

dividend in income as general limitation income.

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§ 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

gross income. Because P is a financial services entity, the inclusion will be financial services income to P.

Example 4. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Neither P nor S is a financial services entity. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. T is a financial services entity. In 1991, T pays a dividend to S. For purposes of determining whether S is a financial services entity under §1.904-4(e)(3)(i), the dividend from T is ignored. For purposes of characterizing the dividend in S's hands under the look-through rules of paragraph (c)(4) of this section, however, the dividend retains its character as financial services income. Similarly, any subpart F inclusion or dividend to P out of the earnings and profits attributable to the dividend from S is excluded in determining whether P is a financial services entity under §1.904-4(e)(3)(i), but retains its character in P's hands as financial services income under paragraph (c)(4) of this section.

Example 5. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 40 percent of foreign corporation A, 45 percent of foreign corporation B, 30 percent of foreign corporation C and 20 percent of foreign corporation D. A, B, C, and D are noncontrolled section 902 corporations. In 1987, S's only income is a \$100 dividend from each foreign corporation. Assume that S pays no foreign taxes and has no expenses. All \$400 of the income is foreign personal holding company income and is included in P's gross income. P must include \$100 in its separate limitation for dividends from A, \$100 in its separate limitation for dividends from B, \$100 in its separate limitation for dividends from C, and \$100 in its separate limitation for dividends from D.

(2) *Interest*—(i) *In general.* For purposes of this paragraph, related person interest is any interest paid or accrued by a controlled foreign corporation to any United States shareholder in that corporation (or to any other related person) to which the look-through rules of section 904(d)(3) and this section apply. Unrelated person interest is all interest other than related person interest. Related person interest shall be treated as income in a separate category to the extent it is allocable to income of the controlled foreign corporation in that category. If related person

interest is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to any separate category of income shall be determined by multiplying the amount of related person interest allocable to that separate category of income by a fraction. The numerator of the fraction is the amount of related person interest received or accrued by that person and the denominator is the total amount of related person interest paid or accrued by the controlled foreign corporation.

(ii) *Allocating and apportioning expenses including interest paid to a related person.* Related person interest and other expenses of a controlled foreign corporation shall be allocated and apportioned in the following manner:

(A) Gross income in each separate category shall be determined;

(B) Any expenses that are definitely related to less than all of gross income as a class, including unrelated person interest that is directly allocated to income from a specific property, shall be allocated and apportioned under the principles of §§1.861-8 or 1.861-10T, as applicable, to income in each separate category;

(C) Related person interest shall be allocated to and shall reduce (but not below zero) the amount of passive foreign personal holding company income as determined after the application of paragraph (c)(2)(ii)(B) of this section;

(D) To the extent that related person interest exceeds passive foreign personal holding company income as determined after the application of paragraphs (c)(2)(ii)(B) and (C) of this section, the related person interest shall be apportioned under the rules of this paragraph to separate categories other than passive income.

(I) If under §1.861-9T, the modified gross income method of apportioning interest expense is elected, related person interest shall be apportioned as follows:

$$\text{Related person interest minus Related person interest allocated under paragraph (c)(2)(ii)(C) of this section} \times \frac{\text{Gross income in a separate category (other than passive)}}{\text{Total gross income (other than passive)}}$$

(2) If under § 1.861-9T, the asset method of apportioning interest expense is elected, related person interest shall be apportioned according to the following formula:

$$\text{Related person interest minus Related person interest allocated under paragraph (c)(2)(ii)(C) of this section} \times \frac{\text{Value of assets in a separate category (other than passive)}}{\text{Value of total assets (other than passive)}}$$

(E) Any other expenses (including unrelated person interest that is not directly allocated to income from a specific property) that are not definitely related expenses or that are definitely related to all of gross income as a class shall be apportioned under the rules of this paragraph to reduce income in each separate category.
 (1) If under § 1.861-9T, the modified gross income method of apportioning interest expense is elected, the interest expense shall be apportioned as follows:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Gross income in a separate category (minus related person interest allocated under paragraph (c)(2)(ii)(C) of this section if the category is passive)}}{\text{Total gross income minus related person interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section}}$$

(2) If under § 1.861-9T, the asset method of apportioning interest expense is elected, then the expense shall be apportioned as follows:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Value of assets in a separate category (minus related person debt allocated to passive assets if the category is passive)}}{\text{Value of total assets minus related person debt allocated to passive assets}}$$

(3) Expenses other than interest shall be apportioned in a similar manner depending on the apportionment method used. See § 1.861-8T(c)(1) (i)-(vi).

(iii) *Definitions*—(A) *Value of assets and reduction in value of assets and gross income.* For purposes of paragraph (c)(2)(ii) (D) and (E) of this section, the value of total assets is the value of assets in all categories (determined under the principles of §1.861-9T(g)). See §1.861-10T(d)(2) to determine the reduction in value of assets and gross income for purposes of apportioning additional third person interest expense that is not directly allocated when some interest expense has been directly allocated. For purposes of this para-

graph and paragraph (c)(2)(ii)(E) of this section, any reduction in the value of assets for indebtedness that relates to interest allocated under paragraph (c)(2)(ii)(C) of this section is made before determining the average of asset values. For rules relating to the averaging of reduced asset values see §1.861-9T(g)(2).

(B) *Related person debt allocated to passive assets.* For purposes of paragraph (c)(2)(ii)(E) of this section, related person debt allocated to passive assets is determined as follows:

$$\text{Related person debt allocated to the passive category} = \frac{\text{Total related person debt}}{\text{Total related person debt}} \times \frac{\text{Related person interest allocable to passive income under paragraph (c)(2)(ii)(C)}}{\text{All related person interest}}$$

For this purpose, the term *total related person debt* means the sum of the principal amounts of obligations of a controlled foreign corporation owed to any United States shareholder of such corporation or to any related entity (within the meaning of paragraph (g) of this section) determined at the end of the taxable year.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (c)(2).

Example 1. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$200 of foreign personal holding company income that is passive income. S also earns \$100 of foreign base company sales income that is general limitation income. S has \$2000 of passive assets and \$2000 of general limitation assets. In 1987, S makes a \$150 interest payment to P with respect to a \$1500 loan from P. S also pays \$100 of interest to an unrelated person on a \$1000 loan from that person. S has no other expenses. S uses the asset method to apportion interest expense.

(ii) Under paragraph (c)(2)(ii)(C) of this section, the \$150 related person interest payment is allocable to S's passive foreign personal holding company income. Therefore, the \$150 interest payment is passive income to P. Because the entire related person interest payment is allocated to passive income under paragraph (c)(2)(ii)(C) of this section, none of the related person interest payment is apportioned to general limitation income under paragraph (c)(2)(ii)(D) of this section.

Under paragraph (c)(2)(iii)(B) of this section, the entire amount of the related person debt is allocable to passive assets (\$150=\$1500×\$150/\$1500). Under paragraph (c)(2)(ii)(E) of this section, \$20 of interest expense paid to an unrelated person is apportioned to passive income (\$20=\$100×(\$2000-\$1500)/(\$4000-\$1500)). Eighty dollars (\$80) of the interest expense paid to an unrelated person is apportioned to general limitation income (\$80=\$100×\$2000/(\$4000-\$1500)).

