SUBCHAPTER Q—READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

PART VII—RECOVERIES OF FOREIGN EXPROPRIATION LOSSES

[Sec. 1351]

SEC. 1351. TREATMENT OF RECOVERIES OF FOREIGN EXPROPRIATION LOSSES.

[Sec. 1351(a)]

(a) ELECTION.—

(1) IN GENERAL.—This section shall apply only to a recovery, by a domestic corporation subject to the tax imposed by section 11 or 801, of a foreign expropriation loss sustained by such corporation and only if such corporation was subject to the tax imposed by section 11 or 801, as the case may be, for the year of the loss and elects to have the provisions of this section apply with respect to such loss.

(2) TIME, MANNER, AND SCOPE.—An election under paragraph (1) shall be made at such time and in such manner as the Secretary may prescribe by regulations. An election made with respect to any foreign expropriation loss shall apply to all recoveries in respect of such loss.

[Sec. 1351(b)]

(b) DEFINITION OF FOREIGN EXPROPRIATION LOSS.—For purposes of this section, the term "foreign expropriation loss" means any loss sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless shall, to the extent of any deduction allowed under section 166(a), be treated as a loss.

[Sec. 1351(c)]

(c) AMOUNT OF RECOVERY.—

(1) GENERAL RULE.—The amount of any recovery of a foreign expropriation loss is the amount of money and the fair market value of other property received in respect of such loss, determined as of the date of receipt.

(2) SPECIAL RULE FOR LIFE INSURANCE COMPANIES.—The amount of any recovery of a foreign expropriation loss includes, in the case of a life insurance company, the amount of decrease of any item taken into account under section 807(c), to the extent such decrease is attributable to the release, by reason of such loss, of its liabilities with respect to such item.

[Sec. 1351(d)]

(d) ADJUSTMENT FOR PRIOR TAX BENEFITS.—

(1) IN GENERAL.—That part of the amount of a recovery of a foreign expropriation loss to which this section applies which, when added to the aggregate of the amounts of previous recoveries with respect to such loss, does not exceed the allowable deductions in prior taxable years on account of such loss shall be excluded from gross income for the taxable year of the recovery for purposes of computing the tax under this subtitle; but there shall be added to, and assessed and collected as a part of, the tax under this subtitle for such taxable year an amount equal to the total increase in the tax under this subtitle for all taxable years which would result by decreasing, in an amount equal to such part of the recovery so excluded, the deductions allowable in the prior taxable years on account of such loss. For purposes of this paragraph, if the loss to which the recovery relates was taken into account as a loss from the sale or exchange of a capital asset, the amount of the loss shall be treated as an allowable deduction even though there were no gains against which to allow such loss.

(2) COMPUTATION.—The increase in the tax for each taxable year referred to in paragraph (1) shall be computed in accordance with regulations prescribed by the Secretary. Such regulations shall give effect to previous recoveries of any kind (including recoveries described in section 111, relating to recovery of tax benefit items) with respect to any prior taxable year, but shall otherwise treat the tax previously determined for any taxable year in accordance with the principles set forth in section 1314(a) (relating to correction of errors).

(A) a certification that such beneficial owner does not have any substantial United States owners, or

(B) the name, address, and TIN of each substantial United States owner of such beneficial owner,

(2) the withholding agent does not know, or have reason to know, that any information provided under paragraph (1) is incorrect, and

(3) the withholding agent reports the information provided under paragraph (1)(B) to the Secretary in such manner as the Secretary may provide.

[Sec. 1472(c)]

(c) EXCEPTIONS.—Subsection (a) shall not apply to—

(1) except as otherwise provided by the Secretary, any payment beneficially owned by—

(A) any corporation the stock of which is regularly traded on an established securities market,

(B) any corporation which is a member of the same expanded affiliated group (as defined in section 1471(e)(2) without regard to the last sentence thereof) as a corporation described in subparagraph (A),

(C) any entity which is organized under the laws of a possession of the United States and which is wholly owned by one or more bona fide residents (as defined in section 937(a)) of such possession,

(D) any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing,

(E) any international organization or any wholly owned agency or instrumentality thereof,

(F) any foreign central bank of issue, or

(G) any other class of persons identified by the Secretary for purposes of this subsection, and

(2) any class of payments identified by the Secretary for purposes of this subsection as posing a low risk of tax evasion.

