

extraordinary income at one-half the ordinary income tax rate. Since these gains are taxed as a reduced rate of tax in comparison to other income, they are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 4. In Belgium, gains derived by an individual in the course of regular speculative transactions are taxed as ordinary income, but with an upper limit of 30 percent. Rates of tax on individuals in Belgium range from approximately 30 percent to approximately 60 percent. Since the gains on speculative transactions are taxed at a maximum rate which is more beneficial than the rates accorded to other income, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 5. In France, gains derived by a company on the sale of fixed assets held for less than 2 years are treated as short-term gains. The excess of short-term gains in any fiscal year is taxed at the full company tax rate of 50 percent. However, this tax may be paid in equal portions over the 5 years immediately following the realization of such short-term gains. Since recognition of the short-term gains for tax purposes is subject to deferral over a 5-year period, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 6. Also in France, in the case of the sale or exchange by a company of depreciable assets and nondepreciable asset owned for at least 2 years, the excess of long-term capital gains over long-term capital losses in a fiscal year is subject to an immediate tax at the reduced rate of 10 percent. Such excess, reduced by the 10-percent tax, is carried in a special reserve account on the taxpayer's books. If the excess is reinvested in other fixed asset within a stated period, no further tax is due. If the amounts in the special reserve are distributed, they will be treated as ordinary income for the fiscal year in which the distribution is made. Since such gains (other than those distributed in the same fiscal year they are realized) are subject to deferral or a reduced rate of tax, they are (except to the extent distributed in the year of realization) considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 7. In Sweden, in the case of gains derived by an individual on the sale of shares or bonds held for 5 years or less, 25 percent of the gains are taxed if the holding period is 4 to 5 years, 50 percent of the gain is taxed if the holding period is 3 to 4 years, and 75 percent of the gain is taxed if the holding period is 2 to 3 years. The gain is fully taxable at ordinary income rates if held for less than 2 years. Thus, gains on shares or bonds held

for 2 years or more are considered accorded preferential treatment in Sweden since they are either subject to exemption or treatment comparable to the U.S. capital gains deduction and are taxed at a reduced rate. Thus, such gains are taken into account for purposes of the minimum tax.

Example 8. Pursuant to Article XIV of the United States-United Kingdom Income Tax Convention, a resident of the United States is exempt from United Kingdom tax on most capital gains. Since such capital gains are exempt from United Kingdom taxation, they are considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 9. An individual resident of the United States, is desirous of selling his stock in a corporation listed on the New York Stock Exchange. He requests the stock certificates from his broker in the United States, travels to a foreign country, delivers the certificates to a broker in that country, and has the foreign broker execute the sale which takes place on the New York Stock Exchange. Since the sale was consummated in the United States, pursuant to paragraph (b) of this section and §1.861-7, the resulting capital gain item of tax preference is attributable to sources within the United States.

Example 10. Two individuals, both residing in the United States, negotiate and reach agreement in New York City for the sale of stock of a closed corporation. Prior to the transfer of the stock, in order to avoid imposition of the minimum tax, both individuals travel to a foreign country which does not accord preferential treatment to capital gains, but imposes a 5-percent rate of income tax which would be fully creditable against U.S. tax under sections 901 and 904 if the capital gains were sourced in that country. The stock is actually transferred and consideration paid in the foreign country. Since the primary purpose of consummating the sale in the foreign country was the avoidance of tax, pursuant to paragraph (b) of this section, and §1.861-7(c), the resulting capital gain item of tax preference will be considered attributable to sources within the country in which the substance of sale took place or, in this case, the United States.

[T.D. 7564, 43 FR 40492, Sept. 12, 1978]

§ 1.58-9 Application of the tax benefit rule to the minimum tax for taxable years beginning prior to 1987.

(a) *In general.* For purposes of computing the minimum tax liability imposed under section 56 of the Internal Revenue Code of 1954 (Code), taxpayers are not liable for minimum tax on tax preference items that do not reduce the taxpayer's tax liability under subtitle A of the Code for the taxable year. In

general, tax preference items that do not reduce tax liability under subtitle A for the taxable year are those from which no current tax benefit is derived because available credits would have reduced or eliminated the taxpayer's regular tax liability if the preference items had not been allowed in computing taxable income. However, any credits that, because of such preference items, are not needed for use against regular tax ("freed-up credits"), are required to be reduced under the rules of paragraph (c) of this section. For purposes of this section, a taxpayer's regular tax is the Federal income tax liability under subchapter A of chapter 1 of the Code, not including the minimum tax imposed by section 56. Unless otherwise noted, all references to Internal Revenue Code sections refer to the Internal Revenue Code of 1954.

(b) *Effective date.* The rules of this section are effective May 5, 1992, but only as they affect tax preference items that arise in taxable years beginning after December 31, 1976, and before January 1, 1987.

