inclusion”). Any increase in foreign taxes paid or accrued, or deemed paid or accrued, when the taxpayer receives an amount that is excluded from gross income under section 959(a) and that is attributable to a controlled foreign corporation’s earnings and profits relating to the amount previously included in gross income will not be considered in determining whether the amount included in income in the taxable year of inclusion is high-taxed income.

(ii) *Exception.* Paragraph (c)(6)(i) of this section shall not apply to an increase in tax in a case in which the taxpayer is required to adjust its foreign taxes in the year of inclusion under section 905(c).

(iii) *Allocation of foreign taxes imposed on distributions of previously taxed income.* If an item of income is considered high-taxed income in the year of inclusion and paragraph (c)(6)(i) of this section applies, then any increase in foreign income taxes imposed with respect to that item shall be considered to be related to general limitation income. If an item of income is not considered to be high-taxed income in the taxable year of inclusion and paragraph (c)(6)(i) of this section applies, the following rules shall apply. The taxpayer shall treat an increase in taxes paid or accrued, or deemed paid or accrued, on any distribution of the earnings and profits attributable to the amount included in gross income in the taxable year of inclusion as taxes related to passive income to the extent of the excess of the product of (A) the highest rate of tax in section 11 (determined with regard to section 15 and determined as of the year of inclusion) and (B) the amount of the inclusion (after allocation of parent expenses) over (C) the taxes paid or accrued, or deemed paid or accrued, in the year of inclusion. The taxpayer shall treat any taxes paid or accrued, or deemed paid or accrued, on the distribution in excess of this amount as taxes related to

general limitation income. If these additional taxes are not creditable in the year of distribution the carryover rules of section 904(c) apply. For purposes of this paragraph, the foreign tax on a subpart F inclusion shall be considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is greater than the total taxes deemed paid in the year of inclusion. Any foreign currency loss associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered as giving rise to an increase in tax.

(iv) *Increase in taxes paid by successors—(A) General rule.* Except as provided in paragraph (c)(6)(iv)(B) of this section, if passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid or accrued, on that distribution shall be treated as taxes related to general limitation income, regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(B) *Exception for U.S. shareholders not entitled to look-through.* In the case of a United States shareholder that, by reason of paragraph (g)(3)(ii) of this section (relating to distributions prior to August 6, 1997, to new shareholders acquiring more than 90 percent of a controlled foreign corporation), is not entitled to look-through treatment with respect to pre-acquisition earnings and profits of the distributing corporation, the increase in foreign taxes described in paragraph (c)(6)(iv)(A) of this section shall be treated as taxes related to the noncontrolled section 902 corporation income of the distributing corporation.

(C) *Effective date.* This paragraph (c)(6)(iv) applies to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on

§1.904-4(c)(6)(iv) of regulations project INTL-1-92, published at 1992-1 C.B. 1209. See § 601.601(d)(2) of this chapter.

(7) *Application of this paragraph to certain reductions of tax on distributions of income*—(i) *In general.* If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income without regard to the possibility of subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general limitation income. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income provided that a redetermination of United States tax liability is required under section 905(c). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its United States tax liability for the year or years affected, shall treat the inclusion and the associated taxes (as reduced on the distribution) as passive income and taxes. See section 905(c) and the regulations thereunder regarding the method of adjustment. For this purpose, the foreign tax on a subpart F inclusion shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less than the total taxes deemed paid in the year of inclusion. Any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered a reduction of tax.

(ii) *Allocation of reductions of foreign tax.* For purposes of paragraph (c)(7)(i) of this section, reductions in foreign tax shall be allocated among the separate categories under the same prin-

ciples as those of §1.904-6 for allocating taxes among the separate categories. Thus, for purposes of determining to which year's taxes the reduction in taxes relates, foreign law shall apply. If, however, foreign law does not attribute a reduction in taxes to a particular year or years, then the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income under section 954(b)(4), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c) (1) and (2), then on a LIFO basis out of earnings and profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F under section 954(b)(4), and finally on a LIFO basis out of other earnings and profits. For purposes of this paragraph (c)(7)(ii), foreign law is not considered to attribute a reduction in tax to a particular year or years if foreign law attributes the tax reduction to a pool or group containing income from more than one taxable year and such pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than on the taxable year in which the income is derived.

(iii) *Interaction with section 954(b)(4).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on distribution of that income, the rules of section 954(b)(4) shall be applied without regard to the possibility of subsequent reduction of foreign tax. If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then, notwithstanding the general rule of §1.904-5(d)(2), the income shall be considered to be passive

income until distribution of that income. At that time, the rules of this paragraph shall apply to determine whether the income is high-taxed income and, therefore, general limitation income. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section shall apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income. For an example illustrating the operation of this paragraph (c)(7)(iii), see paragraph (c)(8) *Example (7)* of this section.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

*Example 1.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a single qualified business unit (QBU) operating in foreign country X. In 1988, S earns \$130 of gross passive royalty income from country X sources, and incurs \$30 of expenses that do not include any payments to P. S's \$100 of net passive royalty income is subject to \$30 of foreign tax, and is included under section 951 in P's gross income for the taxable year. P allocates \$50 of expenses to the \$100 (consisting of the \$70 section 951 inclusion and \$30 section 78 amount), resulting in a net inclusion of \$50. After application of the high-tax kick-out rules of paragraph (c)(1) of this section, the \$50 inclusion is treated as general limitation income, and the \$30 of taxes deemed paid are treated as taxes imposed on general limitation income, because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$50 inclusion ( $\$30 > \$17 (.34 \times \$50)$ ).

*Example 2.* The facts are the same as in *Example (1)* except that instead of earning \$130 of gross passive royalty income, S earns \$65 of gross passive royalty income from country X sources and \$65 of gross passive interest income from country Y sources. S incurs \$15 of expenses and \$5 of foreign tax with regard to the royalty income and incurs \$15 of expenses and \$10 of foreign tax with regard to the interest income. P allocates \$50 of expenses pro rata to the \$50 inclusion (\$45 section 951 inclusion and \$5 section 78 amount) attributable to the royalty income earned by S and the \$50 inclusion (\$40 section 951 inclusion and \$10 section 78 amount) attributable to the interest income earned by S. Under paragraph (c)(4) of this section, the high-tax test is applied separately to the section 951

inclusion attributable to the income from X sources and the section 951 inclusion attributable to the income from Y sources. Therefore, after allocation of P's \$50 of expenses, the resulting \$25 inclusion attributable to the royalty income from X sources is still treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ( $\$5 < \$8.50 (.34 \times \$25)$ ). The \$25 inclusion attributable to the interest income from Y sources is treated as general limitation income because the foreign taxes paid and deemed paid exceed the highest United States tax rate multiplied by the \$25 inclusion ( $\$10 > \$8.50 (.34 \times \$25)$ ).

*Example 3.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is incorporated and operating in country Y and has a branch in country Z. S has two QBUs (QBU Y and QBU Z). In 1988, S earns \$65 of gross passive royalty income in country Y through QBU Y and \$65 of gross passive royalty income in country Z through QBU Z. S allocates \$15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of \$50 in each QBU. Country Y imposes \$5 of foreign tax on the royalty income earned in Y, and country Z imposes \$10 of tax on royalty income earned in Z. All of S's income constitutes subpart F foreign personal holding company income that is passive income and is included in P's gross income for the taxable year. P allocates \$50 of expenses pro rata to the \$100 subpart F inclusion attributable to the QBUs (consisting of the \$45 section 951 inclusion derived through QBU Y, the \$5 section 78 amount attributable to QBU Y, the \$40 section 951 inclusion derived through QBU Z, and the \$10 section 78 amount attributable to QBU Z), resulting in a net inclusion of \$50. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the \$25 inclusion attributable to Y will still be treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ( $\$5 < \$8.50 (.34 \times \$25)$ ). The \$25 inclusion attributable to Z will be treated as general limitation income because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$25 inclusion ( $\$10 \leq \$8.50 (.34 \times \$25)$ ).