[Sec. 1472(d)]

(d) NON-FINANCIAL FOREIGN ENTITY.—For purposes of this section, the term "non-financial foreign entity" means any foreign entity which is not a financial institution (as defined in section 1471(d)(5)).

[Sec. 1473]

SEC. 1473. DEFINITIONS.

For purposes of this chapter—

(1) WITHHOLDABLE PAYMENT.—Except as otherwise provided by the Secretary—

(A) IN GENERAL.—The term "withholdable payment" means—

(i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States, and

(ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

(B) EXCEPTION FOR INCOME CONNECTED WITH UNITED STATES BUSINESS.—Such term shall not include any item of income which is taken into account under section 871(b)(1) or 882(a)(1) for the taxable year.

(C) SPECIAL RULE FOR SOURCING INTEREST PAID BY FOREIGN BRANCHES OF DOMESTIC FINANCIAL INSTITUTIONS.—Subparagraph (B) of section 861(a)(1) shall not apply.

(2) SUBSTANTIAL UNITED STATES OWNER.—

(A) IN GENERAL.—The term "substantial United States owner" means—

[Sec. 6511(d)]

(d) SPECIAL RULES APPLICABLE TO INCOME TAXES.—

* * *

(3) SPECIAL RULES RELATING TO FOREIGN TAX CREDIT.—

(A) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO FOREIGN TAXES PAID OR ACCRUED.—If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued.

(B) EXCEPTION IN THE CASE OF FOREIGN TAXES PAID OR ACCRUED.—In the case of a claim described in subparagraph (A), the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the allowance of a credit for the taxes described in subparagraph (A).

* * *

CHAPTER 68—ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

SUBCHAPTER A—ADDITIONS TO THE TAX AND ADDITIONAL AMOUNTS

PART I—GENERAL PROVISIONS

[Sec. 6652]

SEC. 6652. FAILURE TO FILE CERTAIN INFORMATION RETURNS, REGISTRATION STATEMENTS, ETC.

* * *

[Sec. 6652(f)]

(f) RETURNS REQUIRED UNDER SECTION 6039C.—

(1) IN GENERAL.—In the case of each failure to make a return by section 6039C which contains the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the amount determined under paragraph (2) shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to make such return.

(2) AMOUNT OF PENALTY.—For purposes of paragraph (1), the amount determined under this paragraph with respect to any failure shall be $25 for each day during which such failure continues.

(3) LIMITATION.—The amount determined under paragraph (2) with respect to any person for failing to meet the requirements of section 6039C for any calendar year shall not exceed the lesser of—

(A) $25,000, or

(B) 5 percent of the aggregate of the fair market value of the United States real property interests owned by such person at any time during such year.

For purposes of the preceding sentence, fair market value shall be determined as of the end of the calendar year (or, in the case of any property disposed of during the calendar year, as of the date of such disposition).

* * *

[Sec. 6664(d)]

(d) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—

(1) IN GENERAL.—No penalty shall be imposed under section 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(2) EXCEPTION.—Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).

(3) SPECIAL RULES.—Paragraph (1) shall not apply to any reportable transaction understatement unless—

(A) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under section 6011,

(B) there is or was substantial authority for such treatment, and

(C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

A taxpayer failing to adequately disclose in accordance with section 6011 shall be treated as meeting the requirements of subparagraph (A) if the penalty for such failure was rescinded under section 6707A(d).

(4) RULES RELATING TO REASONABLE BELIEF.—For purposes of paragraph (3)(C)—

(A) IN GENERAL.—A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief—

(i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and

(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

(B) CERTAIN OPINIONS MAY NOT BE RELIED UPON.—

(i) IN GENERAL.—An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if—

(I) the tax advisor is described in clause (ii), or

(II) the opinion is described in clause (iii).