(c) *Adjustment of carryover credits*—(1) *In general.* A taxpayer's freed-up credits must be reduced by the additional minimum tax that would have been imposed if a current tax benefit had been derived from preference items that did not actually produce a current tax benefit. The amount of this reduction shall be calculated in the following manner—

(i) Determine the amount of freed-up credits;

(ii) Determine the amount of tax preference items (if any) from which a current tax benefit was derived for the taxable year ("beneficial preferences"), and the amount of preferences from which no current tax benefit was derived for the taxable year ("non-beneficial preferences"); and

(iii) Determine the portion of the total minimum tax on all tax preference items for the taxable year that is attributable to the non-beneficial preferences.

The freed-up credits are then reduced by an amount equal to such portion of the minimum tax.

(2) *Determine freed-up credits.* (i) To determine the freed-up credits for the taxable year, first determine the reg-

ular tax that would have been imposed for the taxable year if preference items had not been allowed in computing taxable income ("non-preference regular tax"). In the case of a taxpayer with the capital gain preference described in section 57(a)(9)(B), non-preference regular tax is computed without regard to section 1201 and without adding the section 57(a)(9)(B) preference amount to taxable income. Second, compute the amount of credits that would have been allowed to reduce the non-preference regular tax. The credits available to reduce non-preference regular tax shall include any freed-up credits from other taxable years, as reduced under paragraph (c)(5) of this section, that are carried to the current taxable year. Third, subtract the amount of credits that were actually allowed to reduce the regular tax for such taxable year from the amount of credits that would have been allowed to reduce non-preference regular tax. The result is the amount of the freed-up credits.

(ii) The following examples illustrate the determination of freed-up credits. The first two examples assume that the foreign tax credits being used do not exceed the limitation under section 904.

Example 1. In 1982 Corporation B has \$17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been \$10.2 million and foreign tax credits used to reduce regular tax would have been \$10.2 million. Because of tax preference items, however, B's regular tax is \$6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is \$6.3 million. The amount of freed-up foreign tax credits is \$3.9 million (\$10.2 million minus \$6.3 million).

Example 2. Assume the same facts as in *Example 1* of paragraph (c)(2)(ii) of this section except that Corporation B has \$7.2 million dollars in foreign tax credits. If preference items were not allowed, the non-preference regular tax would have been \$10.2 million and the foreign tax credits used to reduce the regular tax would have been \$7.2 million. Because of tax preference items, however, B's regular tax is \$6.3 million, and the amount of foreign tax credits actually used to reduce the regular tax is \$6.3 million. The amount of freed-up foreign tax credits is \$3.9 million (\$7.2 million minus \$6.3 million).

Example 3. In 1983 Corporation C has \$500,000 of investment tax credits available. If preference items were not allowed, non-preference regular tax would have been

\$690,000 and all \$500,000 of investment tax credits would have been allowed to reduce non-preference regular tax liability. Because of tax preferences, however, C's actual regular tax is \$439,750. As a result of the limitation under section 38(c), only \$377,537 of the investment tax credits are allowed to reduce the actual regular tax. Freed-up credits are \$122,463 (\$500,000 minus \$377,537).

Example 4. In 1984 Corporation B has ordinary income of \$20,000 and net section 1201 gain of \$300,000, none of which is attributable to foreign sources. B has no other items of tax preference in 1984. B's non-preference regular tax for 1984 is \$126,950, the amount of tax that would be imposed without regard to section 1201.

(3) *Determination of beneficial and non-beneficial preferences*—(i) *In general.* The amount of tax preferences from which a current tax benefit is derived ("beneficial preferences") and the amount from which no current tax benefit is derived ("non-beneficial preferences") for the taxable year are determined as set forth below.

(ii) *Regular tax liability is the same regardless of preference items.* (A) If the taxpayer's tax liability (after credits) would be the same regardless of whether preference items were allowed to reduce taxable income, then all of the taxpayer's preference items are non-beneficial preference items.

(B) The following example illustrates the rule set forth in paragraph (c)(3)(ii)(A) of this section. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has \$17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been \$10.2 million and foreign tax credits used to reduce regular tax would have been \$10.2 million. Because of tax preference items, however, B's regular tax is \$6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is \$6.3 million. The amount of freed-up foreign tax credits is \$3.9 million (\$10.2 million minus \$6.3 million).

(ii) The total amount of B's tax preference items is \$8.4 million. B's non-preference regular tax is \$10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is \$6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount (\$0) equal to the actual regular tax liability (\$0),

B received a tax benefit from none of the \$8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) *Regular tax liability differs because of preference items.* If tax liability (after credits) is less because preference items are allowed to reduce taxable income, then some of these preference items have provided a current tax benefit. In such cases, the amount of beneficial and non-beneficial preferences are determined as follows:

(A) *Non-beneficial preferences.* (1) The non-beneficial preferences are determined by converting the freed-up credits for such taxable year into an amount of taxable income. To make this conversion, freed-up credits are "grossed up" (*i.e.*, divided by the regular tax marginal rate at which such credits would have offset non-preference regular tax) to determine the amount of tax preferences that freed up such credits. For purposes of this calculation, the 5-percent addition to tax provided by section 11(b) shall be included in determining the marginal rate. The aggregate of these grossed-up amounts is the total amount of non-beneficial preferences for the taxable year.

