

Internal Revenue Service, Treasury

§ 1.964-1T

	Local currency	Exchange rate	U.S. dollars
Current liabilities	180,000	2.00:1	90,000
Long-term liabilities	300,000	(¹)	150,000
Paid-in capital	800,000	(¹)	400,000
Retained earnings	120,000	.....	60,000
Total liabilities and net worth	1,400,000	.....	700,000

¹ Historical.

The exchange gain or loss of N Corporation for 1963 may be computed as follows:

Retained earnings—1963		\$110,410
Less:		
Retained earnings—1962	\$60,000	.....
Operating profit—1963	55,720	115,720
Exchange loss .....	.....	(5,310)

Example 2. Assume the same facts as in example 1. For 1964, N Corporation's operating profit is 104,300 yuccas or \$15,740. It pays a dividend of 26,000 yuccas during a translation period when the appropriate exchange rate is 2.60 yuccas per United States dollar. At year-end, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	91,000	2.60:1	35,000
Accounts receivable	260,000	2.60:1	100,000
Inventory	430,000	(¹)	174,400
Fixed assets	1,646,000	(¹)	790,000
Less: Accumulated depreciation	(663,700)	(¹)	(323,000)
Total assets	1,763,300	.....	776,400
Current liabilities	325,000	2.60:1	125,000
Long-term liabilities	300,000	(¹)	150,000
Paid-in capital	800,000	(¹)	400,000
Retained earnings	338,300	.....	101,400
Total liabilities and net worth	1,763,300	.....	776,400

¹ Historical.

The exchange gain or loss of N Corporation for 1964 would be computed as follows:

Retained earnings—1964		\$101,400
Add:		
Dividends—1964		10,000
Predistribution earnings		111,400
Less:		
Retained earnings—1963	\$110,410	.....
Operating profit—1964	15,740	126,150
Exchange loss .....	.....	(14,750)

(f) *Determination of earnings and profits as if a domestic corporation—(1) In general.* If the books of account regularly maintained by a foreign corporation for the purpose of accounting to its shareholders are kept in U.S. dol-

lars and in accordance with accounting principles generally accepted in the United States, and if it is so elected by or on behalf of such corporation, the earnings and profits of the foreign corporation for a taxable year shall, except as otherwise provided in paragraph (f)(2) of this section, be determined in every respect as if it were a domestic corporation. Such election shall be effective only for the taxable year with respect to which the election is made. Once made, such election shall be irrevocable. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of a foreign corporation.

(2) *Illegal payments.* The amount of any illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations thereunder) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease earnings and profits or increase the deficit in earnings and profits otherwise determined under paragraph (f)(1) of this section.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56491, Dec. 17, 1982; T.D. 7893, 48 FR 22510, May 19, 1983]

§ 1.964-1T Special rules for computing earnings and profits of controlled foreign corporations in taxable years beginning after December 31, 1986 (temporary).

(a)-(f) [Reserved]

(g)(1) *Earnings and profits computed in functional currency—(i) Rule.* For taxable years of a controlled foreign corporation (within the meaning of section 957) beginning after December 31, 1986, earnings and profits shall be computed in the controlled foreign corporation's functional currency (determined under section 985 and the regulations thereunder) in accordance with § 1.964-1

as modified by this paragraph (g). Accordingly, § 1.964-1 (d), (e), and (f) and (to the extent inconsistent with this paragraph (g)) § 1.964-1(c) do not apply for taxable years of a controlled foreign corporation beginning after December 31, 1986. For purposes of this section, the term “earnings and profits” includes a deficit in earnings and profits.

(ii) *Cross reference.* In the case of a controlled foreign corporation with a functional currency other than the United States dollar (dollar), see sections 986(b) and 989(b) for rules regarding the time and manner of translating distributions or inclusions of the controlled foreign corporation’s earnings and profits into dollars.