Example 2. The facts are the same as in *Example 1*, except that S uses the gross income method to apportion interest expense. Under paragraph (c)(2)(ii)(E) of this section, the unrelated person interest expense would be apportioned on a gross income method. Therefore, \$33 of interest expense paid to unrelated persons would be apportioned to passive income (\$33=\$100×(\$200-\$150)/(\$300-\$150)) and \$67 of interest expense paid to unrelated persons would be apportioned to general limitation income (\$67=\$100×\$100/(\$300-\$150)).

Example 3. (i) The facts are the same as in *Example 1*, except that S has an additional \$50 of third person interest expense that is directly allocated to income from a specific property that produces only passive income. The principal amount of indebtedness to which the interest relates is \$500. S also has \$50 of additional non-interest expenses that are not definitely related expenses and that are apportioned on an asset basis.

(ii) Under paragraph (c)(2)(ii)(B) of this section, the \$50 of directly allocated third person interest is first allocated to reduce the passive income of S. Under paragraph (c)(2)(ii)(C) of this section, the \$150 of related

person interest is allocated to the remaining \$150 of passive income. Under paragraph (c)(2)(iii)(B) of this section, all of the related person debt is allocated to passive assets. ($\$150 = \$1500 \times \$150 / \150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, the non-interest expenses that are not definitely related are apportioned on the basis of the asset values reduced by the allocated related person debt. Therefore, \$10 of these expenses are apportioned to the passive category ($\$50 \times (\$2000 - \$1500) / (\$4000 - \$1500)$) and \$40 are apportioned to the general limitation category ($\$50 \times \$2000 / (\$4000 - \$1500)$).

(iv) In order to apportion third person interest between the categories of assets, the value of assets in a separate category must also be reduced under the principles of § 1.861-8 by the indebtedness relating to the specifically allocated interest. Therefore, under paragraph (c)(2)(iii)(B) of this section, the value of assets in the passive category for purposes of apportioning the additional third person interest = 0 ($\$2000$ minus $\$500$ (the principal amount of the debt, the interest payment on which is directly allocated to specific interest producing properties) minus $\$1500$ (the related person debt allocated to passive assets)). Under paragraph (c)(2)(ii)(E) of this section, all \$100 of the non-definitely related third person interest is apportioned to the general limitation category ($\$100 = \$100 \times \$2000 / (\$4000 - \$500 - \$1500)$).

Example 4. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$100 of foreign personal holding company income that is passive income. S also earns \$100 of foreign base company sales income that is general limitation income. S has \$1000 of general limitation assets and \$1000 of passive assets. In 1987, S makes a \$150 interest payment to P on a \$1500 loan from P and has \$20 of general and administrative expenses (G & A) that under the principles of §§ 1.861-8 through 1.861-14T is treated as directly allocable to all of P's gross income. S also makes a \$25 interest payment to an unrelated person on a \$250 loan from the unrelated person. S has no other expenses. S uses the asset method to apportion interest expense. S uses the gross income method to apportion G & A.

(ii) Under paragraph (c)(2)(ii)(C) of this section, \$100 of the interest payment to P is allocable to S's passive foreign personal holding company income. Under paragraph (c)(2)(ii)(D) of this section, the additional \$50 of related person interest expense is apportioned to general limitation income ($\$50 = \$50 \times \$1000 / \1000). Under paragraph (c)(2)(iii)(B) of this section, related person debt allocated to passive assets equals \$1000 ($\$1000 = \$1500 \times \$100 / \150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, none of the \$25 of interest expense paid to an unrelated person is apportioned to passive income ($\$0 = \$25 \times (\$1000 - \$1000) /$

$(\$2000 - \$1000)$). Twenty-five dollars (\$25) of the interest expense paid to an unrelated person is apportioned to general limitation income ($\$25 = \$25 \times \$1000 / (\$2000 - \$1000)$). Under paragraph (c)(2)(ii)(E) of this section, none of the G & A is allocable to S's passive foreign personal holding company income ($\$0 = \$20 \times (\$100 - \$100) / (\$200 - \$100)$). All \$20 of the G & A is apportioned to S's general limitation income ($\$20 = \$20 \times \$100 / (\$200 - \$100)$).

Example 5. The facts are the same as in *Example 4*, except that S uses the gross income method to apportion interest expense. As in *Example 4*, \$100 of the interest payment to P is allocated to passive income under paragraph (c)(2)(ii)(C) of this section. Under paragraph (c)(2)(ii)(D) of this section, the additional \$50 of related person interest expense is apportioned to general limitation income ($\$50 = 100 \times \$100 / \$100$). Under paragraph (c)(2)(ii)(E) of this section, none of the unrelated person interest expense and none of the G & A is apportioned to passive income, because after the application of paragraph (c)(2)(ii)(C) of this section, no passive income remains in the passive income category.

Example 6. Controlled foreign corporation T is a wholly-owned subsidiary of S, a controlled foreign corporation. S is a wholly-owned subsidiary of P, a domestic corporation. S is not a financial services entity. S and T are incorporated in the same country. In 1987, P sells tractors to T, which T sells to X, a foreign corporation that is related to both S and T and is organized in the same country as S and T. S makes a loan to X to finance the tractor sales. Assume that the interest earned by S from financing the sales is export financing interest that is neither related person factoring income nor foreign personal holding company income. The export financing interest earned by S is, therefore, general limitation income. S earns no other income. S makes a \$100 interest payment to P. The \$100 of interest paid is allocable under the look-through rules of paragraph (c)(2)(ii) of this section to the general limitation income earned by S and is therefore general limitation income to P.

(3) *Rents and Royalties.* Any rents or royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent they are allocable to income of the controlled foreign corporation in that category under the principles of §§ 1.861-8 through 1.861-14T.

(4) *Dividends*—(i) *Look-through rule.* Any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation, shall be treated as

income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the controlled foreign corporation. For purposes of this paragraph, the term "dividend" includes any amount included in gross income under section 951(a)(1)(B) as a pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(ii) *Special rule for dividends attributable to certain loans.* If a dividend is distributed to a taxpayer by a controlled foreign corporation, that controlled foreign corporation is the recipient of loan proceeds from a related look-through entity (within the meaning of § 1.904-5(i)), and the purpose of such loan is to alter the characterization of the dividend for purposes of this section, then, to the extent of the principal amount of the loan, the dividend shall be characterized with respect to the earnings and profits of the related person lender rather than with respect to the earnings and profits of the dividend payor. A loan will not be considered made for the purpose of altering the characterization of a dividend if the loan would have been made or maintained on substantially the same terms irrespective of the dividend. The determination of whether a loan would have been made or maintained on substantially the same terms irrespective of the dividend will be made taking into account all the facts and circumstances of the relationship between the lender and the borrower. Thus, for example, a loan by a related party lender to a controlled foreign corporation that arises from the sale of inventory in the ordinary course of business will not be considered a loan made for the purpose of altering the character of any dividend paid by the borrower.