(ii) DISQUALIFIED TAX ADVISORS.—A tax advisor is described in this clause if the tax advisor—

(I) is a material advisor (within the meaning of section 6111(b)(1)) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates,

(II) is compensated directly or indirectly by a material advisor with respect to the transaction,

(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or

(IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

(iii) DISQUALIFIED OPINIONS.—For purposes of clause (i), an opinion is disqualified if the opinion—

(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),

(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,

(III) does not identify and consider all relevant facts, or

(IV) fails to meet any other requirement as the Secretary may prescribe.

[Sec. 7701(o)]

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(1) APPLICATION OF DOCTRINE.—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ECONOMIC SUBSTANCE DOCTRINE.—The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) TRANSACTION.—The term "transaction" includes a series of transactions.

* * *

CHAPTER 80—GENERAL RULES

SUBCHAPTER B—EFFECTIVE DATE AND RELATED PROVISIONS

[Sec. 7852]

SEC. 7852. OTHER APPLICABLE RULES.

* * *

[Sec. 7852(d)]

(d) TREATY OBLIGATIONS.—

(1) IN GENERAL.—For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.

debt required amount for a taxable year is the average of the TLAC long-term debt required amounts, computed on a monthly basis.

(vi) *Amounts paid or accrued in taxable years beginning before January 1, 2018.*—Any amount paid or accrued in taxable years beginning before January 1, 2018.

(vii) *Business interest carried forward from taxable years beginning before January 1, 2018.*—Any disallowed business interest described in section 163(j)(2) that is carried forward from a taxable year beginning before January 1, 2018.

(4) *Rules for determining the amount of certain base erosion payments.*—The following rules apply in determining the deductible amount that is a base erosion payment.

(i) *Interest expense allocable to a foreign corporation's effectively connected income.*—(A) *Method described in § 1.882-5(b) through (d).*—A foreign corporation that has interest expense allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States applying the method described in § 1.882-5(b) through (d) has base erosion payments under paragraph (b)(1)(i) of this section for the taxable year equal to the sum of—

(1) The interest expense on a liability described in § 1.882-5(a)(1)(ii)(A) or (B) (direct allocations) or interest expense on U.S.-booked liabilities, as described in § 1.882-5(d)(2), that is paid or accrued by the foreign corporation to a foreign related party; and

(2) The interest expense on U.S.-connected liabilities in excess of U.S.-booked liabilities (hereafter, excess U.S.-connected liabilities), as described in § 1.882-5(d)(5), multiplied by a fraction, the numerator of which is the foreign corporation's average worldwide liabilities due to a foreign related party, and the denominator of which is the foreign corporation's average total worldwide liabilities. For purposes of this fraction, any liability that is a U.S.-booked liability or is subject to a direct allocation is excluded from both the numerator and the denominator of the fraction.

(B) *Separate currency pools method.*—A foreign corporation that has interest expense allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States applying the separate currency pools method described in § 1.882-5(e) has a base erosion payment under paragraph (b)(1)(i) of this section for the taxable year equal to the sum of—

(1) The interest expense on a liability described in § 1.882-5(a)(1)(ii)(A) or (B) (direct allocations) that is paid or accrued by the foreign corporation to a foreign related party; and

(2) The interest expense attributable to each currency pool, as described in § 1.882-5(e)(1)(iii), multiplied by a fraction equal to the foreign corporation's average worldwide liabilities denominated in that currency and that is due to a foreign related party over the foreign corporation's average total worldwide liabilities denominated in that currency. For purposes of this fraction, any liability that has a direct allocation is excluded from both the numerator and the denominator.

(C) *U.S.-booked liabilities in excess of U.S.-connected liabilities.*—A foreign corporation that is computing its interest expense under the method described in § 1.882-5(b) through (d) and that has U.S.-booked liabilities in excess of U.S.-connected liabilities must apply the scaling ratio pro-rata to all interest expense consistent with § 1.882-5(d)(4) for purposes of determining the amount of allocable interest expense that is a base erosion payment.

(D) *Liability reduction election.*—A foreign corporation that elects to reduce its liabilities under § 1.884-1(e)(3) must reduce its liabilities on a pro-rata basis, consistent with the requirements under § 1.884-1(e)(3)(iii), for purposes of determining the amount of allocable interest expense that is a base erosion payment.