(2) The freed-up credits shall be grossed up beginning at the lowest marginal tax rate that would have applied to the additional taxable income arising if tax preferences were not allowed. Thus, the marginal tax rates at which the actual regular tax was imposed shall not be taken into account in grossing up freed-up credits, even if all or a portion of such tax is not offset by credits because of limitations on the allowance of such credits (such as the section 904 limit on foreign tax credits or the section 38(c) limit on investment tax credits). For example, if the first dollar of additional non-preference taxable income would have been taxed at a rate of 46 percent, then freed-up credits shall be grossed up at 46 percent, even if regular tax imposed on taxable income at a 40-percent rate was not offset by credits because of the limitations on investment tax credits under section 38(c). See *Examples 1 and 2* in paragraph (d) of this section for illustrations of the gross up of freed-up credits in cases where limitations

Internal Revenue Service, Treasury

§ 1.58-9

apply to the amount of credit allowed to offset actual regular tax.

(3) The following example illustrates the gross up of freed-up credits to determine non-beneficial preferences. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income	\$90,000
Regular tax	21,750
Available credits:	
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	25,000
Investment tax credits carried forward from 1984	20,000
	60,000
Credit allowed to offset actual regular tax:	
Foreign tax credits for 1985	15,000
Foreign tax credits carried forward from 1984	6,750
	21,750
Actual regular tax liability	0
Preferences	110,000
Taxable income for 1985 determined as though preferences were not allowed	200,000
Non-preference regular tax	71,750
Credits allowed to offset non-preference regular tax:	
Foreign tax credits for 1985	15,000
Foreign tax credits carried forward from 1984	25,000

Investment tax credits carried forward from 1984	20,000	60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are \$38,250 (\$60,000 minus \$21,750). The non-preference regular tax of \$71,750 is determined by applying the regular tax rates set forth in section 11(b) to the \$200,000 of taxable income as follows:

Taxable income	Rate	Tax
\$25,000 X	.15 =	\$3,750
25,000 X	.18 =	4,500
25,000 X	.30 =	7,500
25,000 X	.40 =	10,000
100,000 X	.46 =	46,000
\$200,000		\$71,750

(iii) Thus, for purposes of determining the non-beneficial preferences, freed-up credits are grossed up as follows: The credits allowed against the regular tax and the freed-up credits are treated as offsetting non-preference regular tax in the same order as such credits would have been allowed to offset such tax, beginning at the lowest marginal tax rate. The freed-up credits are grossed up beginning at the lowest marginal tax rate at which additional taxable income would have been taxed if preferences were not allowed. Thus, in this example freed-up credits are grossed up beginning at 40 percent, and the amount of L's non-beneficial preferences for the 1985 taxable year is \$84,456.

Type	Credit allowed against regular tax	Freed-up credit	Divided by tax rate	Non-beneficial preferences
FTC (85)	\$3,750		.15	
Do	4,500		.18	
Do	6,750		.30	
FTC (84)	750		.30	
Do	6,000		.40	
Do		\$4,000	.40 =	\$10,000
Do		14,250	.46 =	30,978
ITC (84)		20,000	.46 =	43,478
	\$21,750	\$38,250		\$84,456

Foreign tax credit = FTC (year)
Investment tax credit = ITC (year)

(B) *Beneficial preferences.* The amount of beneficial preferences for the taxable year is computed by subtracting the non-beneficial preferences for the taxable year from the total amount of tax preferences for such year. This rule may be illustrated by the following example:

Example. Assume the same facts as in the Example in paragraph (c)(3)(iii)(A)(3) of this section. The amount of L's beneficial preferences for 1985 is \$25,544 (total preferences of \$110,000, minus non-beneficial preferences of \$84,456).

(4) *Determine the minimum tax attributable to non-beneficial preferences.* (i) The portion of the minimum tax that is attributable to the non-beneficial preferences is computed as follows—

(A) Compute the minimum tax that would be imposed on all tax preference items for the taxable year if all of the preferences had produced a tax benefit.

(B) Compute the minimum tax that would be imposed on the beneficial preferences if these were the taxpayer's only preferences. (This is the amount of minimum tax actually imposed for the taxable year.)

(C) Subtract the amount computed in paragraph (c)(4)(i)(B) of this section from the amount computed in paragraph (c)(4)(i)(A) of this section. The result is the minimum tax attributable to the non-beneficial preferences for the taxable year. This amount is sometimes referred to hereinafter as the "credit reduction amount".

(ii) The following examples illustrate determination of the credit reduction amount. These examples assume that foreign tax credits being used do not exceed the limitation under section 904.

Example 1. (i) In 1982 Corporation B has \$17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been \$10.2 million and foreign tax credits used to reduce regular tax would have been \$10.2 million. Because of tax preference items, however, B's regular tax is \$6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is \$6.3 million. The amount of freed-up foreign tax credits is \$3.9 million (\$10.2 million minus \$6.3 million).

(ii) The total amount of B's tax preference items is \$8.4 million. B's non-preference regular tax is \$10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is \$6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount (\$0) equal to the actual regular tax liability (\$0), B received a tax benefit from none of the \$8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has \$8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be \$1,258,500 ((\$8.4 million minus \$10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to non-beneficial preferences (and therefore, the credit reduction amount) is \$1,258,500.