*Example 4.* Domestic corporation M operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, QBU X earns passive royalty income, interest income and rental income. All of the QBU X passive income is from



Country Z sources. The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 5 percent and 10 percent withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraphs (c) (4)(ii) and (3)(ii) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4)(i) (with respect to QBU Y's interest income) and (c) (4)(ii) and (3)(iii) (with respect to QBU X's royalty income) of this section.

*Example 5.* S, a controlled foreign corporation incorporated in foreign country R, is a wholly-owned subsidiary of P, a domestic corporation. For 1988, P is required under section 951(a) to include in gross income \$80 (not including the section 78 amount) attributable to the earnings and profits of S for such year, all of which is foreign personal holding company income that is passive rent or royalty income. S does not make any distributions in 1988 or 1989. Foreign income taxes paid by S for 1988 that are deemed paid by P for such year under section 960(a) with respect to the section 951(a) inclusion equal \$20. Twenty dollars (\$20) of P's expenses are properly allocated to the section 951(a) inclusion. The foreign income tax paid with respect to the section 951(a) inclusion does not exceed the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ( $\$20 < \$27.20 (.34 \times \$80)$ ). Thus, P's section 951(a) inclusion for 1988 is included in P's passive income and the \$20 of taxes attributable to that inclusion are treated as taxes related to passive income. In 1990, S distributes \$80 to P, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by P in 1988 and is excluded from P's gross income. Foreign country R imposes a withholding tax of \$15 on the distribution in 1990. Under paragraph (c)(6)(i) of this section, the withholding tax in 1990 does not affect the characterization of the 1988 inclusion as passive income nor does it affect the characterization of the \$20 of taxes paid in 1988 as taxes paid with respect to passive income. No further parent expenses are allocable to the receipt of that distribution. In 1990, the foreign taxes paid (\$15) exceed the product of the highest United States tax rate and the amount of the inclusion reduced by taxes deemed paid in the year of inclusion ( $\$15 > ((.34 \times \$80) - \$20)$ ). Thus, under paragraph (c)(6)(iii) of this section, \$7.20 ( $(.34 \times \$80) - \$20$ ) of the \$15 withholding tax paid in 1990 is treated as taxes related to passive income

and the remaining \$7.80 ( $\$15 - \$7.20$ ) of the withholding tax is treated as related to general limitation income.

*Example 6.* S, a controlled foreign corporation, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of \$200 of passive income that is foreign personal holding company income that is earned in a foreign country X. Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In 1987, S pays \$100 of foreign tax. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes \$200 in gross income (\$100 of net foreign personal holding company income and \$100 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general limitation income to P. S does not distribute any of its earnings in 1987. In 1988, S has no earnings. On December 31, 1988, S distributes the \$100 of earnings from 1987. At that time, S receives a \$50 refund from X attributable to the reduction of the country X corporate tax imposed on those earnings. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income. Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

*Example 7.* The facts are the same as in *Example 6* except that P elects to apply section 954(b)(4) to S's passive income that is subpart F income. Although the income is not considered to be subpart F income, it remains passive income until distribution. In 1988, S distributes \$150 to P. The distribution is a dividend to P because S has \$150 of accumulated earnings and profits (the \$100 of earnings in 1987 and the \$50 refund in 1988). P has no expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-out rules under paragraph (c)(7)(iii) of this section. The income is passive income to P because the foreign taxes paid and deemed paid by P with respect to the income do not exceed the highest United States tax rate on that income.

*Example 8.* The facts are the same as in *Example 6* except that the distribution in 1988 is subject to a withholding tax of \$25. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income because there is a net \$25 reduction of foreign

tax. By taking into account both the reduction in foreign corporate tax and the withholding tax, the inclusion would continue to be considered high-taxed income. P must follow the appropriate section 905(c) procedures. P must redetermine its foreign tax credit for 1987, but the inclusion and the \$75 taxes (\$50 of deemed paid tax and \$25 withholding tax) will continue to be treated as general limitation income and taxes.

*Example 9.* (i) S, a controlled foreign corporation operating in country G, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. Country G imposes a tax of 50 percent on S's earnings. Under country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30 percent and no withholding tax is imposed. Under country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50 percent tax rate. For 1987, S's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign country G. S has taxable income of \$110 for United States purposes and \$100 for country G purposes. Country G, therefore, imposes a tax of \$50 on the 1987 earnings of S. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes \$110 in gross income (\$60 of net foreign personal holding company income and \$50 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general limitation income to P. S does not distribute any of its taxable income in 1987.

(ii) In 1988, S earns general limitation income that is not subpart F income. S again has \$110 in taxable income for United States purposes and \$100 in taxable income for country G purposes, and S pays \$50 of tax to foreign country G. In 1989, S has no taxable income or earnings. On December 31, 1989, S distributes \$60 of earnings and receives a refund of foreign tax of \$24. Country G treats the distribution of earnings as out of the 50% tax rate pool of earnings accumulated in 1987 and 1988. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the \$60 of passive earnings attributable to income previously taxed in 1987. However, because, under foreign law, only 40 percent (the reduction in tax rates from 50 percent to 30 percent is a 40 percent reduction in the tax) of the \$50 of foreign taxes on the passive earnings can be refunded, \$20 of the \$24 foreign tax refund reduces foreign taxes on passive earnings. The other \$4 of the tax refund reduces the general limitation taxes from \$50 to \$46 (even though for United States purposes the \$60 distribution is entirely out of passive earnings).

(iii) Under paragraph (c)(7) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income ( $\$30 < .34 \times \$110$ ). Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

*Example 10.* P, a domestic corporation, earns \$100 of passive royalty income from sources within the United States. Under the laws of Country X, however, that royalty is considered to be from sources within Country X and Country X imposes a 10 percent withholding tax on the payment of the royalty. P also earns \$100 of passive foreign source dividend income subject to a 10 percent withholding tax to which \$15 of expenses are allocated. In determining whether P's passive income is high-taxed, the \$10 withholding tax on P's royalty income is allocated to passive income, and within the passive category to the group of income described in paragraph (c)(3)(ii) of this section (passive income subject to a withholding tax of less than 15 percent (but greater than zero)). For purposes of determining whether the income is high-taxed, however, only the foreign source dividend income is taken into account. The foreign source dividend income will still be treated as passive income because the foreign taxes paid on the passive income in the group (\$20) do not exceed the highest United States tax rate multiplied by the \$85 of net foreign source income in the group (\$20 is less than  $\$28.90 (\$100 - \$15) \times .34$ ).

*Example 11.* In 2001, P, a U.S. citizen with a tax home in Country X, earns the following items of gross income: \$400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country X income tax of \$100, \$200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is \$10), \$1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is \$325), \$500 of foreign source, general limitation income that gives rise to a \$250 foreign tax, and \$2,000 of U.S. source capital gain that is not subject to any foreign tax. P has a \$900 deduction allocable to its passive rental income. P's only other deduction is a \$700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under § 1.865-2(a)(3)(i). The \$700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The \$300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of

this section. The royalty income is thus reduced by \$100 to \$100 ( $\$200 - (\$300 \times (200/600))$ ) and the rental income is thus reduced by \$200 to \$200 ( $\$400 - (\$300 \times (400/600))$ ). The \$100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the \$200 of rental income and the \$325 of associated foreign tax are assigned to the general limitation category.