(ii) *Other deductions allowed with respect to effectively connected income.*—A deduction allowed under § 1.882-4 for an amount paid or accrued by the foreign corporation to a foreign related party (including a deduction for an amount apportioned in part to effectively connected income and in part to income that is not effectively connected income) is treated as a base erosion payment under paragraph (b)(1) of this section.

(iii) *Depreciable property.*—Any amount paid or accrued by the foreign corporation to a foreign related party of the taxpayer in connection with the acquisition of property by the foreign corporation from the foreign related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation) is a base erosion payment to the extent the property so acquired is used, or held for use, in the conduct of a trade or business within the United States.

(iv) *Coordination with ECI exception.*—For purposes of this paragraph (b)(4), amounts paid or accrued to a foreign related party treated as effectively connected income (or, in the case of foreign related party that determines net taxable income under an applicable income tax treaty, such amounts that are taken into account in determining net taxable income) are not treated as paid to a foreign related party. Additionally, for purposes of paragraph (b)(4)(i)(A)*(2)* or (b)(4)(i)(B)*(2)* of vices, the rules under this paragraph (f) are not applicable to determine the arm's length result.

(ii) *Profit level indicators*.—In addition to the profit level indicators provided in § 1.482-5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting*.—Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as "cost of goods sold" and "selling, general, and administrative expenses." Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in § 1.482-5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) *Examples*.—The principles of this paragraph (f) are illustrated by the following examples:

Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator. (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under § 1.482-5(c). Neither Company A nor the comparable companies use valuable intangible property in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

Example 2. Application of the operating profit to total services costs profit level indicator. (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its year 1 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company B incurs in performing the consulting services and do not make use of valuable intangible property or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for ally accepted accounting principles, the fair value of such stock options attributable to employees' performance of the relevant business activity is 500 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in "total services costs," as defined in paragraph (j) of this section, and deducts these amounts in determining "reported operating profit" (within the meaning of § 1.482-5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Companies A and B expense the stock options for financial accounting purposes in accordance with U.S. generally accepted accounting principles. Companies C and D do not expense the stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies C and D disclose the fair value of these options in their financial statements. The utilization and accounting treatment of options are depicted in the following table:

	Salary and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	500
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in accounting for stock-based compensation (within the meaning of § 1.482-7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of the arm's length result under paragraph (f) of this section. In evaluating the comparable operating profits of the tested party, the Commissioner includes in total services costs Taxpayer's total compensation costs of 1,500 (including stock option fair value of 500). In considering whether an adjustment is necessary to improve comparability under §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner recognizes that the total employee compensation (including stock options) provided by Taxpayer and Companies A, B, C, and D) provides a reliable basis for comparison. Because Companies A and B expense stock-based compensation for financial accounting purposes, whereas Companies C and D do not, an adjustment to the comparables' operating profit is necessary. In computing the net cost plus PLI, the Commissioner uses the financial-accounting data of Companies A and B, as reported. The Commissioner increases the total services costs of Companies C and D by amounts equal to the fair value of their respective stock options, and reduces the operating profits of Companies C and D accordingly.

(v) The adjustments described in paragraph (iv) of this *Example 6* are depicted in the following table. For purposes of illustration, the unadjusted data of Companies A and B are also included.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A)
Per financial Statements:					
Company A	7,000	2,000	27,000	4,000	14.80%
Company B	4,300	250	12,750	2,250	17.65%
As adjusted:					
Company C	12,000	4,500	40,500	6,500	16.05%
Company D	15,000	2,000	29,000	5,000	17.24%

(g) *Profit split method.*—(1) *In general.*—The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed and resources employed by such controlled taxpayer in the relevant business activity. For application of the profit split method (both the comparable profit split and the residual profit split), see § 1.482-6. The residual profit split method may not be used where only one controlled taxpayer makes significant nonroutine contributions.

(2) *Examples.*—The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Residual profit split. (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A's database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also take place. Company A has a wholly-owned subsidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A's interactive database. Company B solicits unrelated companies to auction spare parts on interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in § 301.7701-4(c) of this chapter, liquidating trusts described in § 301.7701-4(d) of this chapter, or environmental remediation trusts described in § 301.7701-4(e) of this chapter.