Example 2. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income	\$90,000
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Regular tax	21,750
Available credits:	
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	25,000
Investment tax credits carried forward from 1984	20,000
	<hr/>
	\$60,000
Credit allowed to offset actual regular tax:	
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	6,750
	<hr/>
	\$21,750
Actual regular tax liability	0
Preferences	110,000
Taxable income for 1985 determined as though preferences were not allowed	200,000
Non-preference regular tax	71,750
Credits allowed to offset non-preference regular tax:	
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	25,000
Investment tax credits carried forward from 1984	20,000
	<hr/>
	\$60,000
Non-preference regular tax liability	11,750

(ii) The freed-up credits for 1985 are \$38,250 (\$60,000 minus \$21,750). The non-preference regular tax is \$71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is \$84,456.

(iii) The minimum tax on L's total preference items of \$110,000 would be \$15,000 ((\$110,000 minus \$10,000) multiplied by .15). Since the amount of non-beneficial preferences is \$84,456, the amount of L's beneficial preferences for 1985 is \$25,544 (\$110,000 minus \$84,456). The minimum tax on L's beneficial preferences of \$25,544 is \$2,332 ((\$25,544 minus \$10,000) multiplied by .15). (This is the amount of minimum tax imposed for 1985.) The minimum tax attributable to non-beneficial preference items (and therefore, the credit reduction amount) is \$12,668 (\$15,000 minus \$2,332).

(5) *Reduction of freed-up credits—(i) In general.* The freed-up credits are reduced by an amount equal to the minimum tax attributable to the non-beneficial preferences ("credit reduction amount"). If the taxpayer has only one type of freed-up credit (*i.e.*, only investment tax credit or only foreign tax credit) and that credit was earned in only one year (the current year or a carryover year), then the credit is reduced by the credit reduction amount. This rule may be illustrated by the following example. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has \$17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been \$10.2 million and foreign tax credits used to reduce regular tax would have been \$10.2 million. Because of tax preference items, however, B's regular tax is \$6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is \$6.3 million. The amount of freed-up foreign tax credits is \$3.9 million (\$10.2 million minus \$6.3 million).

(ii) The total amount of B's tax preference items is \$8.4 million. B's non-preference regular tax is \$10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is \$6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount (\$0) equal to the actual regular tax liability (\$0), B received a tax benefit from none of the \$8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has \$8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be \$1,258,500 ((\$8.4 million minus \$10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to nonbeneficial preferences (and therefore, the credit reduction amount is \$1,258,500.

(iv) All of the \$3.9 million of freed-up credits are foreign tax credits that arise in the same year and that otherwise would be carried forward. Since the entire amount of B's tax preferences are non-beneficial preferences, the minimum tax of \$1,258,500 that would be imposed on the total tax preferences is the credit reduction amount. Thus, B's \$3.9 million of freed-up foreign tax credits is reduced by \$1,258,500. The foreign tax credit carryforward from 1982 is \$10,041,500. This amount is the sum of \$2,641,500 (the freed-up foreign tax credit of \$3,900,000, reduced by the credit reduction amount of \$1,258,500), plus \$7.4 million (the foreign tax credit that would have been carried over even if tax preference items had not been allowed).

However, if the taxpayer has more than one type of freed-up credit, or the taxpayer's freed-up credits are from more than one taxable year, then the credit reduction amount must be allocated under the exact method described in paragraph (c)(5)(ii) of this section, unless an election is made under paragraph (c)(5)(iii) of this section to use the simplified method.

(ii) *Exact method.* For each type of freed-up credits and for each taxable year within such type from which any such credits are earned, the amount of credit reduction shall be equal to the amount of minimum tax attributable to the non-beneficial preferences that freed up the credits for that type and taxable year. The amount of the credit reduction is computed by multiplying the amount of non-beneficial preferences which freed up credits for each type and taxable year by the minimum tax rate. For purposes of this computation, if the amount of the taxpayer's minimum tax exemption for the taxable year (as determined under section 56(a)) exceeds the amount of the taxpayer's beneficial preferences, such excess exemption shall reduce the amount of non-beneficial preferences to be multiplied by the minimum tax rate. The non-beneficial preferences shall be reduced by any such excess exemption in the same order in which the credits that were freed up by such preferences would have been allowed to offset tax. Thus, for example, any excess exemption shall first reduce non-beneficial preferences that freed up foreign tax credits. Any such excess exemption remaining after reducing non-beneficial preferences that freed up foreign tax credits to zero would then be used to reduce the non-beneficial preferences that freed up investment tax credits.

(iii) *Simplified method—(A) Description of method.* In lieu of the exact credit reduction method described in paragraph (c)(5)(ii) of this section, taxpayers may elect to use the simplified credit reduction method. Under the simplified credit reduction method, the amount of freed-up credits for each type of credit and for each taxable year in which such credit is earned is multiplied by a fraction. The numerator of the fraction is the total credit reduction amount as determined in paragraph (c)(4)(i)(C) of this section. The denominator is the total amount of freed-up credits as determined in paragraph (c)(2)(i) of this section. The product of this multiplication is the amount of credit reduction for each type and taxable year of freed-up credit.