(iii) *Examples.* The following examples illustrate the application of this paragraph (c)(4).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S has earnings and profits of \$1,000, \$600 of which is attributable to general limitation income and \$400 of which is attributable to dividends received by S from its wholly-owned subsidiary, T. T is a controlled foreign corporation and is in-

corporated and operates in the same country as S. All of T's income is financial services income. Neither S's general limitation income nor the dividend from T is subpart F income. In December 1987, S pays a dividend to P of \$200, all of which is attributable to earnings and profits earned in 1987. Six-tenths of the dividend (\$120) is treated as general limitation income because six-tenths of S's earnings and profits are attributable to general limitation income. Four-tenths of the dividend (\$80) is treated as financial services income because four-tenths of S's earnings and profits are attributable to dividends from T, and all of T's earnings are financial services income.

Example 2. A, a United States person, has been the sole shareholder in controlled foreign corporation X since its organization on January 1, 1963. Both X and A are calendar year taxpayers. X's earnings and profits for 1963 through the end of 1987 totaled \$3,000. A sells his stock in X at the end of 1987 and realizes a gain of \$4,000. Of the total \$4,000 gain, \$3,000 (A's share of the post-1962 earnings and profits) is includible in A's gross income as a dividend and is subject to the look-through rules including the transition rule of § 1.904-7(a) with respect to the portion of the distribution out of pre-87 earnings and profits. The remaining \$1,000 of the gain is includible as gain from the sale or exchange of the X stock and is passive income to A.

(d) *Effect of exclusions from subpart F income—(1) De minimis amount of subpart F income.* If the sum of a controlled foreign corporation's gross foreign base company income (determined under section 954(a) without regard to section 954(b)(5)) and gross insurance income (determined under section 953(a)) for the taxable year is less than the lesser of 5 percent of gross income or \$1,000,000, then all of that income (other than income that would be financial services income without regard to this paragraph (d)(1)) shall be treated as general limitation income. In addition, if the test in the preceding sentence is satisfied, for purposes of paragraphs (c)(2)(ii) (D) and (E) of this section (apportionment of interest expense to passive income using the asset method), any passive limitation assets shall be treated as general limitation assets. The determination in the first sentence shall be made prior to the application of the exception for certain income subject to a high rate of foreign tax described in paragraph (d)(2) of this section.

(2) *Exception for certain income subject to high foreign tax.* Except as provided in § 1.904-4(c)(7)(iii) (relating to reductions in tax upon distribution), for purposes of the dividend look-through rule of paragraph (c)(4)(i) of this section, an item of net income that would otherwise be passive income (after application of the priority rules of § 1.904-4(1)) and that is received or accrued by a controlled foreign corporation shall be treated as general limitation income, and the earnings and profits attributable to such income shall be treated as general limitation earnings and profits, if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11 (with reference to section 15, if applicable). The preceding sentence has no effect on amounts (other than dividends) paid or accrued by a controlled foreign corporation to a United States shareholder of such controlled foreign corporation to the extent those amounts are allocable to passive income of the controlled foreign corporation.

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

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$100 of gross income, \$4 of which is interest that is subpart F foreign personal holding company income and \$96 of which is gross manufacturing income that is not subpart F income. S has no other earnings for 1987. S has no expenses and pays no foreign taxes. S pays P a \$100 dividend. Under the de minimis rule of section 954(b)(3), none of S's income is treated as foreign base company income. All of S's income, therefore, is treated as general limitation income. The entire \$100 dividend is general limitation income to P.

Example 2. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns \$50 of shipping income of a type that is foreign base company shipping income. S also earns \$50 of dividends from T, a foreign corporation in which S owns 45 percent of the voting stock, and receives \$50 of dividends from U, a foreign corporation in which S owns 5% of the voting stock. Foreign persons hold the remaining voting stock of both T and U. S, T, and U are all incorporated in different foreign countries. The dividends S receives

from T and U are of a type that normally would be subpart F foreign personal holding company income that is passive income. Under § 1.904-4(1)(iv), however, the dividends from T are dividends from a noncontrolled section 902 corporation rather than passive income. S has no expenses. The earnings and profits of S are equal to the net income after taxes of S. The dividends and the shipping income are taxed abroad by S's country of incorporation at an effective rate of 40 percent. P establishes to the satisfaction of the Secretary that the effective rate of tax on both the dividends and the shipping income exceeds 90 percent of the maximum United States tax rate. Thus, under section 954(b)(4), neither the shipping income nor the dividends are taxed currently to P under subpart F. S's earnings attributable to shipping income and dividends from a noncontrolled section 902 corporation retain their character as such. Under paragraph (d)(2) of this section, S's earnings attributable to the dividends from U are treated as earnings attributable to general limitation income. See §§ 1.905-3T and 1.905-4T, however, for rules concerning adjustments to the pools of earnings and profits and foreign taxes and redeterminations of United States tax liability when foreign taxes are refunded in a later year.

(ii) In 1988, S has no earnings and pays a \$150 dividend (including gross-up) to P. The dividend is paid out of S's post-1986 pool of earnings and profits. One-third of the dividend (\$50) is attributable to S's shipping earnings, one-third (\$50) is attributable to the dividend from T, and one-third (\$50) is attributable to the dividend from U. Pursuant to section 904(d)(3)(E) and paragraph (c)(4) of this section, one-third of the dividend is shipping income, one-third is a dividend from a noncontrolled section 902 corporation, T, and one-third is general limitation income to P.

(e) *Treatment of subpart F income in excess of 70 percent of gross income—(1) Rule.* If the sum of a controlled foreign corporation's gross foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the taxable year exceeds 70 percent of the gross income, then all of the controlled foreign corporation's gross income shall be treated as foreign base company income (whichever is appropriate) and, thus, included in a United States shareholder's gross income. However, the inclusion in gross income of an amount that would not otherwise be subpart F income does not affect its character for purposes of determining whether the income is within a separate category.

The determination of whether the controlled foreign corporation's gross foreign base company income and gross insurance income exceeds 70 percent of gross income is made before the exception for certain income subject to a high rate of foreign tax.

(2) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns \$100, \$75 of which is foreign personal holding company income and \$25 of which is non-subpart F services income. S is not a financial services entity. S's gross and net income are equal. Under the 70 percent full inclusion rule of section 954(b)(3)(B), the entire \$100 is foreign base company income currently taxable to P under section 951. Because \$75 of the \$100 section 951 inclusion is attributable to S's passive income, \$75 of the inclusion is passive income to P. The remaining \$25 of the inclusion is treated as general limitation income to P because \$25 is attributable to S's general limitation income.

