

§ 1.959-4 Distributions to United States persons not counting as dividends.

Except as provided in section 960(a)(3) and § 1.960-2, any distribution to a United States person which is excluded from the gross income of such person under section 959(a)(1) and § 1.959-1 shall be treated for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend. However, see paragraph (b)(1) of § 1.956-1, relating to the dividend limitation on the amount of a controlled foreign corporation's investment of earnings in United States property.

[T.D. 7120, 36 FR 10860, June 4, 1971]

§ 1.960-1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

(a) *Scope of regulations under section 960.* This section prescribes rules for determining the foreign income taxes deemed paid under section 960(a)(1) by a domestic corporation which is required under section 951 to include in gross income an amount attributable to a first-, second-, or third-tier corporation's earnings and profits. Section 1.960-2 prescribes rules for applying section 902 to dividends paid by a third-, second-, or first-tier corporation from earnings and profits attributable to an amount which is, or has been, included in gross income under section 951. Section 1.960-3 provides special rules for the application of the gross-up provisions of section 78 where an amount is included in gross income under section 951. Section 1.960-4 prescribes rules for increasing the applicable foreign tax credit limitation under section 904(a) of the domestic corporation for the taxable year in which it receives a distribution of earnings and profits in respect of which it was required under section 951 to include an amount in its gross income for a prior taxable year. Section 1.960-5 prescribes rules for disallowing a deduction for foreign income taxes for such taxable year of receipt where the domestic corporation received the benefits of the foreign tax credit for such previous taxable year of inclusion. Section 1.960-6 provides that

the excess of such an increase in the applicable limitation under section 904(a) over the tax liability of the domestic corporation for such taxable year of receipt results in an overpayment of tax. Section 1.960-7 prescribes the effective dates for application of these rules.

(b) *Definitions.* For purposes of section 960 and §§ 1.960-1 through 1.960-7—

(1) *First-tier corporation.* The term “first-tier corporation” means a foreign corporation at least 10 percent of the voting stock of which is owned by the domestic corporation described in paragraph (a) of this section.

(2) *Second-tier corporation.* In the case of amounts included in the gross income of the taxpayer under section 951—

(i) For taxable years beginning before January 1, 1977, the term “second-tier corporation” means a foreign corporation at least 50 percent of the voting stock of which is owned by such first-tier corporation.

(ii) For taxable years beginning after December 31, 1976, the term “second-tier corporation” means a foreign corporation as least 10 percent of the voting stock of which is owned by such first-tier corporation.

(3) *Third-tier corporation.* In the case of amounts included in the gross income of a domestic shareholder under section 951 for taxable years beginning after December 31, 1976, the term “third-tier corporation” means a foreign corporation at least 10 percent of the voting stock of which is owned by such second-tier corporation.

(4) *Immediately lower-tier corporation.* In the case of a first-tier corporation the term “immediately lower-tier corporation” means a second-tier corporation. In the case of a second-tier corporation, the term “immediately lower-tier corporation” means a third-tier corporation. In the case of a third-tier corporation, the term “immediately lower-tier corporation” means a fourth-tier corporation.

(5) *Foreign income taxes.* The term “foreign income taxes” means income, war profits, and excess profits taxes, and taxes included in the term “income, war profits, and excess profits

taxes'' by reason of section 903, imposed by a foreign country or a possession of the United States.

(c) *Amount of foreign income taxes deemed paid by domestic corporation in respect of earnings and profits of foreign corporation attributable to amount included in income under section 951—(1) In general.* For purposes of section 901—

(i) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a first- or second-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid, accrued, or deemed (in accordance with paragraph (b) of §1.960-2) to be paid by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (in the case of a first-tier corporation, determined without regard to section 958(a)(2); in the case of a second-tier corporation, determined without regard to section 958(a)(1)(A) and, to the extent that stock of such second-tier corporation is owned by the domestic corporation through a foreign corporation other than the first-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation for its taxable year. This paragraph (c)(1)(i) shall not apply to amounts included in the gross income of the domestic corporation under section 951 with respect to the second-tier corporation unless the percentage-of-voting-stock requirement of section 902(b)(3)(A) is satisfied.