(B) *Election to use simplified method.* A taxpayer may elect to use the simplified credit reduction method for all taxable years to which this section applies by attaching a statement indicating such an election on the amended Federal income tax return or returns applying the adjustments of this section. If an election is made for any taxable year, it must be made for all taxable years. Once an election has been made, it can be revoked only with the permission of the Commissioner. Similarly, once returns have been filed applying the exact credit reduction method, an election to apply the simplified method can be made only with the consent of the Commissioner.

(iv) *Effect of credit reduction on credit carryovers.* Under both the exact method and the simplified method, the determination of credit carryovers to other taxable years is made on the basis of freed-up credits remaining after such reduction, plus any other unused credits. Thus, an amount of freed-up credits that is equal to the credit reduction amount shall not be allowed to reduce tax liability in any taxable year. Such disallowance is without regard to whether such credits would otherwise be allowed as a carryover. The freed-up credits, as reduced under this paragraph (c)(5), shall be carried over or carried back in applying this section in a carryover or carryback year. No minimum tax liability shall be due with respect to the non-beneficial preferences for any taxable year.

(v) *Examples.* The following examples illustrate reduction of freed-up credits.

Example 1. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		\$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	25,000
Investment tax credits carried forward from 1984	20,000
		60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	\$15,000

Foreign tax credits carried forward from 1984	6,750
		21,750
Actual regular tax liability		21,750
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	\$15,000
Foreign tax credits carried forward from 1984	\$25,000
Investment tax credits carried forward from 1984	20,000
		60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are \$38,250 (\$60,000 minus \$21,750). The non-preference regular tax is \$71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is \$84,456.

(iii) The credit reduction amount for 1985 is \$12,668, the amount of minimum tax attributable to L's non-beneficial preferences. This amount is allocated to reduce each category of freed-up credit and to each year from which such credit is carried over. L's \$38,250 of freed-up credits consists of \$18,250 of foreign tax credits carried forward from 1984, which were freed up by \$40,978 of non-beneficial preferences, and \$20,000 of investment tax credits carried forward from 1984, which were freed up by \$43,478 of non-beneficial preferences.

(iv) The apportionment of this credit reduction amount to each category of freed-up credit and each taxable year from which such credits are carried over is determined as follows under the exact credit reduction method:

(A) Foreign tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 FTC × .15 = Credit reduction of 1984 FTC
 $\$40,978 \times .15 = \$6,146$

(B) Investment tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 ITC × .15 = Credit reduction of 1984 ITC
 $\$43,478 \times .15 = \$6,522$

Thus, the foreign tax credits from 1984 that are carried forward to 1986 are \$12,104 (\$18,250 minus \$6,146). The investment tax credits from 1984 that are carried forward to 1986 are \$13,478 (\$20,000 minus \$6,522).

(v) The reduction of the freed-up credit under the simplified credit reduction method is as follows:

(A) Foreign tax credit carried forward from 1984:

$$\text{Freed-up foreign tax credits from 1984} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \frac{\text{Credit reduction allocated to freed-up foreign tax credits carried forward from 1984}}{\text{Total freed-up credit}}$$

$$\$18,250 \times \frac{\$12,668}{\$38,250} = \$6,044$$

(B) Investment tax credits carried forward from 1984:

$$\text{Freed-up investment tax credits from 1984} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \frac{\text{Credit reduction allocated to freed-up investment tax credit carried forward from 1984}}{\text{Total freed-up credit}}$$

$$\$20,000 \times \frac{\$12,668}{\$38,250} = \$6,624$$

\$30,978 × .15 = \$4,646

Thus, the foreign tax credit from 1984 that is carried forward to 1986 is \$9,604 (\$14,250 minus \$4,646). Since the foreign tax credit from 1980 expires after 1985, none of that credit is carried forward to 1986.

Thus, under the simplified credit reduction method, L has \$12,206 of foreign tax credits for 1984 (\$18,250 minus \$6,044) that are carried forward to 1986, and \$13,376 of investment tax credits for 1984 (\$20,000 minus \$6,624) that are carried forward to 1986.

(d) *Examples.* The following examples are comprehensive illustrations of the adjustments described in paragraph (c) of this section:

Example 2. Assume the same facts as in *Example 1* of this paragraph (c)(5)(v), except that the foreign tax credits available for use in 1985 include \$10,750 in credits carried forward from 1980 and \$14,250 in credits carried forward from 1984, rather than \$25,000 carried forward from 1984. Thus, \$4,000 of the freed-up foreign tax credit is carried over from 1980. The other \$14,250 of freed-up foreign tax credit is carried over from 1984. The non-beneficial preferences that freed up the 1980 foreign tax credit are \$10,000. The non-beneficial preferences that freed up the 1984 foreign tax credit are \$30,978. Under the exact credit reduction method, the credit reduction amounts for each of these credits are determined as follows:

Example 1. (i) This example illustrates the operation of the credit reduction adjustment when the amount of foreign tax credit allowed is subject to the overall limitation under section 904. For purposes of this example, assume that Corporation X has the following items for the 1984 taxable year:

(i) Foreign tax credit carried forward from 1980:

$$\$10,000 \times .15 = \$1,500$$

(ii) Foreign tax credit carried forward from 1984:

Taxable income (determined as though preferences were not allowed)	\$140,000
From foreign sources	70,000
Foreign tax credits from 1984.....	5,000
Foreign tax credits from 1983.....	7,000
Actual taxable income	50,000
From foreign sources	25,000

(ii) The credit reduction adjustment and minimum tax liability for the taxable year are determined as follows:

1. Taxable income (determined as though preferences were not allowed)	\$140,000
2. Tax preferences for 1984	90,000
3. Taxable income (line 1 minus line 2)	50,000
4. Regular tax on line 3 amount (actual regular tax) before credits:	
\$25,000 × .15 = \$3,750	
25,000 × .18 = 4,500	8,250
5. Foreign tax credits allowed against regular tax (limited to 50% of actual regular tax under sec. 904)—1984 foreign tax credits	4,125
6. Regular tax after credits (line 4 minus line 5)	4,125
7. Regular tax on line 1 amount (non-preference regular tax) before credits:	
25,000 × .15 = \$3,750	
25,000 × .18 = 4,500	

§ 1.58-9

26 CFR Ch. I (4-1-04 Edition)

25,000×.3=7,500.		
25,000×.4=10,000.		
40,000×.46=18,400		44,150
8. Foreign tax credits allowed against non-preference regular tax:		
\$5,000 (1984 foreign tax credits)		
7,000 (1983 foreign tax credits)		12,000
(the allowed credits do not exceed the section 904 limitation of \$22,075)		
9. Non-preference regular tax after credits (line 7 minus line 8)		32,150
10. Freed-up credits (line 8 minus line 5):		
1984 foreign tax credits	\$5,000 (4,125)	
		\$875
1983 foreign tax credits	\$7,000 0	
		7,000
Total		\$7,875

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 30 per cent marginal tax rate.

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
FTC (84)	\$875	.30	\$2,917
FTC (83)	6,625	.30	22,083
Do	375	.40	938
	7,875		25,938
Total non-beneficial preferences			25,938

12. Beneficial preferences (line 2 minus line 11)	64,062
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or \$10,000)×.15)	12,000
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or \$10,000)×.15)	8,109
15. Credit reduction amount (line 13 minus line 14)	3,891
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):	
(a) 1984 foreign tax credits: \$2,917×.15=\$438	
(b) 1983 foreign tax credits: (\$22,083+\$938) ×.15=\$3,453	
(c) Total credit reduction	3,891

NOTE: If X had elected to use the simplified credit reduction method, the amount of credit reduction would be determined by multiplying the amount of freed-up credit in each category and taxable year by the following ratio:

$$\frac{\text{credit reduction amount}}{\text{total freed-up credit}} = \frac{\$3,891}{\$7,875} = .494$$

(d) Under this method, the 1984 freed-up foreign tax credits would be reduced by \$438 (\$875×.494) and the 1983 freed-up foreign tax credits would be reduced by \$3,453 (\$7,000×.494).

17. Freed-up credits after reduction under the exact method (line 10 subtotal minus line 16 subtotals):

(a) 1984 foreign tax credits (\$874 minus \$438)	437
(b) 1983 foreign tax credits (\$7,000 minus \$3,453)	3,547

Thus, assuming that Corporation X did not elect to use the simplified method, Corporation X will carryover \$437 of 1984 foreign tax credits to 1985 and \$3,547 of 1983 foreign tax credits to 1985. Had Corporation X elected to use the simplified method, freed-up credits after reduction would be as follows:

(a) 1984 foreign tax credits (\$875 minus \$433)	442
(b) 1983 foreign tax credits (\$7,000 minus \$3,458)	3,542

Example 2. (i) Corporation X has the following items for its 1985 taxable year:

Taxable income (determined as though preferences were not allowed)	\$1,500,000
1984 investment tax credits	400,000
1985 investment tax credits	100,000
Actual taxable income	1,000,000
(ii) The credit reduction and minimum tax of X for 1985 are determined as follows:	
1. Taxable income determined as though	\$1,500,000
2. Tax preferences for 1985	500,000
3. Taxable income (line 1 minus line 2)	1,000,000

Internal Revenue Service, Treasury

§ 1.58-9

4. Regular tax on line 3 amount (actual regular tax) before credits:	
\$25,000×.15=\$3,750	
25,000×.18=4,500	
25,000×.30=7,500	
25,000×.40=10,000	
900,000×.46=414,000	439,750
5. Investment tax credits allowed (limited under section 38 (c) to \$25,000 of net tax liability, plus 85 percent of net tax liability in excess of \$25,000	377,537
6. Regular tax after credits (line 4 minus line 5)	62,212
7. Regular tax on line 1 amount (non-preference regular tax) before credits:	
25,000×.15=\$3,750	
25,000×.18=4,500	
25,000×.30=7,500	
25,000×.40=10,000	
900,000×.46=414,000	
405,000×.51=206,550	
95,000×.46=43,700	690,000
8. Investment tax credits allowed against non-preference regular tax	500,000
9. Non-preference regular tax after credits (line 7 minus line 8)	190,000
10. Freed-up credits (line 8 minus line 5):	
1984 investment tax credit ..	\$400,000
	(377,537)
	<hr/>
	22,463
1985 investment tax credit ..	\$100,000
	—0—
	<hr/>
	100,000
	<hr/>
Total	\$122,463