(f) *Modification of look-through rules for certain income—(1) High withholding tax interest.* If a taxpayer receives or accrues interest from a controlled foreign corporation that is a financial services entity, and the interest would be described as high withholding tax interest if section 904(d)(3) and paragraph (c)(2) of this section (the look-through rules for interest) did not apply, then the interest shall be treated as high withholding tax interest to the extent that the interest is allocable under section 904(d)(3) and paragraph (c)(2)(i) of this section to financial services income of the controlled foreign corporation. See section 904(d)(3)(H). The amount treated as high-withholding tax interest under this paragraph (f)(1) shall not exceed the interest, or equivalent income, of the payor that would be taken into account in determining the financial services income of the payor if the look-through rules applied.

(2) *Dividends from a noncontrolled section 902 corporation.* (i) *Rule.* If a United States shareholder that is a corporation receives or accrues income from a controlled foreign corporation that is attributable to dividends from a noncontrolled section 902 corporation, such income shall be subject to a separate limitation for such dividends except as

provided in § 1.904-4(g)(2)(ii) (relating to dividends from a foreign corporation with respect to which the United States shareholder does not meet the stock ownership requirements of section 902).

(ii) *Example.* The following example illustrates the provisions of this paragraph (f)(2).

Example. P, a domestic corporation, owns 40 percent of S, a controlled foreign corporation. U, an unrelated domestic corporation, owns the remaining 60 percent of S. S owns 10 percent of T, a noncontrolled section 902 corporation. In 1990, T pays S a dividend, which S includes in its gross income as a dividend from a noncontrolled section 902 corporation. S has no other income during 1990. P and U must include S's dividend income from T in their gross income under subpart F. Pursuant to § 1.904-4(g)(2)(ii)(C), the subpart F inclusion to U is characterized as a dividend from a noncontrolled section 902 corporation because U meets the 5 percent ownership requirement of section 902(b) ($60\% \times 10\% = 6\%$). The subpart F inclusion to P is characterized as passive income because P does not meet the 5 percent ownership requirement of section 902(b) ($40\% \times 10\% = 4\%$).

(3) *Distributions from a FSC.* Income received or accrued by a taxpayer that, under the rules of paragraph (c)(4) of this section (look-through rules for dividends), would be treated as foreign trade income or as passive income that is interest and carrying charges (as defined in section 927(d)(1)), and that is also a distribution from a FSC (or a former FSC), shall be treated as a distribution from a FSC (or a former FSC).

(4) *Example.* The following example illustrates the operation of paragraph (f)(1) of this section.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1988, S earns \$80 of interest that meets the definition of financial services income and \$20 of high withholding tax interest. S makes a \$100 interest payment to P. The interest payment to P is subject to a withholding tax of 15 percent. Twenty dollars (\$20) of the interest payment to P is considered to be high withholding tax interest because, under section 904(d)(3), it is allocable to the high withholding tax interest earned by S. The remaining eighty dollars (\$80) of the interest payment is also treated as high withholding tax interest to P because, under paragraph (f)(1) of this section, interest that is subject to a high withholding tax but

would not be considered to be high withholding tax interest under the look-through rules of paragraph (c)(2) of this section, shall be treated as high withholding tax interest to the extent that the interest would have been treated as financial services interest income under the look-through rules of paragraph (c)(2)(i) of this section.

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents and royalties paid by a United States corporation to a related corporation. For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock of the other corporation or more than 50 percent of the total value of the other corporation. In addition, a United States corporation and another corporation shall be considered to be related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock or more than 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 and the regulations under that section apply. For taxable years beginning before January 1, 2001, this paragraph (g) shall be applied by substituting "50 percent or more" for "more than 50 percent" each place it appears.

(h) *Application of look-through rules to partnerships and other pass-through entities—(1) General rule.* Except as provided in paragraph (h)(2) of this section, a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. Payments to a partner described in section 707 (e.g., payments to a partner not acting in capacity as a partner) shall be characterized as income in a separate category to the extent that the payment is attributable under the principles of § 1.861-8 and this section to income earned or accrued by the partnership in such category, if the payments are interest, rents, or royal-

ties that would be characterized under the look-through rules of this section if the partnership were a foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership. A payment by a partnership to a member of the controlled group (as defined in paragraph (a)(3) of this section) of the partner shall be characterized under the look-through rules of this section if the payment would be a section 707 payment entitled to look-through treatment if it were made to the partner.

(2) *Exception for certain partnership interests—(i) Rule.* Except as otherwise provided, if any limited partner or corporate general partner owns less than 10 percent of the value in a partnership, the partner's distributive share of partnership income from the partnership shall be passive income to the partner, and the partner's distributive share of partnership deductions from the partnership shall be allocated and apportioned under the principles of § 1.861-8 only to the partner's passive income from that partnership.

(ii) *Exceptions.* To the extent a partner's distributive share of income from a partnership is a share of high withholding tax interest received or accrued by the partnership, that partner's distributive share of partnership income will be high withholding tax interest regardless of the partner's level of ownership in the partnership. If a partnership interest described in paragraph (h)(2)(i) of this section is held in the ordinary course of a partner's active trade or business, the rules of paragraph (h)(1) of this section shall apply for purposes of characterizing the partner's distributive share of the partnership income. A partnership interest will be considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations (within the meaning of section 1504(a) and without regard to section 1504(b)(3))) engages (other than through a less than 10 percent interest in a partnership) in the same or related trade or business as the partnership.

(3) *Income from the sale of a partnership interest.* To the extent a partner

recognizes gain on the sale of a partnership interest, that income shall be treated as passive income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(A)(iii)(III) and § 1.904-4(c).

(4) *Value of a partnership interest.* For purposes of paragraphs (i), (h)(1), and (h)(2) of this section, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner has 10 percent of the capital and profits interest of the partnership. Similarly, a partnership (first partnership) is considered as owning 50 percent of the value of another partnership (second partnership) if the first partnership owns 50 percent of the capital and profits interests of another partnership. For this purpose, value will be determined at the end of the partnership's taxable year. Similarly, a partnership (first partnership) is considered as owning more than 50 percent of the value of another partnership (second partnership) if the first partnership owns more than 50 percent of the capital and profits interests of the second partnership. For this purpose, value will be determined at the end of the partnership's taxable year. For taxable years beginning before January 1, 2001, the second preceding sentence shall be applied by substituting "50 percent" for "more than 50 percent".

(i) *Application of look-through rules to related entities—(1) In General.* Except as provided in paragraphs (i) (2) and (3) of this section, the principles of this section shall apply to distributions and payments that are subject to the look-through rules of section 904(d)(3) and this section from a controlled foreign corporation or other entity otherwise entitled to look-through treatment (a "look-through entity") under this section to a related lookthrough entity. Two look-through entities shall be considered to be related to each other if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of voting stock of the other entity or more than 50 percent of the total value of such entity. In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total vot-

ing power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 31B and the regulations thereunder. For taxable years beginning before January 1, 2001, the third sentence of this paragraph (i)(1) shall be applied by substituting "50 percent or more" for "more than 50 percent" each place it appears.