(g) *Examples.*—The following examples illustrate the rules of this section. In all examples, *A* is a U.S. citizen and *FT* is a foreign trust. The examples are as follows:

Example 1. Transfer to owner trust. In 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *FT*. At the time of the transfer, *FT* has a U.S. beneficiary within the meaning of § 1.679-2, and *A* is treated as owning *FT* under section 679. Under paragraph (a) of this section, § 1.684-1 does not cause *A* to recognize gain at the time of the transfer. See § 1.684-2(e) for rules that may require *A* to recognize gain if the trust is no longer owned by *A*.

Example 2. Transfer of property at death: Basis determined under section 1014(a). (i) The initial facts are the same as *Example 1*.

(ii) *A* dies on July 1, 2004. The fair market value at *A*'s death of all property transferred to *FT* by *A* is 1500X. The basis in the property is 400X. *A* retained the power to revoke *FT*, thus, the value of all property owned by *FT* at *A*'s death is includible in *A*'s gross estate for U.S. estate tax purposes. Pursuant to paragraph (c) of this section, *A* is not required to recognize gain under § 1.684-1 because the basis of the property in the hands of the foreign trust is determined under section 1014(a).

Example 3. Transfer of property at death: Basis not determined under section 1014(a). (i) The initial facts are the same as *Example 1*.

(ii) *A* dies on July 1, 2004. The fair market value at *A*'s death of all property transferred to *FT* by *A* is 1500X. The basis in the property is 400X. *A* retains no power over *FT*, and *FT*'s basis in the property transferred is not determined under section 1014(a). Under § 1.684-2(e)(1), *A* is treated as having transferred the property to *FT* immediately before his death, and must recognize 1100X of gain at that time under § 1.684-1.

Example 4. Transfer of property for fair market value to an unrelated foreign trust. *A* sells a house with a fair market value of 1000X to *FT* in exchange for a 30-year note issued by *FT*. *A* is not related to *FT* as defined in § 1.679-1(c)(5). *FT* is not treated as owned by any person. Pursuant to paragraph (d) of this section, *A* is not required to recognize gain under § 1.684-1.

[Reg. § 1.684-3.]

☐ [*T.D.* 8956, 7-19-2001. *Amended by T.D.* 9811, 1-18-2017.]

§ 1.684-4. Outbound migrations of domestic trusts.—(a) *In general.*—If a U.S. person transfers property to a domestic trust, and such trust becomes a foreign trust, and neither trust is treated as owned by any person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, the trust shall be treated for purposes of this section as having transferred all of its assets to a foreign trust and the trust is required to recognize gain on the transfer under § 1.684-1(a). The trust must also comply with the rules of section 6048.

(b) *Date of transfer.*—The transfer described in this section shall be deemed to occur immediately before, but on the same date that, the trust meets the definition of a foreign trust set forth in section 7701(a)(31)(B).

(c) *Inadvertent migrations.*—In the event of an inadvertent migration, as defined in § 301.7701-7(d)(2) of this chapter, a trust may avoid the application of this section by complying with the procedures set forth in § 301.7701-7(d)(2) of this chapter.

(d) *Examples.*—The following examples illustrate the rules of this section. In all examples, *A* is a U.S. citizen, *B* is a U.S. citizen, *C* is a nonresident alien, and *T* is a trust. The examples are as follows:

Example 1. Migration of domestic trust with U.S. beneficiaries. *A* transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *T*, a domestic trust, for the benefit of *A*'s children who are also U.S. citizens. *B* is the trustee of *T*. On January 1, 2001, while *A* is still alive, *B* resigns as trustee and *C* becomes successor trustee under the terms of the trust. Pursuant to § 301.7701-7(d) of this chapter, *T* becomes a foreign trust. *T* has U.S. beneficiaries within the meaning of § 1.679-2 and *A* is, therefore, treated as owning *FT* under section 679. Pursuant to § 1.684-3(a), neither *A* nor *T* is required to recognize gain at the time of the migration. Section 1.684-2(e) provides rules that may require *A* to recognize gain upon a subsequent change in the status of the trust.