*Example 12.* The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under § 1.865-2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is \$1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of \$800 must be re-apportioned to the \$200 of net royalty income subject to a 5 percent withholding tax and the \$400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of \$200 constitutes a separate limitation loss with respect to passive income.

*Example 13.* In 2001, P, a domestic corporation, earns a \$100 dividend that is foreign source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether P's passive income is high-taxed, the \$100 dividend and the \$30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

(d) *High withholding tax interest.* The term "high withholding tax interest" means any interest if such interest is subject to a withholding tax of a foreign country or a possession of the United States and the rate of tax applicable to such interest is at least 5 percent. For purposes of the preceding sentence, a withholding tax is any tax imposed by a foreign country or possession of the United States that is determined on a gross basis. A withholding tax shall not be considered to be determined on a gross basis if the tax is not the final tax payable on the interest income, but is merely a prepayment or credit against a final foreign tax liability determined on a net basis on the interest alone or on interest and other

income. High withholding tax interest does not include any interest described as export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section).

(e) *Financial services income*—(1) *In general.* The term "financial services income" means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(i) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income as defined in paragraph (e)(2) of this section), except income described in paragraph (e)(2)(i)(W) of this section (high withholding tax interest);

(ii) Passive income as defined in section 904(d)(2)(A) and paragraph (b) of this section as determined before the application of the exception for high-taxed income;

(iii) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section that, but for section 904(d)(2)(B)(ii), would also meet the definition of high withholding tax interest; or

(iv) Incidental income as defined in paragraph (e)(4) of this section.

(2) *Active financing income*—(i) *Income included.* For purposes of paragraph (e)(1) and (e)(3) of this section, income is active financing income only if it is described in any of the following subdivisions.

(A) Income that is of a kind that would be insurance income as defined in section 953(a) (including related party insurance income as defined in section 953(c)(2)) and determined without regard to those provisions of section 953(a)(1)(A) that limit insurance income to income from countries other than the country in which the corporation was created or organized.

(B) Income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services.

(C) Income from investing funds in circumstances in which the taxpayer

holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates.

(D) Income from making personal, mortgage, industrial, or other loans.

(E) Income from purchasing, selling, discounting, or negotiating on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.

(F) Income from issuing letters of credit and negotiating drafts drawn thereunder.

(G) Income from providing trust services.

(H) Income from arranging foreign exchange transactions, or engaging in foreign exchange transactions.

(I) Income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

(J) Income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments and dividend and interest income earned by broker dealers on stock, debt obligations, or other financial instruments that are held for sale.

(K) Service fee income from investment and correspondent banking.

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services.

(N) Income from services with respect to the management of funds.

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services or for factoring receivables obtained in the course of providing such services.

(Q) Income from financing purchases from third parties.

(R) Income from gains on the disposition of tangible or intangible personal

property or real property that was used in the active financing business (as defined in paragraph (e)(3)(i) of this section) but only to the extent that the property was held to generate or generated active financing income prior to its disposition.

(S) Income from hedging gain with respect to other active financing income.

(T) Income from providing traveller's check services.

(U) Income from servicing mortgages.

(V) Income from a finance lease. For this purpose, a finance lease is any lease that is a direct financing lease or a leveraged lease for accounting purposes and is also a lease for tax purposes.

(W) High withholding tax interest that would otherwise be described as active financing income.

(X) Income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services.

(Y) Any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Internal Revenue Service.

(3) *Financial services entities*—(i) *In general.* The term “financial services entity” means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable Year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an entity is a financial services entity shall be done on an entity-by-entity basis. An individual or entity is predominantly engaged in the active financing business for any year if for that year at least 80 percent of its gross income is income described in paragraph (e)(2)(i) of this section. For this purpose, gross income includes all income realized by an individual or entity, whether includible or excludible from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the

transferor within the meaning of section 267(b). For this purpose, income received from a related person that is a financial services entity shall be excluded if such income is characterized under the look-through rules of section 904(d)(3) and §1.904-5. In addition, income received from a related person that is not a financial services entity but that is characterized as financial services income under the look-through rules shall be excluded. See paragraph (e)(3)(iv) *Example 5* of this section. Any income received from a related person that is characterized under the look-through rules and that is not otherwise excluded by this paragraph will retain its character either as active financing income or other income in the hands of the recipient for purposes of determining if the recipient is a financial services entity and if the income is financial services income to the recipient. For purposes of this paragraph, related person is defined in §1.904-5(i)(1).

(ii) *Special rule for affiliated groups.* In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group, such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), affiliated group means an affiliated group as defined in section 1504(a), determined without regard to section 1504(b)(3). In counting the income of the group for purposes of determining whether the group meets the requirements of paragraph (e)(3)(i) of this section, the following rules apply. Only the income of group members that are United States corporations or foreign corporations that are controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock shall be included. For purposes of this paragraph (e)(3)(ii), indirect ownership shall be determined under section 318 and the regulations under that section. The income of the group will not include any income from transactions with other members of the group. Pas-

sive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii). This paragraph (e)(3)(ii) applies to taxable years beginning after December 31, 2000.

(iii) *Treatment of partnerships and other pass-through entities* For purposes of determining whether a partner (including a partnership that is a partner in a second partnership) is a financial services entity, all of the partner's income shall be taken into account, except that income that is excluded under paragraph (e)(3)(i) of this section shall not be taken into account. Thus, if a partnership is determined to be a financial services entity none of the income of the partner received from the partnership that is characterized under the look-through rules shall be included for purpose of determining if the partner is a financial services entity. If a partnership is determined not to be a financial services entity, then income of the partner from the partnership that is characterized under the look-through rules will be taken into account (unless such income is financial services income) and such income will retain its character either as active financing income or as other income in the hands of the partner for purposes of determining if the partner is a financial service entity and if the income is financial services income to the partner. If a partnership is a financial services entity and the partner's income from the partnership is characterized as financial services income under the look-through rules, then, for purposes of determining a partner's foreign tax credit limitation, the income from the partnership shall be considered to be financial services income to the partner regardless of whether the partner is itself a financial services entity. The rules of this paragraph (e)(3)(iii) will apply for purposes of determining whether an owner of an interest in any other pass-through entity the character of the income of which is preserved when such income is included in the income of the owner of the interest is a financial services entity.

(iv) *Examples.* The principles of paragraph (e)(3) of this section are illustrated by the following examples.

*Example 1.* P is a domestic corporation that owns 100 percent of the stock of S, a controlled foreign corporation incorporated in Country X. For the 1990 taxable year, 60 percent of S's income is active financing income that consists of income that will be considered general limitation or passive income if S is not a financial services entity. The other 40 percent of S's income is passive non-active financing income. S is not a financial services entity and its active financing income thus retains its character as general limitation and passive income. S makes an interest payment to P in 1990 that is characterized under the look-through rules. Although the interest is not financial services income to S under the look-through rules, it retains its character as active financing income when paid to P and P must take that income into account in determining whether it is a financial services entity under paragraph (e)(3)(i) of this section. If P is determined to be a financial services entity, both the portion of the interest payment characterized as active financing income (whether general limitation or passive income in S's hands) and the portion characterized as passive non-active financing income received from S will be recharacterized as financial services income.