(2) *Exception for distributive shares of partnership income.* In the case of tiered partnership arrangements, a distributive share of partnership income will be characterized under the look-through rules of section 904(d)(3) and this section if the partner meets the requirements of paragraph (h)(1) of this section with respect to the partnership (first partnership), whether or not the income is received through another partnership or partnerships (second partnership) and whether or not the first partnership and the second partnership are considered to be related under the rules of paragraph (i)(1) of this section.

(3) *Special rule for dividends.* Solely for purposes of dividend payments between controlled foreign corporations in taxable years beginning after December 31, 2000, two controlled foreign corporations shall be considered related look-through entities if the same United States shareholder owns, directly or indirectly, at least 10 percent of the total voting power of all classes of stock of each foreign corporation. Taxpayers may choose to apply this paragraph (i)(3) in taxable years beginning after December 31, 1991, provided that appropriate adjustments are made to eliminate any double benefit arising from the application of this paragraph (i)(3) to taxable years that are not open for assessment.

(4) *Examples.* The following examples illustrate the provisions of this paragraph (i):

Example 1. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. S owns 40 percent of the stock of T, a Country X corporation that is a controlled foreign corporation. The remaining 60 percent of the stock of T is owned by V, a domestic corporation. The percentages of value and voting power of T owned by S and V correspond to their percentages of stock ownership. T owns 40 percent (by vote and value) of the stock of U, a Country Z corporation that is a controlled foreign corporation. The remaining 60 percent of U is owned by unrelated U.S. persons. U earns exclusively general limitation non-subpart F income. In 2001, U makes an interest payment of \$100 to T. Look-through principles do not apply because T and U are not related look-through entities under paragraph (i)(1) of this section (because T does not own more than 50 percent of the voting power or value of U). The interest is passive income to T, and is subpart F income to P and V. Under paragraph (c)(1) of this section, look-through principles determine P and V's characterization of the subpart F inclusion from T. P and V therefore must characterize the inclusion as passive income.

Example 2. The facts are the same as in *Example 1* except that instead of a \$100 interest payment, U pays a \$50 dividend to T in 2001. P and V each own, directly or indirectly, more than 10 percent of the voting power of all classes of stock of both T and U. Pursuant to paragraph (i)(3) of this section, for purposes of applying this section to the dividend from U to T, U and T are treated as related look-through entities. Therefore, look-through principles apply to characterize the dividend income as general limitation income to T. The dividend is subpart F income of T that is taxable to P and V. The subpart F inclusions of P and V are also subject to look-through principles, under paragraph (c)(1) of this section, and are characterized as general limitation income to P and V because the income is general limitation income of T.

Example 3. The facts are the same as in *Example 1*, except that U pays both a \$100 interest payment and a \$50 dividend to T, and T owns 80 percent (by vote and value) of U. Under paragraph (i)(1) of this section, T and U are related look-through entities, because T owns more than 50 percent (by vote and value) of U. Therefore, look-through principles apply to both the interest and dividend income paid or accrued by U to T, and T treats both types of income as general limitation income. Under paragraph (c)(1) of this section, P and V apply look-through principles to the resulting subpart F inclusions, which therefore are also general limitation income to P and V.

(j) *Look-through rules applied to passive foreign investment company inclusions.* If a passive foreign investment company is a controlled foreign corporation and the taxpayer is a United States shareholder in that passive foreign investment company, any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by that controlled foreign corporation that is described as income in the separate category. For purposes of this paragraph (j), the priority rules of § 1.904-4(1) shall apply prior to the application of the rules of this paragraph.

(k) *Ordering rules—(1) In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply.

(2) *Specific rules.* For purposes of characterizing income under this paragraph, the following types of income are characterized in the order stated:

- (i) Rents and royalties;
- (ii) Interest;
- (iii) Subpart F inclusions and distributive shares of partnership income;
- (iv) Dividend distributions.

If an entity is both a recipient and a payor of income described in any one of the categories described in (k)(2) (i) through (iv) of this section, the income received will be characterized before the income that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by a person to a related person shall be offset against and eliminate any interest received or accrued, directly or indirectly, by a person from that related person before application of the ordering rules of this paragraph. In a case in which a person pays or accrues interest to a related

person, and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amount of all other interest payments are reduced by the amount of the smallest interest payment.

(1) *Examples.* The following examples illustrate the application of paragraphs (g), (h), (i), and (k) of this section.

Example 1. S and T, controlled foreign corporations, are wholly-owned subsidiaries of P, a domestic corporation. S and T are incorporated in two different foreign countries and T is a financial services entity. In 1987, S earns \$100 of income that is general limitation foreign base company sales income. After expenses, including a \$50 interest payment to T, S's income is subject to foreign tax at an effective rate of 40 percent. P elects to exclude S's \$50 of net income from subpart F under section 954(b)(4). T earns \$350 of income that consists of \$300 of subpart F financial services income and \$50 of interest received from S. The \$50 of interest is foreign personal holding company income in T's hands because section 954(c)(3)(A)(i) (same country exception for interest payments) does not apply. The \$50 of interest is also general limitation income to T because S and T are related look-through entities within the meaning of paragraph (i)(1) of this section and, therefore the look-through rules of paragraph (c)(2)(i) of this section apply to characterize the interest payment. Thus, with respect to T, P includes in its gross income \$50 of general limitation foreign personal holding company income and \$300 of financial services income.

Example 2. The facts are the same as in *Example 1* except that instead of earning \$100 of general limitation foreign base company sales income, S earns \$100 of foreign personal holding company income that is passive income. Although the interest payment to T would otherwise be passive income, T is a financial services entity and, under § 1.904-4(e)(1), the income is treated as financial services income in T's hands. Thus, P's entire \$350 section 951 inclusion consists of financial services income.

Example 3. P, a domestic corporation, wholly-owns S, a domestic corporation that is a 80/20 corporation. In 1987, S's earnings consist of \$100 of foreign source shipping income and \$100 of foreign source high withholding tax interest. S makes a \$100 foreign source interest payment to P. The interest payment to P is subject to the look-through rules of paragraph (c)(2)(i) of this section, and is characterized as shipping income and high withholding tax interest to the extent that it is allocable to such income in S's hands.

Example 4. PS is a domestic partnership that is the sole shareholder of controlled for-

ign corporation S. PS has two general partners, A and B. A and B each have a greater than 10 percent interest in PS. PS also has two limited partners, C and D. C has a 50 percent interest in the partnership and D has a 9 percent interest. A, B, C and D are all United States persons. In 1987, S has \$100 of general limitation non-subpart F income on which it pays no foreign tax. S pays a \$100 dividend to PS. The dividend is the only income of PS. Under the look-through rule of paragraph (c)(4) of this section, the dividend to PS is general limitation income. Under paragraph (h)(1) of this section, A's, B's, and C's distributive shares of PS's income are general limitation income. Under paragraph (h)(2) of this section, because D is a limited partner with a less than 10 percent interest in PS, D's distributive share of PS's income is passive income.

Example 5. P has a 25 percent interest in partnership PS that he sells to X for \$110. P's basis in his partnership interest is \$35. P recognizes \$75 of gain on the sale of its partnership interest and is subject to no foreign tax. Under paragraph (h)(3) of this section, the gain is treated as passive income.