(ii) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a third-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid or accrued by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (determined without regard to section

958(a)(1)(A) and, to the extent that stock of such third-tier corporation is owned by the domestic corporation through a foreign corporation other than the second-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation. This paragraph (c)(1)(ii) shall not apply unless the percentage-of-voting-stock requirement of section 902(b)(3)(B) is satisfied.

(iii) In applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to a first-, second-, or third-tier corporation which for the taxable year has income excluded under section 959(b), paragraph (c)(3) of this section shall apply for purposes of excluding certain earnings and profits of such foreign corporation and foreign income taxes, if any, attributable to such excluded income.

(iv) This paragraph (c)(1) applies whether or not the first-, second-, or third-tier corporation makes a distribution for the taxable year of its earnings and profits which are attributable to the amount included in the gross income of the domestic corporation under section 951.

(v) This paragraph (c)(1) does not apply to an increase in current earnings invested in United States property which, but for paragraph (e) of §1.963-3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), would be included in the gross income of the domestic corporation under section 951(a)(1)(B) but which, pursuant to such paragraph, counts toward a minimum distribution for the taxable year. This subdivision shall apply in taxable years subsequent to the Tax Reduction Act of 1975 only in those cases where an adjustment is required as a result of an election made under section 963 prior to the Act.

(2) *Taxes paid or accrued on or with respect to earnings and profits of foreign corporation.* For purposes of paragraph (c)(1) of this section, the foreign income taxes paid or accrued by a first-, second- or third-tier corporation on or with respect to its earnings and profits for its taxable years shall be the total amount of the foreign income taxes

paid or accrued by such foreign corporation for such taxable year.

(3) *Exclusion of earnings and profits and taxes of a first-, second-, or third-tier corporation having income excluded under section 959(b).* If in the case of a first-, second-, or third-tier corporation to which paragraph (c)(1)(i) or (c)(1)(ii) of this section is applied—

(i) The earnings and profits of such foreign corporation for its taxable year consist of (A) earnings and profits attributable to dividends received from an immediately lower-tier corporation which are attributable to amounts included in the gross income of a domestic corporation under section 951 with respect to the immediately lower- or lower-tier corporations, and (B) other earnings and profits, and

(ii) The effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the dividends to which its earnings and profits described in paragraph (c)(3)(i)(A) of this section are attributable is higher or lower than the effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable,

then, for the purposes of applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation on or with respect to its earnings and profits for such taxable year, the earnings and profits of such foreign corporation for such taxable year shall be considered not to include the earnings and profits described in paragraph (c)(3)(i)(A) of this section and only the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable shall be taken into account. For purposes of applying this paragraph (c)(3), the effective rate of foreign income taxes paid or accrued in respect to income shall be determined consistently with the principles of paragraphs (b)(3)(iv) and (viii) and (c) of § 1.954-1. Thus, for example, the effective rate of foreign income taxes paid or accrued in

respect to dividends received by such foreign corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income \$50 attributable to the earnings and profits of A Corporation for such year, but A Corporation does not distribute any earnings and profits for such year. The foreign income taxes paid by A Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of A Corporation	\$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income under section 951	50.00
Dividends paid to N Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of A Corporation	20.00
Foreign income taxes of A Corporation deemed paid by N Corporation under section 960(a)(1) (\$50/\$80×\$20)	12.50

Example 2. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income \$45 attributable to the earnings and profits of B Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation for such year. Neither B Corporation nor A Corporation distributes any earnings and profits for 1978. The foreign income taxes paid by B Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of B Corporation	\$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amounts required to be included in N Corporation's gross income under section 951 with respect to B Corporation	45.00
Dividends paid	0
Foreign income taxes paid on or with respect to earnings and profits of B Corporation	40.00
Foreign income taxes of B Corporation deemed paid by N Corporation under section 960(a)(1) (\$45/\$60×\$40)	30.00