*Example 2.* Foreign corporation A, which is not a controlled foreign corporation, owns 100 percent of the stock of domestic corporation B, which owns 100 percent of the stock of domestic corporation C. A also owns 100 percent of the stock of foreign corporation D. D owns 100 percent of the stock of domestic corporation E, which owns 100 percent of the stock of controlled foreign corporation F. All of the corporations are members of an affiliated group within the meaning of section 1504(a) (determined without regard to section 1504(b)(3)). Pursuant to paragraph (e)(3)(ii) of this section, however, only the income of B, C, E, and F is counted in determining whether the group meets the requirements of paragraph (e)(3)(i) of this section. For the 2001 taxable year, B's income consists of \$95 of active financing income and \$5 of passive non-active financing income. C has \$40 of active financing income and \$20 of passive non-active financing income. E has \$70 of active financing income and \$15 of passive non-active financing income. F has \$10 of passive income. B and E qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. Therefore, B and E are financial services entities without regard to whether the group as a whole is a financial services entity and all of the income of B and E shall be treated as financial services income. C and F do not qualify

as financial services entities under the entity test of paragraph (e)(3)(i) of this section. However, under the affiliated group test of paragraph (e)(3)(ii) of this section, C and F are financial services entities because at least 80 percent of the group's total income consists of active financing income (\$205 of active financing income is 80.4 percent of \$255 total income). B's and E's passive income is not treated as active financing income for purposes of the affiliated group test of paragraph (e)(3)(ii) of this section even though it is treated as financial services income without regard to whether the group satisfies the affiliated group test. Once C and F are determined to be financial services entities under the affiliated group test, however, all of the passive income of the group is treated as financial services income. Thus, 100 percent of the income of B, C, E, and F for 2001 is financial services income.

*Example 3.* PS is a domestic partnership operating in branch form in foreign country X. PS has two equal general partners, A and B. A and B are domestic corporations that each operate in branch form in foreign countries Y and Z. All of A's income, except that derived through PS, is manufacturing income. All of B's income, except that derived through PS, is active financing income. A and B's only income from PS are distributive shares of PS's income. PS is a financial services entity and all of its income is financial services income. The income from PS is excluded in determining if A or B are financial services entities. Thus, A is not a financial services entity because none of A's income is active financing income and B is a financial services entity because all of B's income is active financing income. However, both A and B's distributive shares of PS's taxable income consist of financial services income even though A is not a financial services entity.

*Example 4.* PS is a domestic partnership operating in foreign country X. A and B are domestic corporations that are equal general partners in PS and, therefore, the look-through rules apply for purposes of characterizing A's and B's distributive shares of PS's income. Fifty (50) percent of PS's gross income is active financing income that is not high withholding tax interest. The active financing income includes income that also meets the definition of passive income and income that meets the definition of general limitation income. The other 50 percent of PS's income is from manufacturing. PS is, therefore, not a financial services entity. A's and B's distributive shares of partnership taxable income consist of general limitation manufacturing income and active financing income. Under paragraph (c)(3)(i) of this section, the active financing income shall be financial services income to A or B if either A or B is determined to be a financial services entity. If A or B is not a financial services

entity, the distributive shares of income from PS will not be financial services income to A or B and will consist of passive and general limitation income. All of the income from PS is included in determining if A or B are financial services entities.

*Example 5.* P is a United States corporation that is not a financial services entity. P owns 100 percent of the stock of S, a controlled foreign corporation that is not a financial services entity. S owns 100 percent of the stock of T, a controlled foreign corporation that is a financial services entity. In 1991, T pays a dividend to S. The dividend from T is characterized under the look-through rules of section 904(d)(3). Pursuant to paragraph (e)(3)(i) of this section, the dividend from T is excluded in determining whether S is a financial services entity. S is determined not to be a financial services entity but the dividend retains its character as financial services income in S's hands. Any subpart F inclusion or dividend to P out of earnings and profits attributable to the dividend from T will be excluded in determining whether P is a financial services entity but the inclusion or dividend will retain its character as financial services income.

(4) *Definition of incidental income—(i) In general—(A) Rule.* Incidental income is income that is integrally related to active financing income of a financial services entity. Such income includes, for example, income from precious metals trading and commodity trading that is integrally related to futures income. If securities, shares of stock, or other types of property are acquired by a financial services entity as an ordinary and necessary incident to the conduct of an active financing business, the income from such property will be considered to be financial services income but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus property, including stock, acquired as the result of, or in order to prevent, a loss in an active financing business upon a loan held by the taxpayer in the ordinary course of such business will be considered ordinary and necessary to the conduct of such business, but income from such property will be considered financial services income only so long as the holding of such property remains an ordinary and necessary incident to the conduct of such business. If an entity holds such property for five years or less then the property is considered held incident to the financial services

business. If an entity holds such property for more than five years, a presumption will be established that the entity is not holding such property incident to its financial services business. An entity will be able to rebut the presumption by demonstrating that under the facts and circumstances it is not holding the property as an investment. However, the fact that an entity holds the property for more than five years and is not able to rebut the presumption that it is not holding the property incident to its financial services business will not affect the characterization of any income received from the property during the first five years as financial services income.

(B) *Examples.* The following examples illustrate the application of paragraph (e)(4)(i) of this section.

*Example 1.* X is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. In 1987, X made a loan in the ordinary course of its business to an unrelated foreign corporation, Y. As security for that loan, Y pledged certain operating assets. Those assets generate income of a type that would be subject to the general limitation. In January 1989, Y defaulted on the loan and forfeited the collateral. During the period X held the assets, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In 1993, X sold the forfeited assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from 1989 to 1993 and the income on the sale of the assets in 1993 are financial services income of X.

*Example 2.* The facts are the same as in *Example 1*, except that instead of pledging its operating assets as collateral for the loan, Y pledged the stock of its operating subsidiary Z. In 1993 X sold the stock of Z in complete satisfaction of Y's obligation. X's income from the sale of Z stock in satisfaction of Y's obligation is financial services income.

*Example 3.* P, a domestic corporation, is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. P holds a United States dollar denominated debt (the "obligation") of the Central Bank of foreign country X. The obligation evidences a loan of \$100 made by P to the Central Bank. In 1988, pursuant to a program of country X, P delivers the obligation to the Central Bank which credits 70 units of country X currency to M, a country X corporation. M issues all of its only class of capital stock to P. M invests the 70 units of country X currency in the construction and operation of a new

hotel in X. In 1994, M distributes 10 units of country X currency to P as a dividend. P is not able to rebut the presumption that it is not holding the stock of M incident to its financial services business. The dividend to P is, therefore, not financial services income.

(ii) *Income that is not incidental income.* Income that is attributable to non-financial activity is not incidental income within the meaning of paragraph (e)(4) (i) and (ii) of this section solely because such income represents a relatively small proportion of the taxpayer's total income or that the taxpayer engages in non-financial activity on a sporadic basis. Thus, for example, income from data processing services provided to related or unrelated parties or income from the sale of goods or non-financial services (for example travel services) is not financial services income, even if the recipient is a financial services entity.

(5) *Exceptions.* Financial services income does not include income that is:

(i) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section unless that income would be high withholding tax interest as defined in section 904(d)(2)(B) but for paragraph (d)(2)(B)(ii) of that section;

(ii) High withholding tax interest as defined in section 904(d)(2)(B) unless that income also meets the definition of export financing interest; and

(iii) Dividends from noncontrolled section 902 corporations as defined in section 904(d)(2)(E) and paragraph (g) of this section.