Example 6. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. S has \$100 of passive foreign personal holding company income from unrelated persons and \$100 of general limitation income. S also has \$50 of interest income from T. S pays T \$100 of interest. Under paragraph (k)(2) of this section, the \$100 interest payment from S to T is reduced for limitation purposes to the extent of the \$50 interest payment from T to S before application of the rules in paragraph (c)(2)(ii) of this section. Therefore, the interest payment from T to S is disregarded. S is treated as if it paid \$50 of interest to T, all of which is allocable to S's passive foreign personal holding company income. Therefore the \$50 interest payment from S to T is passive income.

Example 7. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation. S owns 100 percent of the stock of T, a controlled foreign corporation and 100 percent of the stock of U, a controlled foreign corporation. In 1988, T pays S \$5 of interest, S pays U \$10 of interest and U pays T \$20 of interest. Under paragraph (k)(2) of this section, the interest payments from S to U must be offset by the amount of interest that S is considered as receiving indirectly from U and the interest payment from U to T is offset by the amount of the interest payment that U is considered as receiving indirectly from T. The \$10 payment by S to U is reduced by \$5, the amount of the interest payment from T to S that is treated as being paid indirectly by U to S. Similarly, the \$20 interest payment from U to T is reduced by \$5, the amount of the interest payment from

S to U that is treated as being paid indirectly by T to U. Therefore, under paragraph (k)(2) of this section, T is treated as having made no interest payment to S, S is treated as having paid \$5 of interest to U, and U is treated as having paid \$15 to T.

Example 8. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. In 1987, S earns \$100 of passive foreign personal holding company income and \$100 of general limitation non-subpart F sales income from unrelated persons and \$100 of general limitation non-subpart F interest income from a related person, W. S pays \$150 of interest to T. T earns \$200 of general limitation sales income from unrelated persons and the \$150 interest payment from S. T pays S \$100 of interest.

(ii) Under paragraph (k)(2) of this section, the \$100 interest payment from T to S reduces the \$150 interest payment from S to T. S is treated as though it paid \$50 of interest to T. T is treated as though it made no interest payment to S.

(iii) Under paragraph (k)(2)(ii) of this section, the remaining \$50 interest payment from S to T is then characterized. The interest payment is first allocable under the rules of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, the \$50 interest payment to T is passive income. The interest income is foreign personal holding company income in T's hands. T, therefore, has \$50 of subpart F passive income and \$200 of non-subpart F general limitation income.

(iv) Under paragraph (k)(2)(iii) of this section, subpart F inclusions are characterized next. P has a subpart F inclusion with respect to S of \$50 that is attributable to passive income of S and is treated as passive income to P. P has a subpart F inclusion with respect to T of \$50 that is attributable to passive income of T and is treated as passive income to P.

Example 9. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1987, S earns \$100 of passive foreign personal holding company income and \$200 of non-subpart F general limitation income from unrelated persons. S also receives \$150 of dividend income from T. S pays \$100 of interest to T and \$100 of interest to U. U earns \$300 of non-subpart F general limitation income and the \$100 of interest received from S. U pays a \$100 royalty to T. T earns the \$100 interest payment received from S and the \$100 royalty received from U.

(ii) Under paragraph (k)(2)(i) of this section, the royalty paid by U to T is characterized first. Assume that the royalty is directly allocable to U's general limitation in-

come. Also assume that the royalty is not subpart F income to T. With respect to T, the royalty is general limitation income.

(iii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized next. This characterization is done without regard to any dividend income received by S because, under paragraph (k)(2) of this section, dividends are characterized after interest payments from a related person. The interest payments are first allocable to S's passive income under paragraph (c)(2)(ii)(C) of this section. Therefore, \$50 of the interest payment to T is passive and \$50 of the interest payment to U is passive. The remaining \$50 paid to T is general limitation income and the remaining \$50 paid to U is general limitation income. All of the interest payments to T and U are subpart F foreign personal holding company income to both recipients.

(iv) Under paragraph (k)(2)(iii) of this section, P has a \$100 subpart F inclusion with respect to T that is characterized next. Fifty dollars (\$50) of the subpart F inclusion is passive income to P because it is attributable to the passive income portion of the interest income received by T from S, and \$50 of the inclusion is treated as general limitation income to P because it is attributable to the general limitation portion of the interest income received by T from S. Under paragraph (k)(2)(iii) of this section, P also has a \$100 subpart F inclusion with respect to U. Fifty dollars (\$50) of the subpart F inclusion is passive income to P because it is attributable to the passive portion of the interest income received by U from S, and \$50 of the inclusion is general limitation income to P because it is attributable to the general limitation portion of the interest income received by U from S.

(v) Under paragraph (k)(2)(iv) of this section, the \$150 distribution from T to S is characterized next. One-hundred dollars (\$100) of the distribution is out of earnings and profits attributable to previously taxed income. Therefore, only \$50 is a dividend that is subject to the look-through rules of paragraph (d) of this section. The \$50 dividend is attributable to T's general limitation income and is general limitation income to S in its entirety.

Example 10. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. S, T and U are all incorporated in the same foreign country. In 1987, S earns \$100 of passive foreign personal holding company income and \$200 of general limitation non-subpart F income from unrelated persons. S pays \$100 of interest to T and \$100 of interest to U. U earns \$300 of general limitation non-subpart F income and the \$100 of interest received

from S. T's only income is the \$100 interest payment received from S.

(i) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized first. The interest payments are first allocated under the rule of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, under that provision and paragraph (c)(2)(i) of this section, \$50 of the interest payment to T is passive income to T and \$50 of the interest payment to U is passive income to U. The remaining \$50 paid to T is general limitation income and the remaining \$50 paid to U is general limitation income.

(iii) Under paragraph (k)(2)(iii) of this section, any subpart F inclusion of P is determined and characterized next. Under paragraph (c)(1)(i) of this section, paragraphs (c)(2)(i) and (c)(2)(ii) apply not only for purposes of determining the separate category of income of S to which the interest payments from S to T and U are allocable but also for purposes of determining the subpart F income of T and U. Although the interest payments from S to T and U are "same country" interest payments that would otherwise be excludible from T's and U's subpart F income under section 954(c)(3)(A)(i), section 954(c)(3)(B) provides that the exception for same country payments between related persons shall not apply to the extent such payments have reduced the subpart F income of the payor. In this case, \$50 of the \$100 interest payment from S to T reduced S's subpart F income and \$50 of the \$100 interest payment from S to U reduced the remaining \$50 of S's subpart F income. Therefore, T has \$50 of subpart F income that is passive income and U has \$50 of subpart F income that is passive income. P includes \$100 of subpart F income in gross income that is passive income to P.

(iv) The remaining \$50 of interest paid by S to T and the remaining \$50 of interest paid by S to U is not subpart F income to T or U because it did not reduce S's subpart F income and is therefore eligible for the same country exception.