Example 3. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income \$80 attributable to the earnings and profits of C Corporation for such year, \$45 attributable to the earnings and profits of B Corporation for such year and \$50 attributable to the earnings and profits of A Corporation for such year. Neither C Corporation nor B corporation distributes any earnings and profits for 1978. The foreign income taxes which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

C Corporation (third-tier corporation):

Pretax earnings of C Corporation	\$150.00
Foreign income taxes (40%)	60.00
Earnings and profits	90.00
Amounts required to be included in N Corporation's gross income under section 951	80.00
Dividends paid to B Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of C Corporation	60.00

B Corporation (second-tier corporation):

Pretax earnings of B Corporation	\$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amount required to be included in N Corporation's gross income under section 951	45.00
Dividends paid to A Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of B Corporation	40.00

A Corporation (first-tier corporation):

Pretax earnings and profits of A Corporation	\$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income under section 951	50.00
Dividends paid to N Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of A Corporation	20.00

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1):	
Taxes of C Corporation $\$80/\$90 \times \$60$	\$53.33
Taxes of B Corporation $\$45/\$60 \times \$40$	30.00
Taxes of A Corporation $\$50/\$80 \times \$20$	12.50
Total taxes deemed paid under section 960(a)(1)	\$95.83

Example 4. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns 5 percent of the one class of stock of controlled foreign corporation B. N Corporation also directly owns 95 percent of the one class of stock of B Corporation. (Under these facts, B Corporation is only a first-tier corporation with respect to N Corporation) all such corporations use the calendar year as the taxable year. For 1978, N Corporation is required

under section 951 to include in gross income \$60 attributable to the earnings and profits of B Corporation and \$79.20 attributable to the earnings and profits of A Corporation. For 1978, B Corporation distributes \$19 to N Corporation and \$1 to A Corporation, but A Corporation makes no distribution to N Corporation. The foreign income taxes paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed in accordance with § 1.960-1(c)(1)(i):

B Corporation (first-tier corporation):

Pretax earnings and profits	\$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation	60.00

A Corporation (first-tier corporation):

Pretax earnings and profits (including \$1 dividend from B Corporation)	\$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income with respect to A Corporation (\$99 - $[\$99 \times 0.20]$)	79.20

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to—	
B Corporation $([\$60 \times 0.95/\$60] \times \$40)$	\$38.00
A Corporation $(\$79.20/\$80 \times \$20)$	19.80
Total taxes deemed paid under section 960(a)(1)	\$57.80

Example 5. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income \$175 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation has earnings and profits of \$225, on which it pays foreign income taxes of \$75. In 1978, B Corporation distributes \$150, which, under paragraph (b) of § 1.960-2, consists of \$100 to which section 902(b)(1) does not apply (from B Corporation's earnings and profits attributable to an amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation) and \$50 to which section 902(b)(1) applies (from B Corporation's other earnings and profits). The country under the laws of which A Corporation is incorporated imposes an income tax of 40 percent on all income but exempts from tax dividends received from a subsidiary corporation. A Corporation makes no distribution for 1978. Under paragraph (b) of § 1.960-2, A Corporation is deemed to have paid \$25 ($\$50/\$150 \times \75) of the \$75 foreign income taxes paid by B Corporation on its pretax earnings and profits of \$225. The foreign income taxes deemed paid by N Corporation for 1978 under

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section 960(a)(1) with respect to A Corporation are determined as follows upon the basis of the following assumed facts:

Pretax earnings and profits of A Corporation:			
Dividends received from B Corporation		\$150.00	
Other income		250.00	
	Total pretax earnings and profits		\$400.00
Foreign income taxes:			
On dividends received from B Corporation		0	
On other income (\$250×0.40)		100.00	
	Total foreign income taxes		100.00
Earnings and profits:			
Attributable to dividends received from B Corporation which are attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation			
			100.00
Attributable to other income:			
Attributable to dividends received from B Corporation which are attributable to amounts not included in N Corporation's gross income under 951 with respect to B Corporation			
		\$50.00	
Attributable to other income (\$250 - \$100 [\$250×0.40])			
		150.00	\$200.00
	Total earnings and profits		\$300.00
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation:			
Tax paid by A Corporation in respect to its income other than dividends received from B Corporation attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation (\$175/\$200×\$100)			
			87.50
Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) in respect to such income (\$175/\$200×\$25)			
			21.88
	Total foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation		\$109.38

(d) *Time for meeting stock ownership requirements*—(1) *In general.* For the purposes of applying paragraph (c) of this section to amounts included in the gross income of a domestic corporation attributable to the earnings and profits of a first-, second-, or third-tier corporation, the stock ownership requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirements of paragraph (c)(1)(i) and (ii) of this section, if applicable, must be satisfied on the last day in the taxable year of such first-, sec-

ond-, or third-tier corporation, as the case may be, on which such foreign corporation is a controlled foreign corporation. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a second-tier corporation, the requirements of paragraph (b)(1) and (2) of this section and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section must be met on such date. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a third-tier corporation, the requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section must be met on such date.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation N is required for its taxable year ending June 30, 1978, to include in gross income under section 951 an amount attributable to the earnings and profits of controlled foreign corporation A for 1977 and another amount attributable to the earnings and profits of controlled foreign corporation B for such year. Corporations A and B use the calendar year as the taxable year. Such amounts are required to be included in N Corporation's gross income by reason of its ownership of stock in A Corporation and in turn by A Corporation's ownership of stock in B Corporation. Corporation A is a controlled foreign corporation throughout 1977, but B Corporation is a controlled foreign corporation only from January 1, 1977, through September 30, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on December 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

Example 2. The facts are the same as in example 1, except that A Corporation is a controlled foreign corporation only from January 1, 1977, through March 31, 1977. Corporation N may obtain credit under section

960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on March 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

Example 3. Domestic Corporation N owns 100 percent of the stock of controlled foreign corporation A. A Corporation owns 20 percent of the stock of controlled foreign corporation B. B Corporation owns 10 percent of the voting stock of controlled foreign corporation C. For calendar year 1983, N Corporation is required to include amounts in its gross income attributable to the earnings and profits of A, B, and C Corporations. A, B, and C Corporations were all controlled foreign corporations throughout their respective taxable years ending as follows: A Corporation, December 31, 1983; B Corporation, November 31, 1983; and C Corporation, August 31, 1983. Paragraph (c) of this section applies to amounts included in gross income of N Corporation with respect to the earnings and profits of A Corporation because the 10 percent ownership requirement of paragraph (b)(1) of this section is met on December 31, 1983. Paragraph (c) of this section applies to amounts included in the gross income of N Corporation with respect to the earnings and profits of B Corporation because the 10 percent stock ownership requirements of paragraphs (b)(1) and (2) of this section are met on November 30, 1983, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section (5 percent) is also met on such date. The percentage of voting stock in A Corporation owned by N Corporation (100 percent) multiplied by the percentage of voting stock in B Corporation owned by A Corporation (20 percent) is 20 percent. Paragraph (c) of this section will not apply to amounts included in N Corporation's gross income attributable to the earnings and profits of C Corporation even though on August 31, 1983, the 10 percent stock ownership requirements of paragraphs (b)(1), (2), and (3) of this section are met, because the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section (5 percent) is not met on such date. The percentage of voting stock of C Corporation owned by B Corporation (10 percent) multiplied by 20 percent (the percentage of voting stock of A Corporation owned by N Corporation multiplied by the percentage of voting stock of B Corporation owned by A Corporation) is 2 percent.

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed paid under section 960(a)(1), the domestic corporation must furnish the same information with respect to the taxes so deemed paid as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See §1.905-2. For other information required to be furnished by the domestic corporation for the annual accounting period of certain foreign corporations ending with or within such corporation's taxable year, see section 6038(a) and the regulations thereunder.