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
ITC (84)	\$22,463	.51	\$44,045
ITC (85)	100,000	.51	196,078
	<hr/>		<hr/>
	122,463		240,123
	<hr/>		<hr/>
Total non-beneficial preferences ...			240,123

12. Beneficial preferences (line 2 minus line 11)	259,877
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or \$10,000) X .15)	65,668
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or \$10,000) X .15	29,650
15. Credit reduction amount (line 13 minus line 14)	36,018
16. Reduction of freed-up credits under the exact method (sub-totals of line 11 multiplied by .15):	
(a) 1984 investment tax credits: \$44,045 × .15=\$6,607	
(b) 1985 investment tax credits: \$196,078 × .15=\$29,411	
(c) Total credit reduction	36,018
17. Fixed-up credits after reduction (assuming that Corporation X does not elect the simplified method):	
(a) 1984 investment credit (\$22,463 minus \$6,607)	15,856
(b) 1985 investment credit (\$100,000 minus \$29,411)	70,589

(e) *Miscellaneous rules*—(1) *Investment Credit Recapture*. If during any taxable year property to which section 47 applies is disposed of, then for purposes of determining any increase in tax under section 47 for such year, the amount of any reduction under this section of freed-up section 38 credit which was earned in the year the property was placed in service shall be treated as a credit that was allowed in a prior taxable year.

Example. Corporation D places property in service in 1983 that generates investment tax credits of \$10,000. D earns no other investment tax credits in 1983. None of the investment tax credits are used to reduce tax liability in 1983 or any prior years. In 1984, D uses \$1,000 of this credit to reduce regular tax liability. In addition, D has items of tax preferences in 1984. However, under section 58(h), D is not liable for minimum tax on any

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 51 percent marginal tax rate. Although some of the income offset by preferences would be taxed at the 46 percent marginal rate (because taxable income in excess of \$1,405,000 is not subject to the 5 percent addition to tax on taxable income in excess of \$1 million), the 51 percent marginal rate is taken into account first.

of these preference items because none of these preference items produces a tax benefit in 1984. As a result, an adjustment is made under the provisions of § 1.58-9 and the investment tax credit carryforward from 1983 is reduced by \$4,000. Thus, D has an investment tax credit carryforward of \$5,000 that is attributable to the property placed in service in 1983. In 1986, the property is disposed of and the investment tax credits earned in 1983 are recomputed as required under section 47. This recomputation results in a reduction of \$6,000 of the investment tax credits earned in 1983. D must now adjust its 1983 investment tax credit carryforward under section 47(a)(6) by reducing this carryforward to zero. In addition, D has an additional tax liability of \$1,000 for 1986.

(2) *Period of limitations; adjustments to tax liability.* The adjustments described in this section shall, in general, apply for purposes of assessing deficiencies or claiming refunds of tax for any taxable year for which the tax liability is affected by the adjustments of this section, provided that the period of limitations under section 6501 has not expired for such taxable year. Therefore, these adjustments generally apply for purposes of assessing deficiencies and refunding any overpayment of tax for all years for which the period of limitations has not expired regardless of whether the period of limitations has expired for the taxable year in which the non-beneficial preferences arose. However, the adjustments of this section do not apply to reduce otherwise allowable credits that were freed up by such non-beneficial preferences where:

(i) The taxpayer paid minimum tax on all tax preference items arising in the taxable year in which the non-beneficial preferences arose;

(ii) The taxpayer has not made a claim for a credit or refund for such minimum tax; and

(iii) The period of limitations for claiming a credit or refund under section 6511 has expired for such taxable year.

(A) Further, if—

(1) the taxpayer never paid minimum tax attributable to non-beneficial preferences;

(2) credits that were freed up by such preferences were used to reduce tax liability for a taxable year for which the period of limitations has expired; and

(3) credits so used exceed the amount of credits that would have been avail-

able if the credit reduction required under this section with respect to such preferences had been made,

(B) Then, the taxpayer shall be liable for the minimum tax equal to the amount of credits so used, provided the period of limitations has not expired for the taxable year in which preferences arose.

(3) *Claims for credit or refund.* A taxpayer may claim a credit or refund of minimum tax that was made on non-beneficial preferences. However, such a claim for a credit or refund shall be disallowed to the extent that the taxpayer has reduced tax liability in a taxable year for which the period of limitations has expired by using freed-up credits in excess of the amount that would have been available if the credit reduction required under this section had been made. Such claim must be made by filing an amended return for the taxable year for which such minimum tax was paid. Further, if a claim for credit or refund is filed, amended returns must also be filed for any taxable year for which tax liability would be affected as a result of the reduction, under this section, of credits freed up by such non-beneficial preferences. See section 6511 and the regulations thereunder regarding the period of limitations for claiming a credit or refund.