Example 11. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1991, T earns \$100 of general limitation income that is not subpart F income and distributes the entire amount to S as a dividend. S earns \$100 of passive foreign personal holding company income and the \$100 dividend from T. S pays \$100 of interest to U. U earns \$200 of general limitation income that is foreign base company income and \$100 of interest income from S. This transaction does not involve circular payments and, therefore, the ordering rules of paragraph (k)(2) of this section do not apply. Instead,

pursuant to paragraph (k)(1) of this section, income received is characterized first. T's earnings and, thus, the dividend from T to S are characterized first. S includes the \$100 dividend from T in gross income as general limitation income because all of T's earnings are general limitation income. S thus has \$100 of passive foreign personal holding company income and \$100 of general limitation income. The interest payment to U is then characterized as \$100 passive income under paragraph (c)(2)(ii)(C) of this section (allocation of related person interest to passive foreign personal holding company income). For 1991, U thus has \$200 of general limitation income that is subpart F income, and \$100 of passive foreign personal holding company income. For 1991, P includes in its gross income \$200 of general limitation subpart F income from U, \$100 of passive subpart F income from U (relating to the interest payment from S to U), and \$100 of general limitation subpart F income from S (relating to the dividend from T to S).

(m) *Application of section 904(g)—(1) In general.* For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation from sources within the United States under section 904(g)(3), the rules in paragraph (m)(2) of this section apply. For purposes of determining the portion of a dividend paid or accrued (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) by a controlled foreign corporation that is treated as from sources within the United States under section 904(g)(4), the rules in paragraph (m)(4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951(a)(1)(A) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904(g)(2), the rules in paragraph (m)(5) of this section apply. In order to determine whether section 904(g) applies, section 904(g)(5) (exception if controlled foreign corporation has a de minimis amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation for a taxable year without regard to the characterization of those earnings under section 904(d).

(2) *Treatment of interest payments.* If interest is received or accrued by a

United States shareholder or a person related to a United States shareholder (within the meaning of paragraph (c)(2)(ii) of this section) from a controlled foreign corporation, the interest shall be considered to be allocable to income of the controlled foreign corporation from sources within the United States for purposes of section 904(d) to the extent that the interest is allocable under paragraph (c)(2)(ii)(C) of this section to passive income that is from sources within the United States. If related person interest is less than or equal to passive income, the related person interest will be allocable

to United States source passive income based on the ratio of United States source passive income to total passive income. To the extent that related person interest exceeds passive income, and, therefore, is allocated under paragraph (c)(2)(ii)(D) of this section to income in a separate category other than passive, the following formulas apply in determining the portion of the interest payment that is from sources within the United States. If the taxpayer uses the gross income method to allocate interest, the portion of the interest payment from sources within the United States is determined as follows:

$$\frac{\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section}}{\text{Gross income from United States sources in that category}} \times \frac{\text{Gross income from all sources in that category}}{\text{Gross income from all sources in that category}}$$

If the taxpayer uses the asset method to allocate interest, then the portion of the interest payment from sources within the United States is determined as follows:

$$\frac{\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section}}{\text{Value of domestic assets in that category}} \times \frac{\text{Value of total assets in that category}}{\text{Value of total assets in that category}}$$

For purposes of this paragraph, the value of assets in a separate category is the value of assets as determined under the principles of § 1.861-9T(g). See § 1.861-10T(d)(2) for purposes of determining the value of assets and gross income in a separate category as reduced for indebtedness the interest on which is directly allocated.

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

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays P \$300 of interest. S has no other expenses. In 1988, S has \$3000 of assets that generate \$650 of foreign source general limitation sales income and a \$1000 loan to an unrelated foreign person that generates \$20 of foreign source passive interest income. S also has a \$4000 loan to an unrelated United States person that generates \$70 of United States source passive income and \$4000 of inventory that generates \$100 of United States source general limitation income. S uses the asset method to allo-

cate interest expense. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	4000	5000
General	3000	4000	7000
Total	4000	8000	12000
Income:			
Passive	20	70	90
General	650	100	750
Total	670	170	840

Under paragraph (c)(2)(ii)(C) of this section, \$90 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, \$70 is from sources within the United States and \$20 is from foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining \$210 of the related person interest payment is allocated to general limitation income. Under paragraph (m)(2) of this section, \$120 of the remaining \$210 is treated as income from sources within the United States

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(\$120=\$210×\$4000/\$7000) and \$90 is treated as income from foreign sources. (\$90=\$210×\$3000/\$7000).

Example 2. The facts are the same as in *Example 1* except that S uses the gross income method to allocate interest expense. The first \$90 of related person interest expense is allocated to passive income in the same manner as in *Example 1*. Under paragraph (c)(2)(ii)(D) of this section, the remaining \$210 of the related person interest expense is allocated to general limitation income. Under paragraph (m)(2) of this section, \$28 of the remaining \$210 is treated as income from United States sources (\$28=\$210×\$100/\$750) and \$182 is treated as income from foreign sources (\$182=\$210×\$650/\$750).

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays \$300 of interest to P. S has no other expenses. S uses the asset method to allocate interest expense. In 1988, S has \$4000 of assets that generate \$650 of foreign source general limitation manufacturing income and a \$1000 loan to an unrelated foreign person that generates \$100 of foreign source passive interest income. S has \$500 of shipping assets that generate \$200 of foreign source shipping income and \$500 of shipping assets that generate \$200 of United States source shipping income. S also has a \$1000 loan to an unrelated United States person that generates \$100 of United States source passive income. S's passive income is not also described as shipping income. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	1000	2000
Shipping	500	500	1000
General	4000	0	4000
Total	5500	1500	7000
Income:			
Passive	100	100	200
Shipping	200	200	400
General	650	0	650
Total	950	300	1250

Under paragraph (c)(2)(ii)(C) of this section, \$200 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, \$100 of this amount is from foreign sources and \$100 is from sources within the United States.

Under paragraph (c)(2)(ii)(D) of this section, \$80 of the remaining \$100 of the related person interest payment is allocated to general limitation income (\$80=\$100×\$4000/\$5000) and \$20 is allocated to shipping income (\$20=\$100×\$1000/\$5000).

Under paragraph (m)(2) of this section, none of \$80 of the interest payment allocated to general limitation income is treated as in-

come from United States sources (\$0=\$80×\$0/\$4000). Therefore, the entire \$80 is treated as income from foreign sources.

Under paragraph (m)(2) of this section, \$10 of the \$20 of the interest payment allocated to the shipping income is treated as income from United States sources (\$10=\$20×\$500/\$1000) and \$10 of the \$20 is treated as income from foreign sources (\$10=\$20×\$500/\$1000).

Example 4. The facts are the same as in *Example 3* except that S uses the gross income method to allocate interest expense. The interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section is the same, \$200, \$100 from United States sources and \$100 from foreign sources.