(f) *Shipping income.* The term "shipping income" means any income received or accrued by any person that is of a kind that would be foreign base company shipping income (as defined in section 954(f) and the regulations thereunder). Shipping income does not include any dividends received or accrued from a noncontrolled section 902 corporation, any income that is financial services income, or any income described in section 904(d)(1)(G) (foreign trade income within the meaning of section 923(b)).

(g) *Noncontrolled section 902 corporation—(1) Definition.* Except as otherwise provided, the term "noncontrolled section 902 corporation" means any foreign corporation with respect to which

the taxpayer meets the stock ownership requirements of section 902(a) or, for purposes of applying the look-through rules described in section 904(d)(3) and § 1.904-5, the taxpayer meets the requirements of section 902(b). Except as provided in section 902 and the regulations under that section and paragraph (g)(3) of this section, a controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902 (a) or (b) will be made with respect to the partner's indirect ownership, and not the partnership's direct ownership, in the foreign corporation.

(2) *Treatment of dividends from each separate noncontrolled section 902 corporation—(i) In general.* Except as otherwise provided, a separate foreign tax credit limitation applies to dividends received or accrued by a corporation from each noncontrolled section 902 corporation. Any dividend distribution made by a noncontrolled section 902 corporation out of earnings and profits attributable to periods in which the shareholder did not meet the stock ownership requirements of section 902(a) or section 902(b) shall be treated as distributions made by a noncontrolled section 902 corporation.

(ii) *Special rule for dividends received by a controlled foreign corporation.* If—

(A) Stock in a foreign corporation that it is not a controlled foreign corporation is owned by a controlled foreign corporation, see paragraph (g)(4) *Example 1*,

(B) There are two or more shareholders of that controlled foreign corporation, and

(C) The ownership requirements of section 902(b) with respect to the foreign corporation are met by at least one of the United States shareholders of the controlled foreign corporation,

then any dividends received by the controlled foreign corporation from the foreign corporation shall be treated in their entirety to the controlled foreign



corporation as dividends from a noncontrolled section 902 corporation, notwithstanding that all the United States shareholders of the controlled foreign corporation do not meet the requirements of section 902(b). Any income received or accrued by a United States shareholder of a controlled foreign corporation described in the preceding sentence that is attributable to a dividend paid by a foreign corporation shall be considered to be passive income if the shareholder's interest in that foreign corporation does not satisfy the requirements of section 902(b).

(iii) *Special rules for high withholding tax interest.* If a taxpayer receives or accrues a dividend distribution from a noncontrolled section 902 corporation out of earnings and profits attributable to high withholding tax interest earned or accrued by the noncontrolled section 902 corporation, any gross basis foreign tax (as defined in paragraph (d) of this section) imposed on such interest, to the extent that the taxes are imposed at a rate in excess of 5 percent, shall not be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid or accrued by the taxpayer under section 902. The preceding sentence shall have no effect upon the determination of the amount of earnings and profits of a noncontrolled section 902 corporation.

(iv) *Treatment of inclusions under section 1293.* If a foreign corporation is a noncontrolled section 902 corporation with respect to a taxpayer, any inclusion in the taxpayer's gross income under section 1293 with respect to that corporation shall be treated as a dividend from a noncontrolled section 902 corporation and thus shall be subject to a separate limitation.

(2)(v) *Examples.* The following examples illustrate the application of this paragraph (g).

*Example 1.* A and B are domestic corporations. A owns 90 percent of the stock of C, a foreign corporation and B owns the remaining 10 percent of the C stock. C is a controlled foreign corporation. A and B are United States shareholders. C owns 20 percent of the stock of D, a foreign corporation, not a controlled foreign corporation, that is incorporated in a different country than C. D is a noncontrolled section 902 corporation with respect to C and A, but not with respect to B. In 1987, C has foreign personal holding

company income of \$1000, \$100 of which is attributable to a dividend from D. The remainder of the foreign personal holding company income is passive income. Assume that gross income and net income are equal and that C pays no foreign taxes on its foreign personal holding company income. In 1987, A and B have section 951(a)(1)(A) inclusions of \$900 and \$100, respectively, attributable to the foreign personal holding company income. Under paragraph (g)(2)(ii) of this section, the \$900 included by A consists of \$810 passive income and \$90 of income attributable to a dividend from a noncontrolled section 902 corporation. The \$100 included by B in gross income is characterized as passive income in its entirety although \$10 of the \$100 is attributable to the dividend from D, and, as to C, that dividend is characterized as a dividend from a noncontrolled section 902 corporation. As to B, the \$10 is characterized as passive income because B does not meet the ownership requirements of section 902(b) with regard to D.

*Example 2.* In 1987, A, a domestic corporation, owned 9 percent of the stock of B, a foreign corporation. In 1988, A acquired an additional 20 percent of the stock of B. Thus, in 1988, B is a noncontrolled section 902 corporation with regard to A. In 1989, A acquired an additional 25 percent of the stock of B. A acquired no additional stock in 1990. In 1989 and 1990, A owned 54 percent of the stock of B. For 1989 and 1990, B is a controlled foreign corporation in which A is a United States shareholder. B has no subpart F income in 1989 or 1990. In 1990, B pays a dividend of \$3,000 to A. One thousand dollars (\$1,000) of the dividend is attributable to earnings and profits from 1987, \$1,000 is attributable to earnings and profits from 1988, and \$1,000 is attributable to earnings and profits from 1989. Under paragraph (g)(1) of this section, the \$1,000 attributable to the earnings and profits from 1989 is subject to the look through rules of section 904(d)(3) and § 1.904-5(c)(4) and is characterized in A's hands according to those rules. Under section 904(d)(2)(E)(i) and paragraph (g)(3) of this section, the \$2,000 attributable to the 1987 and 1988 earnings and profits is treated as income subject to a separate limitation for dividends from a noncontrolled section 902 corporation (B corporation).

*Example 3.* M owns 40 percent of the voting stock of foreign corporation N. N is a noncontrolled section 902 corporation. In 1987, N earns \$2,000 of gross interest income and incurs \$1,700 of interest expense. N incurs no other expenses and earns no other income. One-thousand dollars (\$1,000) of the interest income is subject to a 10 percent withholding tax and is, therefore, high withholding tax interest. N's earnings and profits are \$200 (\$2,000 gross interest income less \$1,700 interest expense less \$100 withholding tax). N pays the full \$200 out as a dividend. M receives \$80

(40 percent of the \$200). Under paragraph (g)(2)(iii) of this section, \$50 ( $\$100 - 5\% \times \$1,000$ ) of the \$100 withholding tax is not treated as a foreign tax for purposes of determining the amount of foreign taxes deemed paid by M under section 902. M's deemed paid credit with respect to the \$80 dividend it receives is, therefore, reduced from \$40 ( $\$100 \times \$80 / \$200$ ) to \$20 ( $\$50 \times \$80 / \$200$ ).

(3) *Special rule for dividends paid by a controlled foreign corporation*—(i) *Distributions out of earnings and profits accumulated when the distributing corporation was not a controlled foreign corporation*—(A) *General rule.* Distributions from a controlled foreign corporation shall be treated as dividends from a noncontrolled section 902 corporation, and therefore not subject to the look-through rules of § 1.904-5, to the extent that the distribution is out of earnings and profits accumulated during periods when the distributing corporation was not a controlled foreign corporation.