(2) *Election required when first significant.* Tax accounting methods or elections may be adopted or made by, or on behalf of, a controlled foreign corporation in the manner prescribed by the Code and regulations no later than 180 days after the close of the first taxable year of the controlled foreign corporation in which the computation of its earnings and profits is significant for United States income tax purposes with respect to its controlling United States shareholders (as defined in § 1.964-1(c)(5)). For taxable years of a controlled foreign corporation beginning before January 1, 1989, only the events listed in § 1.964-1(c)(6) are considered to cause a controlled foreign corporation’s earnings and profits to have United States tax significance. For taxable years of a controlled foreign corporation beginning after December 31, 1988, events that cause a controlled foreign corporation’s earnings and profits to have United States tax significance include, without limitation—

(i) The events listed in § 1.964-1(c)(6),

(ii) A distribution from the controlled foreign corporation to its shareholders with respect to their stock,

(iii) Any event making the controlled foreign corporation subject to tax under section 882,

(iv) An election by the controlled foreign corporation’s controlling United States shareholders to use the tax book value method of allocating interest expense under section 864(e)(4), and

(v) A sale or exchange of the controlled foreign corporation’s stock by the controlling United States shareholders.

The filing of the information return required by section 6038 shall not itself constitute a significant event.

(3) *Effect of failure to make required election.* If an accounting method or election is not timely adopted or made by, or on behalf of, a controlled foreign corporation, and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause under § 1.964-1(c)(6), earnings and profits shall be computed in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. Thereafter, any change in a particular accounting method or methods may be made by, or on behalf of, the controlled foreign corporation only with the Commission’s consent.

(4) *Computation of earnings and profits by a minority shareholder prior to majority election or significant event.* A minority United States shareholder (as defined in section 951(b)) of a controlled foreign corporation may be required to compute a controlled foreign corporation’s earnings and profits before the controlled foreign corporation or its controlling United States shareholders make, or are required under this section to make, an election or adopt a method of accounting for United States tax purposes. In such a case, the minority United States shareholder must compute earnings and profits in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. However, a later, properly filed, and timely election or adoption of method by, or on

behalf of, the controlled foreign corporation shall not be treated as a change in accounting method.

(5) *Binding effect.* For taxable years beginning after December 31, 1986, except as otherwise provided in the Code or regulations, earnings and profits of a controlled foreign corporation shall be computed consistently under the rules of sections 964(a) and 986(b) for all federal income tax purposes. An election or adoption of a method of accounting for United States tax purposes by a controlled foreign corporation, or on its behalf pursuant to § 1.964-1(c) or any other provision of the regulations (e.g., § 1.985-2(c)(3)), shall bind both the controlled foreign corporation and its United States shareholders as to the computation of the controlled foreign corporation's earnings and profits under section 964(a) for the year of the election or adoption and in subsequent taxable years unless the Commissioner consents to a change. The preceding sentence shall apply regardless of—

(i) Whether the election or adoption of a method of accounting was made in a pre-1987 or a post-1986 taxable year;

(ii) Whether the controlled foreign corporation was a controlled foreign corporation at the time of the election or adoption of method;

(iii) When ownership was acquired; or

(iv) Whether the United States shareholder received the written notice required by § 1.964-1(c)(3).

Adjustments to the appropriate separate category (as defined in § 1.904-5(a)(1)) of earnings and profits and income of the controlled foreign corporation shall be required using the principles of section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any such election or adoption.

(6) *Examples.* The following examples illustrate the rules of this section.

Example 1: (i) *P*, a calendar year domestic corporation, owns all of the outstanding stock of *FX*, a calendar year controlled foreign corporation. None of the significant events specified in § 1.964-1(c)(6) or this section has occurred. In addition, neither *P* nor *FX* has ever made or adopted, or been required to make or adopt, an election or method of accounting for United States tax purposes with respect to *FX*. On June 1, 1990,

FX makes a distribution to *P*. *FX* does not act to make any election or adopt a method of accounting for United States tax purposes.