(f) *Reduction of foreign income taxes paid or deemed paid.* For reduction of the amount of foreign income taxes paid or deemed paid by a foreign corporation for purposes of section 960, see section 6038(c) (as amended by section 338 of the Tax Equity and Fiscal Responsibility Act of 1982) and the regulations thereunder, relating to failure to furnish information with respect to certain foreign corporations. For reduction of the foreign income taxes deemed paid by a domestic corporation under section 960 with respect to foreign oil and gas extraction income, see section 907(a).

(g) *Amounts under section 951 treated as distributions for purposes of applying effective dates.* For purposes of applying section 902 in determining the amount of credit allowed under section 960(a)(1) and paragraph (c) of this section, the effective date provisions of the regulations under section 902 shall apply, and for purposes of so applying the regulations under section 902, any amount attributable to the earnings and profits for the taxable year of a first-, second-, or third-tier corporation which is included in the gross income of a domestic corporation under section 951 shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such foreign corporation is a controlled foreign corporation.

(h) *Source of income and country to which tax is deemed paid—(1) Source of income.* For purposes of section 904—

(i) The amount included in gross income of a domestic corporation under

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section 951 for the taxable year with respect to a first-, second-, or third-tier corporation, plus

(ii) Any section 78 dividend to which such section 951 amount gives rise by reason of taxes deemed paid by such domestic corporation under section 960(a)(1),

shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

(2) *Country to which taxes deemed paid.* For purposes of section 904, the foreign income taxes paid by the first-, second-, or third-tier corporation and deemed to be paid by the domestic corporation under section 960(a)(1) by reason of the inclusion of the amount described in paragraph (h)(1)(i) of this section in the gross income of such domestic corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

(3) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, incorporated under the laws of foreign country X, which owns all the one class of stock of controlled foreign corporation B, incorporated under the laws of foreign country Y. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income \$45 attributable to the earnings and profits of B Corporation for such year and \$50 attributable to the earnings and profits of A Corporation for such year. For 1978, because of the inclusion of such amounts in gross income, N Corporation is deemed under section 960(a)(1) and paragraph (c) of this section to have paid \$15 of foreign income taxes paid by B Corporation for such year and \$10 of foreign income taxes paid by A Corporation for such year. For purposes of section 904, the amount (\$95) included in N Corporation's gross income under section 951 attributable to the earnings and profits of corporations A and B is deemed to be derived from sources within country X, and the section 78 dividend con-

sisting of the foreign income taxes (\$25) deemed paid by N Corporation under section 960(a)(1) with respect to such \$95 is deemed to be derived from sources within country X. The \$25 of foreign income taxes so deemed paid by N Corporation are deemed to be paid to country X for purposes of section 904.

(i) *Computation of deemed-paid taxes in post-1986 taxable years—(1) General rule.* If a domestic corporation is eligible to compute deemed-paid taxes under section 960(a)(1) with respect to an amount included in gross income under section 951(a), then, such domestic corporation shall be deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes determined under section 902 and the regulations under that section in the same manner as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B)).

(2) *Ordering rule for computing deemed-paid taxes under sections 902 and 960.* If a domestic corporation computes deemed-paid taxes under both sections 902 and 960 in the same taxable year, section 960 shall be applied first. After the deemed-paid taxes are computed under section 960 with respect to a deemed income inclusion, post-1986 undistributed earnings and post-1986 foreign income taxes in each separate category shall be reduced by the appropriate amounts before deemed-paid taxes are computed under section 902 with respect to a dividend distribution.

(3) *Computation of post-1986 undistributed earnings.* Post-1986 undistributed earnings (or an accumulated deficit in post-1986 undistributed earnings) are computed under section 902 and the regulations under that section.