(B) *Ordering rule.* The determination of the earnings to which a distribution from a controlled foreign corporation is attributable shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from post-1986 undistributed earnings attributable to the period after the distributing corporation became a controlled foreign corporation (look-through pools), next from the non-look-through pool of post-1986 undistributed earnings, if any, and finally on a LIFO basis from pre-1987 accumulated profits.

(C) *Effect of intervening noncontrolled status.* [Reserved]

(D) *Examples.* The following examples illustrate the application of paragraph (g)(3)(i):

*Example 1.* S is a foreign corporation formed in 1980. Until 1992, S had no United States shareholders. In 1992, P, a domestic corporation, acquires 10 percent of the stock of S. Thus, for 1992 and subsequent years, S is a noncontrolled section 902 corporation. Because the 10-percent ownership requirement of section 902(a) was not satisfied until 1992, earnings accumulated by S before 1992 will be treated as pre-1987 accumulated profits for purposes of section 902, and the amount of foreign taxes deemed paid with respect to any distribution out of such pre-1987 accumulated profits will be computed on a year-by-year basis under the rules of section 902(c)(6)(A) and § 1.902-1(b)(3). In 2000, P acquires an additional 45 percent of the stock

of S. Thus, for 2000 and subsequent years, S is a controlled foreign corporation. In 2000, S has no earnings and profits and pays a dividend out of prior years' earnings and profits. Pursuant to paragraph (g)(3)(i) of this section, because S was not a controlled foreign corporation before 2000, the dividend to P will be treated as a dividend from a noncontrolled section 902 corporation. The dividend is treated as paid first out of S's non-look-through pool of post-1986 undistributed earnings to the extent thereof, and then out of S's pre-1987 accumulated profits on a LIFO basis. The entire dividend will be subject to a single separate limitation for dividends from a noncontrolled section 902 corporation.

*Examples 2 through 4.* [Reserved]

(ii) *Pre-August 6, 1997, dividend distributions out of earnings and profits accumulated before a more-than-90-percent United States shareholder became a United States shareholder*—(A) *General rule.* Look-through principles do not apply to distributions made before August 6, 1997, to a more-than-90-percent United States shareholder in the distributing corporation, to the extent the distributions are made from earnings and profits accumulated before the taxpayer became a United States shareholder of the distributing corporation (pre-acquisition earnings). Therefore, in the case of a distribution made before August 6, 1997, a dividend shall be treated as a dividend from a noncontrolled section 902 corporation, and the look-through rules of section 904(d)(3) and § 1.904-5 shall not apply, if—

(1) The distribution is received by a United States shareholder, or by an upper-tier controlled foreign corporation of a United States shareholder, at a time when such United States shareholder is a more-than-90-percent United States shareholder of the distributing corporation; and

(2) The more-than-90-percent United States shareholder was not a United States shareholder at the time the distributed earnings and profits were accumulated by the distributing corporation.

(B) *Exception for certain intra-group acquisitions.* Notwithstanding paragraph (g)(3)(ii)(A) of this section, a dividend recipient shall be entitled to look-through treatment on a distribution out of pre-acquisition earnings if—

(1) The dividend recipient is a United States shareholder of the distributing corporation;

(2) The immediately preceding owner or owners were entitled to look-through treatment on distributions from the distributing corporation (determined after the application of paragraphs (g)(3)(i) and (g)(3)(ii)(A) of this section); and

(3) Both at the time of such distribution and at the time that the dividend recipient acquired its interest from such immediately preceding owner or owners, such recipient and such preceding owner or owners are members of the same affiliated group (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)).

(C) *Ordering rule.* If, under paragraph (g)(3)(ii) of this section (or under paragraphs (g)(3)(i)(A) and (g)(3)(ii) of this section), a shareholder is not entitled to look-through treatment, the determination of whether a distribution from its controlled foreign corporation is attributable to pre-acquisition earnings shall be made on a last-in first-out (LIFO) basis. Thus, a distribution shall be deemed made first from the post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation, and then from pre-acquisition earnings, in the order described in paragraph (g)(3)(i)(B) of this section.

(D) *Distributions after August 5, 1997.* Look-through principles shall apply to distributions made after August 5, 1997, to a distribution from a controlled foreign corporation to a more-than-90-percent United States shareholder out of pre-acquisition earnings that were accumulated in years during which the corporation was a controlled foreign corporation. Post-1986 undistributed earnings attributable to the period after the shareholder became a United States shareholder in the distributing corporation and other post-1986 undistributed earnings accumulated while the distributing corporation was a controlled foreign corporation shall be combined into a single set of post-1986 undistributed earnings pools for each separate category described in § 1.904-5(a)(1) as of August 6, 1997.

(E) *Examples.* The following examples illustrate the application of this paragraph (g)(3)(ii):

*Example 1.* (i) P, a domestic corporation, owns 100 percent of the stock of U, a controlled foreign corporation. In 1992, P sells 100 percent of the stock of U to T, an unrelated domestic corporation. In 1992, U has no earnings and pays a dividend to T out of earnings and profits attributable to prior years. T is not related to P and P's ownership of U will not be attributed to T. Because the dividend to T in 1992 is out of post-1986 undistributed earnings that are pre-acquisition earnings, the dividend will be treated as a dividend from a noncontrolled section 902 corporation. In 1993, U pays a dividend to T out of current earnings and profits. T is entitled to look-through treatment on the dividend.

(ii) In September 1997, U pays a dividend to T out of both post-acquisition earnings and pre-acquisition earnings accumulated while U was a controlled foreign corporation. Under paragraph (g)(3)(ii)(D) of this section, T is entitled to look-through treatment on the full amount of the dividend.

*Example 2.* (i) Domestic corporation P has owned 95 percent of the stock of S, a controlled foreign corporation, from the time of S's organization in 1990. Domestic corporation R owns the remaining 5 percent of the stock of S. On December 1, 1996, T, an unrelated domestic corporation, acquires P's 95 percent interest in S. On December 31, 1996, S pays a dividend out of current and prior years' earnings and profits. T is a more-than-90-percent United States shareholder of S at the time it receives the dividend, but was not a United States shareholder at the time the distributed earnings were accumulated. Under this paragraph (g)(3)(ii), the portion of the dividend to T attributable to pre-acquisition earnings will be treated as a dividend from a noncontrolled section 902 corporation. Under paragraph (g)(3)(iii) of this section, T will be entitled to look-through treatment on the portion of the dividend attributable to 1996 earnings and profits. Under paragraph (g)(3)(ii)(C) of this section, the dividend received by T will be treated as coming first from S's post-1986 undistributed earnings attributable to 1996, and then from pre-acquisition earnings.

(ii) On December 31, 1997, S pays a second dividend out of current and prior years' earnings and profits. Under paragraph (g)(3)(ii)(D) of this section, T will be entitled to look-through treatment on the full amount of the dividend because all of S's earnings and profits were accumulated in years during which S was a controlled foreign corporation. The dividends to R will be treated as passive income because R owns less than 10 percent of the stock of S and,

therefore, is not entitled to look-through treatment.

*Example 3.* The facts are the same as in *Example 2* except that R, rather than T, acquires from P an 86 percent interest in S in 1996. Although R was a shareholder of S before the acquisition, it was not a United States shareholder because it did not own 10 percent of the voting stock of S. Thus, because R owns more than 90 percent of the stock of S, and received a distribution of earnings before August 7, 1997, that were accumulated before it became a United States shareholder of S, this paragraph (g)(3)(ii) applies and R is not entitled to look-through treatment on the 1996 dividend. R is entitled to look-through treatment on the 1997 dividend.