(ii) *P* must compute *FX*'s earnings and profits in order to determine if any portion of the distribution is taxable as a dividend and to determine *P*'s foreign tax credit on such portion under section 902. *P* must satisfy the requirements of § 1.964-1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1990 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of earnings and profits of *FX* for all federal income tax purposes (including, e.g., the determination of foreign tax credits on subpart F inclusions) in 1990 and subsequent taxable years unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method shall be effective only if the Commissioner consents to the change.

Example 2: (i) The facts are the same as in *Example 1*, except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1989 taxable year under the tax book value method of § 1.861-12T(c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1989 taxable year. *P* must satisfy the requirements of § 1.964-1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1989 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1989 and subsequent taxable years for all federal income tax purposes (including, e.g., the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method

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shall be effective only if the Commissioner consents to the change.

Example 3: (i) The facts are the same as in *Example 2*, except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1988 taxable year under the tax book value method of § 1.861-12T (c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1988 taxable year. *P* must satisfy the requirements of § 1.964-1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1988 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1988 and subsequent taxable years for all federal income tax purposes (including, *e.g.*, *P*'s basis adjustment for purposes of section 864(e)(4) in 1989 and the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* for 1988 shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. However, a properly filed, timely election or adoption of method by, or on behalf of, *FX* with respect to its 1989 taxable year, when *P*'s basis adjustment for purposes of section 864(e)(4) first constitutes a significant event, shall not be treated as a change in accounting method. No recomputation of *P*'s basis adjustment for 1988 shall be required by reason of any such election or adoption of method with respect to *FX*'s 1989 taxable year, but prospective adjustments to *FX*'s earnings and profits and income shall be made to the extent required by § 1.964-1T(g)(5).

Example 4: (i) The facts are the same as in *Example 3*, except that *FX* had subpart F income taxable to *P* in 1986, and *P* computed *FX*'s earnings and profits for purposes of determining the amount of the inclusion and the foreign taxes deemed paid by *P* in 1986 under section 960 pursuant to § 1.964-1 (a) through (e).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to § 1.964-1(c) in 1986 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1986 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1990 dividend, *FX*'s earnings and profits must be computed consistently with

the method used by *P* with regard to the 1986 subpart F inclusion. (However, § 1.964-1 (d), (e), and (f) do not apply in computing *FX*'s earnings and profits in post-1986 taxable years.)

Example 5: (i) The facts are the same as in *Example 4*, except that *FX* made a dividend distribution to *P* on June 1, 1985, and *P* computed *FX*'s earnings and profits for purposes of computing the foreign taxes deemed paid by *P* in 1985 under section 902 with respect to the distribution under § 1.964-1 exclusive of paragraphs (d), (e), and (f) pursuant to a timely election under § 1.902-1(g)(1).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to § 1.964-1(c) in 1985 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1985 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1986 subpart F inclusion and the 1990 dividend, *FX*'s earnings and profits must be computed consistently with the method used by *P* with regard to the 1985 dividend. If, rather than choosing under § 1.902-1(g)(1) to use the section 964 rules, *P* computed *FX*'s earnings and profits for purposes of section 902 in 1985 in all respects as if *FX* were a domestic corporation, then *P* would have been free to make elections or adopt a method of accounting on behalf of *FX* under § 1.964-1(c) with respect to the subpart F inclusion in 1986. Any such election or adoption would be binding on *P* and *FX* as to the computation of *FX*'s earnings and profits in 1986 and subsequent taxable years.

[T.D. 8283, 55 FR 2516, Jan. 25, 1990; 55 FR 7711, Mar. 5, 1990]

§ 1.964-2 Treatment of blocked earnings and profits.

(a) *General rule.* If, in accordance with paragraph (d) of this section, it is established to the satisfaction of the district director that any amount of the earnings and profits of a controlled foreign corporation for the taxable year (determined under § 1.964-1) was subject to a currency or other restriction or limitation imposed under the laws of any foreign country (within the meaning of paragraph (b) of this section) on its distribution to United States shareholders who own (within the meaning of section 958(a)) stock of such corporation, such amount shall not be included in earnings and profits for purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956 for such taxable year. For rules