(4) *Allocation of accumulated deficits.* For purposes of computing post-1986 undistributed earnings under sections 902 and 960, a post-1986 accumulated deficit in a separate category shall be allocated proportionately to reduce post-1986 undistributed earnings in the other separate categories. However, a deficit in any separate category shall not permanently reduce earnings in other separate categories, but after the deemed-paid taxes are computed the

separate limitation deficit shall be carried forward in the same separate category in which it was incurred. In addition, because deemed-paid taxes may not exceed taxes paid or accrued by the controlled foreign corporation, in computing deemed-paid taxes with respect to an inclusion out of a separate category that exceeds post-1986 undistributed earnings in that separate category, the numerator of the deemed-paid credit fraction (deemed inclusion from the separate category) may not exceed the denominator (post-1986 undistributed earnings in the separate category).

(5) *Examples.* The application of this paragraph (i) may be illustrated by the following examples. See §1.952-1(f)(4) for additional illustrations of these rules.

Example 1. (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1998, whose functional currency is the u. In 1998 CFC earns 100u of general limitation income described in section 904(d)(1)(I) that is not subpart F income and 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A). In 1998 CFC also incurs a (50u) loss in the shipping category described in section 904(d)(1)(D). CFC's subpart F income for 1998, 100u, does not exceed CFC's current earnings and profits of 150u. Accordingly, all 100u of CFC's subpart F income is included in A's gross income under section 951(a)(1)(A). Under section 904(d)(3)(B) of the Internal Revenue Code and paragraph (i)(1) of this section, A includes 100u of passive limitation income in gross income for 1998.

(ii) For purposes of computing post-1986 undistributed earnings under sections 902, 904(d) and 960 with respect to the subpart F inclusion, the shipping limitation deficit of (50u) is allocated proportionately to reduce general limitation earnings of 100u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 25u to 75u ($100u \text{ general limitation earnings} / 200u \text{ total earnings in positive separate categories} \times (50u) \text{ shipping deficit} = 25u \text{ reduction}$), and passive limitation earnings are reduced by 25u to 75u ($100u \text{ passive earnings} / 200u \text{ total earnings in positive separate categories} \times (50u) \text{ shipping deficit} = 25u \text{ reduction}$). All of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the 100u subpart F inclusion of passive income (75u inclusion (numerator limited to denominator under paragraph (i)(4) of this section)/75u passive earnings). After the

inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 100u of general limitation earnings, 0 of passive limitation earnings (100u of foreign personal holding company income — 100u inclusion), and a (50u) deficit in shipping limitation earnings.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1999, CFC distributes 150u to A. CFC has 100u of previously-taxed earnings and profits described in section 959(c)(2) attributable to 1998, all of which is passive limitation earnings and profits. Under section 959(c), 100u of the 150u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). The entire dividend distribution of 50u is treated as made out of CFC's general limitation earnings and profits. See section 904(d)(3)(D).

(ii) For purposes of computing post-1986 undistributed earnings under section 902 with respect to the 1999 dividend of 50u, the shipping limitation accumulated deficit of (50u) reduces general limitation earnings and profits of 100u to 50u. Thus, 100% of CFC's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by A under section 902 with respect to the 1999 dividend of 50u (50u dividend/50u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1999 CFC has 50u of general limitation earnings (100u opening balance—50u distribution), 0 of passive limitation earnings, and a (50u) deficit in shipping limitation earnings.

(6) *Effective date.* This paragraph (i) applies to taxable years of a controlled foreign corporation beginning after March 3, 1997.

[T.D. 7120, 36 FR 10852, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; T.D. 7649, 44 FR 60088, 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50472, Nov. 8, 1982; 47 FR 55477, Dec. 10, 1982; T.D. 7961, 49 FR 26225, June 27, 1984; T.D. 8704, 62 FR 21, Jan. 2, 1997]

§ 1.960-2 Interrelation of section 902 and section 960 when dividends are paid by third-, second-, or first-tier corporation.

(a) *Scope of this section.* This section prescribes rules for the application of section 902 in a case where dividends are paid by a third-, second-, or first-tier corporation, as the case may be, from its earnings and profits for a taxable year when an amount attributable to such earnings and profits is included