*Example 4.* Since its organization in 1980, S, a controlled foreign corporation, has been owned 60 percent by domestic corporation P and 40 percent by domestic corporation R. On November 15, 1996, domestic corporation T acquires R's 40 percent interest in the stock of S. S has no income in 1996 and pays a dividend on December 15, 1996, out of prior years' earnings and profits. This paragraph (g)(3)(ii) does not apply because T acquired less than 90 percent of the stock of S. Thus, T is entitled to look-through treatment on dividends distributed out of pre-acquisition earnings, because such earnings are attributable to periods in which S was a controlled foreign corporation.

(iii) *Treatment of earnings and profits accumulated in a transition year.* Earnings and profits accumulated in the taxable year in which a corporation became a controlled foreign corporation or in which a more-than-90-percent United States shareholder became a United States shareholder shall be considered earnings and profits accumulated after the corporation became a controlled foreign corporation or the shareholder became a United States shareholder, respectively.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (g)(3):

(A) *More-than-90-percent United States shareholder.* The term *more-than-90-percent United States shareholder* means, with respect to any controlled foreign corporation, a United States shareholder that owns more than 90 percent of the total combined voting power of all classes of stock entitled to vote of the controlled foreign corporation. In determining ownership for purposes of this definition, the indirect stock ownership rules of sections 958 and 318 and

the regulations under those sections shall apply.

(B) *Non-look-through pool.* Except as otherwise provided, the term *non-look-through pool* means post-1986 undistributed earnings accumulated during periods in which the distributing corporation was a noncontrolled section 902 corporation that was not a controlled foreign corporation.

(C) *Post-1986 undistributed earnings.* The term *post-1986 undistributed earnings* has the meaning set forth in § 1.902-1(a)(9).

(D) *Pre-1987 accumulated profits.* The term *pre-1987 accumulated profits* has the meaning set forth in § 1.902-1(a)(10).

(E) *Upper-tier controlled foreign corporation.* The term *upper tier controlled foreign corporation* of a United States shareholder means a controlled foreign corporation in which the taxpayer is a United States shareholder and which is an upper-tier corporation as defined in § 1.902-1(a)(6) with respect to the distributing corporation.

(v) *Effective date.* The provisions of this paragraph (g)(3) apply to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on § 1.904-4(g)(3)(ii), (iii) and (iv) of regulations project INTL-1-92, published at 1992-1 C.B. 1209. See § 601.601(d)(2) of this chapter.

(h) *Export financing interest—(1) Definitions—(i) Export financing interest.* The term “export financing interest” means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For purposes of this paragraph, the term “United States” includes the fifty States, the District of Columbia, and the Commonwealth of Puerto Rico.

(ii) *Fair market value.* For purposes of this paragraph, the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with

its importation. For purposes of determining the foreign content of an item of property imported into the United States, see section 927 and the regulations thereunder.

(iii) *Related person.* For purposes of this paragraph, the term “related person” has the meaning given it by section 954(d)(3) except that such section shall be applied by substituting “the person with respect to whom the determination is being made” for “controlled foreign corporation” each place it applies.

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer (including a financial services entity) receives or accrues export financing interest from an unrelated person, then that interest shall be treated as general limitation income.

(3) *Exceptions—(i) Export financing interest that is high withholding tax interest.* If a financial services entity receives or accrues export financing interest that would also be high withholding tax interest but for section 904(d)(2)(B)(ii), that income shall be treated as financial services income.

(ii) *Export financing interest that is also related person factoring income.* Export financing interest shall be treated as passive income if that income is also related person factoring income. For this purpose, related person factoring income is—

(A) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(B) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

(iii) *Export financing interest that is related person factoring income and is received or accrued by a financial services entity.* If a financial services entity receives or accrues export financing interest that is also related person factoring income, then the income shall be treated as financial services income. See section 864(d)(5)(A)(i).

(iv) *Export financing interest that is related person factoring income and high withholding tax interest.* If any taxpayer (including a financial services entity) receives or accrues export financing interest that is also related person factoring income and high withholding tax interest, then that income shall be treated as high withholding tax interest. See section 864(d)(5)(A)(i).

(4) *Examples.* The following examples illustrate the operation of paragraph (h)(3) of this section:

*Example 1.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P sells the receivables at a discount (“factors”) to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive income to S.

*Example 2.* The facts are the same as in *Example 1* except that S is a financial services entity and derives the income in an active financing business. The income derived by S on the receivables is related person factoring income and is also export financing interest. Therefore, pursuant to paragraph (h)(3)(iii) of this section, the income is financial services income to S.

*Example 3.* Domestic corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P factors the receivables to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. The income will be passive income to S.

*Example 4.* The facts are the same as in *Example 3* except that instead of factoring P’s receivables, S finances the sales of P’s goods by making loans to the purchasers of P’s goods. The interest derived by S on these loans is export financing interest and is not related person factoring income. The income will be general limitation income to S.

(5) *Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment—(i) Income other than interest.* If any foreign person that is not a financial services entity receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) and such income would also meet the

definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income shall be considered to be export financing interest and shall be treated as general limitation income. If a financial services entity receives or accrues that income, the income shall not be considered to be export financing interest and, therefore, shall be treated as financial services income.

(ii) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income under section 864(d)(6) if section 864(d)(7) did not apply, section 904(d)(2)(A)(iii)(II) shall apply, and the interest shall be treated as general limitation income unless the interest is received or accrued by a financial services entity. If that interest is received or accrued by a financial services entity, section 904(d)(2)(C)(iii)(III) shall apply and the interest shall be treated as general limitation income. If that interest also would be high withholding tax interest but for section 904(d)(2)(B)(ii), then the interest shall be treated as financial services income.

(iii) *Examples.* The following examples illustrate the operation of this paragraph (h)(5):

*Example 1.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in Country M. In 1987, P sells tractors to T, which T sells to X, an unrelated foreign corporation organized in country M. The tractors are to be used in country M. T uses a substantial part of its assets in its trade or business located in Country M. T has uncollected trade receivables from X that it factors to S. S derived more than 20 percent of its gross income for 1987 other than from an active financing business and the income derived by S from the receivables is not derived in an active financing business. Thus, pursuant to paragraph (e)(3)(i) of this section, S is not a financial services entity. The income is not related person factoring income because it is described in section 864(d)(7) (income eligible for the same country exception). If section 864(d)(1) applied, the income S derived from the receivables would meet the definition of export financing interest. The income, therefore, is

considered to be export financing interest and is general limitation income to S.

*Example 2.* The facts are the same as in *Example 1* except that S is a financial services entity and derives the income on the receivables from the conduct of an active financing business. The income S derives from the receivables is not related person factoring income because it is described in section 864(d)(7). If the income would be high withholding tax interest but for section 904(d)(2)(B)(ii), then the income will not be considered to be export financing interest and will be financial services income to S. Otherwise, the income will be considered to be export financing interest and will be general limitation income to S.

*Example 3.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. S is not a financial services entity. In 1987, P sells tractors to T, which T sells to X, a foreign partnership that is organized in country M and is related to S and T. S makes a loan to X to finance the tractor sales. The interest earned by S from financing the sales is described in section 864(d)(7) and is export financing interest. Therefore, the income shall be general limitation income to S.