Under paragraph (c)(2)(ii)(D) of this section, the remaining \$100 of related person interest is allocated between the shipping and general limitation categories based on the gross income in those categories. Therefore, \$38 of the remaining \$100 interest payment is allocated to shipping income (\$38=\$100×\$400/(\$1250-\$200)) and \$62 is treated as allocated to general limitation income (\$62=\$100×\$650/(\$1250-\$200)).

Under paragraph (m)(2) of this section, \$19 of the \$38 allocable to shipping income is treated as income from United States sources (\$19=\$38×\$200/\$400) and \$19 is treated as income from foreign sources (\$19=\$38×\$200/\$400).

Under paragraph (m)(2) of this section, all of the \$62 allocated to general limitation income is treated as income from foreign sources (\$62=\$62×\$650/\$650).

(4) *Treatment of dividend payments—(i) Rule.* Any dividend or distribution treated as a dividend under this section (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation in that separate category.

(ii) *Determination of earnings and profits from United States sources.* In order to determine the portions of earnings and profits from United States sources and from foreign sources within each separate category, related person interest shall be allocated to the United States source portion of income in a separate

category by applying the rules of paragraph (m)(2) of this section. Other expenses shall be allocated by applying the rules of paragraph (c)(2)(ii) of this section separately to the United States source income and the foreign source income in each category. For example, unrelated person interest expense that is allocated among categories of income based upon the relative amounts of assets in a category must be allocated between United States and foreign source income within each category by applying the rules of paragraph (c)(2)(ii)(E) of this section separately to United States source and foreign source assets in the separate category.

(iii) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation, S, is a wholly owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1987, S has \$100 of non-subpart F general limitation earnings and profits and \$100 of non-subpart F financial services income. None of the general limitation earnings and profits are from sources within the United States, and \$50 of the financial services earnings and profits are from United States sources. In 1988, S earns \$300 of non-subpart F general limitation earnings and profits and \$500 of non-subpart F financial services earnings and profits. One hundred dollars (\$100) of the general limitation earnings and profits are from sources within the United States. None of the financial services earnings and profits are from United States sources. In 1988, S pays P a \$500 dividend. Under paragraph (c)(4) of this section, \$200 of the dividend is attributable to general limitation earnings and profits ($\$200 = \$500 \times \$400 / \1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to general limitation earnings and profits from sources within the United States is \$50 ($\$200 \times \$100 / \400). Under paragraph (c)(4) of this section, \$300 of the dividend is attributable to financial services earnings and profits ($\$300 = \$500 \times \$600 / \1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to financial services earnings and profits from sources within the United States is \$25 ($\$300 \times \$50 / \600).

(5) *Treatment of subpart F inclusions—*(i) *Rule.* Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a)(1)(A) shall be treated as income subject to a separate limitation that is derived from sources

within the United States to the extent such amount is attributable to income of the controlled foreign corporation in the corresponding category of income from sources within the United States. In order to determine a controlled foreign corporation's taxable income and earnings and profits from sources within the United States in each separate category, the principles of paragraph (m)(4)(ii) of this section shall apply.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(5).

Example. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. In 1987, S earns \$100 of subpart F foreign personal holding company income that is passive income. Of this amount, \$40 is derived from sources within the United States. S also earns \$50 of subpart F general limitation income. None of this income is from sources within the United States. Assume that S pays no foreign taxes and has no expenses. P is required to include \$150 in gross income under section 951(a). Of this amount, \$60 will be foreign source passive income to P and \$40 will be United States source passive income to P. Fifty dollars (\$50) will be foreign source general limitation income to P.

(6) *Treatment of section 78 amount.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that are paid or accrued with respect to United States source income in a separate category shall be treated as United States source income in that separate category.

(7) *Coordination with treaties—*(i) *Rule.* If any amount of income derived from a United States-owned foreign corporation, as defined in section 904(g)(6), would be treated as derived from sources within the United States under section 904(g) and this paragraph (m) and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits of the convention that treat that amount as arising from sources outside the United States under a rule explicitly treating the income as foreign source, then that amount will be treated as foreign source income. However, sections 904 (a), (b), (c), (d) and (f), 902, 907, and 960 shall be applied separately to amounts described in the preceding

sentence with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(7).

Example. Controlled foreign corporation S is incorporated in Country A and is a wholly-owned subsidiary of P, a domestic corporation. In 1990, S earns \$80 of foreign base company sales income in Country A which is general limitation income and \$40 of U.S. source interest income. S incurs \$20 of expenses attributable to its sales business. S pays P \$40 of interest that is allocated to U.S. source passive income under paragraphs (c)(2)(ii)(C) and (m)(2) of this section. Assume that earnings and profits equal net income. All of S's net income of \$60 is includible in P's gross income under subpart F (section 951(a)(1)). For 1990, P also has \$100 of passive income derived from investments in Country B. Pursuant to section 904(g)(3) and paragraph (m)(2) of this section, the \$40 interest payment from S is United States source income to P because it is attributable to United States source interest income of S. The United States-Country A income tax treaty, however, treats all interest payments by residents of Country A as Country A sourced and P elects to apply the treaty. Pursuant to section 904(g)(10) and this paragraph (m)(7), the entire interest payment will be treated as foreign source income to P. P thus has \$60 of foreign source general limitation income, \$40 of foreign source passive income from S, and \$100 of other foreign source passive income. In determining P's foreign tax credit limitation on passive income, the passive income from Country A shall be treated separately from any other passive income.

(n) *Order of application of sections 904(d) and (g).* In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation to determine the amount of income and earnings and profits derived by the controlled foreign corporation in each separate category. The income and earnings and profits in each separate category that is from United States sources shall then be determined. Sections 904(d)(3), 904(g), and this section shall then be applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder in the controlled foreign corporation that is attributable or allo-

cable to income or earnings and profits of the controlled foreign corporation.

(o) *Effective date.* Section 904(d)(3) and this section apply to distributions and section 951 inclusions of earnings and profits of a controlled foreign corporation (or other entity to which this section applies) derived during the first taxable year of the controlled foreign corporation (or other entity) beginning after December 31, 1986, and thereafter, and to payments made by a controlled foreign corporation (or other entity) during such taxable years, without regard to whether the corresponding taxable year of the recipient of the distribution or payment or of one or more of the United States shareholders of the controlled foreign corporation begins after December 31, 1986.

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§ 1.904-6 Allocation and apportionment of taxes.

(a) *Allocation and apportionment of taxes to a separate category or categories of income—(1) In general—(i) Taxes related to a separate category of income.* The amount of foreign taxes paid or accrued with respect to a separate category of income (including United States source income) shall include only those taxes that are related to income in that separate category. Taxes are related to income if the income is included in the base upon which the tax is imposed. If, for example, foreign law exempts certain types of income from foreign taxes, or certain types of income are exempt from foreign tax under an income tax convention, then no taxes are considered to be related to such income for purposes of this paragraph. As another example, if foreign law provides for a specific rate of tax with respect to certain types of income (*e.g.*, capital gains), or certain expenses, deductions, or credits are allowed under foreign law only with respect to a particular type of income, then such provisions shall be taken into account in determining the amount of foreign tax imposed on such income. A withholding tax (unless it is