(4) *Carryovers of foreign tax credit to taxable years after 1986.* In the case of foreign tax credit carryforwards to taxable years beginning after December 31, 1986, reductions in such credits required under this section shall apply for purposes of computing the alternative minimum tax foreign tax credit under section 59(a) of the Internal Revenue Code of 1986 as well as for purposes of computing the foreign tax credit for regular tax purposes.

(5) *Credit Carrybacks.* If credit carrybacks increase the amount of credits for a taxable year, the adjustments described in this section shall be recomputed taking into account the additional credits. This rule may be illustrated by the following examples:

Example 1. (i) In 1981 corporation D has actual taxable income of \$72,500 and regular tax before credits of \$15,000. In computing actual regular taxable income, D made use of \$36,739 of tax preference items, so that D's

taxable income determined as though preference were not allowed would be \$109,239. D's non-preference regular tax before credits is \$30,000. D earns \$25,000 of foreign tax credits in 1981, none of which exceed the limitation under section 904 determined using either actual regular taxable income or the non-preference taxable income. These credits reduce actual regular tax to zero (\$0) and would have reduced non-preference regular tax to \$5,000 (\$30,000 minus \$25,000). Thus, D has freed-up foreign tax credits from 1981 of \$10,000 (\$25,000 minus \$15,000). Pursuant to the adjustments required under this section, D determines that its credit reduction amount is \$3,843 and reduces its freed-up credit (and its credit carryover) from 1981 to \$6,157 (\$10,000 minus \$3,843). D also pays minimum tax of \$167 on \$11,114 of beneficial preferences ((\$11,114 minus \$10,000) multiplied by .15).

(ii) In 1982 D earns additional foreign tax credits. After application of the foreign tax credit carryback rules, D would have \$5,000 of 1982 foreign tax credits available for use in 1981. D must recalculate the adjustments required under this section by treating \$5,000 of foreign tax credit from 1982 as carried back and (assuming that these credits do not exceed the limitation under section 904) used to reduce non-preference regular tax liability in 1981 to zero (\$0). That is, \$5,000 of the foreign tax credits earned in 1982 are treated as credits freed up because of D's tax preference items in 1981. Pursuant to the rules set forth herein, D must take into account the foreign tax credits from both 1981 and 1982 in determining to what extent a tax benefit was derived from the preference items used to determine actual regular tax liability in 1981 and in computing the credit reduction amount. When the \$5,000 of foreign tax credits from 1982 are considered, all preferences become non-beneficial preferences, and the credit reduction amount is \$4,010. Assuming that D elects the simplified method, the 1981 freed-up credits and the 1982 freed-up credits will each be reduced by the following percentage:

$$\frac{\$4,010 \text{ (credit reduction amount)}}{\$15,000 \text{ (total freed - up credits)}} = .2673$$

The 1981 freed-up foreign tax credits of \$10,000 are thus reduced by \$2,673 (\$10,000 multiplied by .2673), to \$7,327 and the 1982 freed-up foreign tax credits of \$5,000 are reduced by \$1,334 (\$5,000 multiplied by .2673) to \$3,666. D also files a claim for credit or refund of the \$167 of minimum tax paid in 1981.

Example 2. In 1985 corporation E's non-preference regular taxable income was \$25,000. E had no available credits. It paid zero in regular tax, however, because of \$25,000 in preference items. E paid \$2,250 of minimum tax on these preferences ((\$25,000 minus \$10,000) multiplied by .15). In 1986, E has additional investment tax credits. After application of the investment tax credit carryback rules, E would have \$1,000 investment tax credit from 1986 available for use in 1985. E must recompute the adjustments required under this section by treating \$1,000 of these 1986 investment tax credits as carried back and used to reduce non-preference regular tax liability for 1985. Pursuant to the rules of this section, all of these \$1,000 of credits are freed-up credits. Non-beneficial preferences are \$6,667 (\$1,000 grossed up at a 15 percent regular tax rate). Beneficial preferences are \$18,333 (\$25,000 minus \$6,667). Minimum tax on all preferences would be \$2,250 ((\$25,000 minus \$10,000) multiplied by .15); minimum tax on beneficial preferences would be \$1,250 ((\$18,333 minus \$10,000) multiplied by .15). Minimum tax attributable to the non-beneficial preferences is thus \$1,000 (\$2,250 minus \$1,250), which is the credit reduction amount. E thus reduces the \$1,000 of credits carried back to 1985 to zero. Under the rules of this section, the amount of minimum tax due for 1985 is redetermined. It is equal to the minimum tax on beneficial preferences, which, as described above, is \$1,250. Because E paid minimum tax of \$2,250 in 1985, E files a claim for credit or refund for \$1,000 of the minimum tax paid in 1985.

(f) *Treatment of net operating losses.*
[Reserved]

[T.D. 8416, 57 FR 19255, May 5, 1992; 57 FR 24848, June 11, 1992]

§§ 1.59-1.60 [Reserved]