*Example 4.* The facts are the same as in *Example 3* except that S is a financial services entity and derives the interest on the loan to X in an active financing business. The interest S earns is export financing interest that is not described in section 864(d)(1) because it is described in section 864(d)(7). Because the interest is described in section 864(d)(7) and is export financing interest, section 904(d)(2)(C)(iii)(III) shall apply and the income shall be general limitation income to S, unless it would also be high withholding tax interest but for section 904(d)(2)(B)(ii), in which case it will be financial services income to S.

(i) *Interaction of section 907(c) and income described in this section.* If a person receives or accrues income that is income described in section 907(c) (relating to oil and gas income), the rules of section 907(c) and the regulations thereunder, as well as the rules of this section, shall apply to the income. Thus, for example, if a taxpayer receives or accrues a dividend distribution from two separate noncontrolled section 902 corporations out of earnings and profits attributable to income received or accrued by the noncontrolled section 902 corporations that is income described in section 907(c), the rules

provided in section 907 shall apply separately to the dividends received from each noncontrolled section 902 corporation. The reduction in amount allowed as foreign tax provided by section 907(a) shall therefore be calculated separately for dividends received or accrued by the taxpayer from each separate noncontrolled section 902 corporation.

(j) *Special rule for DASTM gain or loss.* Any DASTM gain or loss computed under §1.985-3(d) must be allocated among the categories of income under the rules of §1.985-3 (e)(2)(iv) or (e)(3). The rules of §1.985-3(e) apply before the rules of section 904(d)(2)(A)(iii)(III) (the exception from passive income for high-taxed income).

(k) *Special rule for alternative minimum tax foreign tax credit.* For purposes of computing the alternative minimum tax foreign tax credit under section 59(a), items included in alternative minimum taxable income by reason of section 56(g) (adjustments based on adjusted current earnings) shall be characterized as income described in a separate category under section 904(d) and this section based on the character of the underlying items of income.

(l) *Priority rules—(1) In general.* In the case of income that meets the definitions of more than one category of separate limitation income, the following priority rules apply:

(i) Income that meets the definitions of passive income and of any other separate limitation income described in section 904(d)(1) (B) through (H) will be subject to the other separate limitation;

(ii) Income that meets the definitions of financial services income and of either shipping income or passive income will be subject to the separate limitation for financial services income;

(iii) Income that meets the definitions of financial services income and of any separate limitation income other than shipping or passive income will be subject to the other separate limitation;

(iv) Income that meets the definitions of dividends from a noncontrolled section 902 corporation and of any other separate limitation income will be subject to the separate limitation

for dividends from a noncontrolled section 902 corporation unless that income is foreign oil and gas extraction income defined in section 907(c), in which case it will be treated as general limitation income pursuant to §1.907(a)-1(f);

(v) Income that meets the definitions of high withholding tax interest and of any other separate limitation income will be high withholding tax interest; and

(vi) Income that meets the definitions of shipping income and of foreign trade income will be subject to the separate limitation for foreign trade income.

(2) *Examples.* The provisions of this paragraph (1) are illustrated by the following examples:

*Example 1.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 20 percent of the voting stock of T, a foreign corporation that is not a controlled foreign corporation. In 1987, T pays S a dividend that qualifies as foreign base company shipping income to S under §1.954-6(f)(1). The dividend from T is also a dividend from a noncontrolled section 902 corporation. Therefore, pursuant to section 904(d)(2)(D) and paragraph (1)(1)(iv) of this section, the dividend from T is treated as a dividend from a noncontrolled section 902 corporation.

*Example 2.* In 1987, domestic corporation P received a dividend from R, a foreign corporation that is not a controlled foreign corporation. P owns 30 percent of the voting stock of R. P is a financial services entity and the dividend from R qualifies as financial services income under paragraph (e)(4)(i)(A) of this section. The dividend from R is also a dividend from a noncontrolled section 902 corporation. Therefore, pursuant to section 904(d)(2)(C) (iii)(II) and paragraphs (1)(1)(iii) and (iv) of this section, the dividend from R is treated as a dividend from a noncontrolled section 902 corporation.

*Example 3.* P, a domestic corporation, owns 10 percent of foreign corporation S. S is a noncontrolled section 902 corporation. In 1990, S earns foreign oil and gas extraction income which is general limitation income. S pays a dividend to P out of its earnings and profits for 1990. The dividend from S is a dividend from a noncontrolled section 902 corporation that is also foreign oil and gas extraction income. Pursuant to section 907(c)(3)(A), §1.907(a)-1(f) and paragraph (1)(1)(iv) of this section, P will include the

dividend in income as general limitation income.

[T.D. 8214, 53 FR 27011, July 18, 1988, as amended by T.D. 8412, 57 FR 20644, May 14, 1992; 57 FR 45660, Oct. 2, 1992; T.D. 8556, 59 FR 37672, July 25, 1994; T.D. 8805, 64 FR 1515, Jan. 11, 1999; T.D. 8805, 64 FR 32181, June 16, 1999; T.D. 8916, 66 FR 275, Jan. 3, 2001; 66 FR 16126, Mar. 23, 2001; T.D. 8973, 66 FR 67086, Dec. 28, 2001]

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

(a) *Definitions.* For purposes of section 904(d)(3) and the regulations under section 904, the following definitions apply:

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1) (A), (B), (C), (D), (E), (F), (G), (H), or (I) and in § 1.904-4 (b), (d), (e), (f), and (g), or any category of earnings and profits to which income described in such provisions is attributable.

(2) The term *controlled foreign corporation* has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(3) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder shall include any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that “more than 50 percent” shall be substituted for “at least 80 percent” wherever it appears in section 1504(a)(2). For taxable years beginning before January 1, 2001, the preceding sentence shall be applied by substituting “50 percent” for “more than 50 percent”.

(b) *In general.* Except as otherwise provided in section 904(d) (2)(E) and (3) and this section, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as general limitation income.

(c) *Rules for specific types of inclusions and payments—(1) Subpart F inclusions—*

(i) *Rule.* Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by the controlled foreign corporation that is described as income in such category. For purposes of this § 1.904-5, income shall be characterized under the rules of § 1.904-4 prior to the application of the rules of paragraph (c) of this section. For rules concerning inclusions under section 951(a)(1)(B), see paragraph (c)(4)(i) of this section.

(ii) *Examples.* The following examples illustrate the application of this paragraph (c)(1):

*Example 1.* Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns \$200 of net income, \$85 of which is foreign base company shipping income, \$15 of which is foreign personal holding company income, and \$100 of which is non-subpart F general limitation income. No foreign tax is imposed on the income. One hundred dollars (\$100) of S's income is subpart F income taxed currently to P under section 951(a)(1)(A). Because \$85 of the subpart F inclusion is attributable to shipping income of S, \$85 of the subpart F inclusion is shipping income to P. Because \$15 of the subpart F inclusion is attributable to passive income of S, \$15 of the subpart F inclusion is passive income to P.

*Example 2.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a financial services entity. P manufactures cars and is not a financial services entity. In 1987, S earns \$200 of interest income unrelated to its banking business and \$900 of interest income related to its banking business. Assume that S pays no foreign taxes and has no expenses. All of S's income is included in P's gross income as foreign personal holding company income. Because S is a financial services entity, income that would otherwise be passive income is considered to be financial services income. P, therefore, treats the entire subpart F inclusion as financial services income.

*Example 3.* Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. P is a financial services entity. S manufactures cars and is not a financial services entity. In 1987, S earns \$200 of passive income that is subpart F income and \$900 of general limitation non-subpart F income. Assume that S pays no foreign taxes on its passive earnings and has no expenses. P includes the \$200 of subpart F income in