Example 2. Migration of domestic trust with no U.S. beneficiaries. *A* transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *T*, a domestic trust for the benefit of *A*'s mother who is not a citizen or resident of the United States. *T* is not treated as owned by another person. *B* is the trustee of *T*. On January 1, 2001, while *A* is still alive, B resigns as trustee and *C* becomes successor trustee under the terms of the trust. Pursuant to § 301.7701-7(d) of this chapter, *T* becomes a foreign trust, *FT*. *FT* has no U.S. beneficiaries within the meaning of § 1.679-2 and no person is treated as owning any portion of *FT*. *T* is required to recognize gain of 600X on January 1, 2001. Paragraph (c) of this section provides rules with respect to an inadvertent migration of a domestic trust.

[Reg. § 1.684-4.]

☐ [*T.D.* 8956, 7-19-2001.]

(3) Controlled foreign corporations.—For purposes of this section, the term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(*d*)(*5*) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(4) United States person.—For purposes of this section, a *United States person* is a person described in section 7701(a)(30).

(5) United States shareholder.—For purposes of this section, a *United States shareholder* is a person described in section 951(b) or section 953(c).

(6) Indirect ownership.—For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.

(e) De minimis rule.—(1) Partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012.—Except as provided in paragraph (b)(2)(iii)(*e*)(*2*) of this section, for purposes of applying this paragraph (b)(2)(iii), for partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012, the tax attributes of de minimis partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(*e*)(*1*), a de minimis partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(*d*)(*6*) of this section for the definition of indirect ownership.

* * *

(2) Nonapplicability of de minimis rule.—(i) Allocations that become part of the partnership agreement on or after December 28, 2012. Paragraph (b)(2)(iii)(*e*)(*1*) of this section does not apply to allocations that become part of the partnership agreement on or after December 28, 2012.

(ii) Retest for allocations that become part of the partnership agreement prior to December 28, 2012. If the de minimis partner rule of paragraph (b)(2)(iii)(*e*)(*1*) of this section was relied upon in testing the substantiality of allocations that became part of the partnership agreement before December 28, 2012, such allocations must be retested on the first day of the first partnership taxable year beginning on or after December 28, 2012, without regard to paragraph (b)(2)(iii)(*e*)(*1*) of this section.

* * *

(3) *Partner's interest in the partnership.*—(i) *In general.*—References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit makeup obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.

(ii) *Factors considered.*—In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(*a*) The partners' relative contributions to the partnership,

(*b*) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(*c*) The interests of the partners in cash flow and other non-liquidating distributions, and

(*d*) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7)(i), (ii), and (iv), (8), (10)(ii), (16)(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for determining the partners' interests in the partnership with respect to certain tax items.

(iii) *Certain determinations.*—If—

(*a*) Requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, and

(*b*) All or a portion of an allocation of income, gain, loss, or deduction made to a relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75% to A and 25% to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if $15,000 of such taxes is allocated 75% to A and 25% to B and the other $10,000 of such taxes is allocated 50% to A and 50% to B. No inference is intended with respect to the application of other provisions to arrangements that involve disregarded payments.

(iii) Assume that the facts are the same as in paragraph (i) of this *Example 24*, except that in order to reflect the $75,000 payment from DE1 to DE2, the partnership agreement allocates $75,000 of the income attributable to business M equally between A and B (50% each). In order to prevent separating the CFTEs from the related foreign income, the $75,000 payment is treated as a divisible part of the business M activity and, therefore, a separate activity. See paragraph (b)(4)(viii)(*c*)(*2*)(*iii*) of this section. Because items from the disregarded payment and business N are both shared equally between A and B, the disregarded payment activity and the business N activity are treated as a single CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*)(*i*) of this section. Accordingly, $25,000 of net income attributable to business M is in the business M CFTE category and $75,000 of income of business M attributable to the disregarded payment and the $50,000 of net income attributable to business N are in the business N CFTE category. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $10,000 of country X taxes is allocated to the business M CFTE category and all $25,000 of the country Y taxes is allocated to the business N CFTE category. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75% to A and 25% to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 50% to A and 50% to B.

Example 25. [Reserved]. For further guidance, see § 1.704-1T(b)(5) *Example 25*.

Example 26. (i) A and B form AB, an eligible entity (as defined in § 301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. A, a U.S. corporation, contributes a building with a fair market value of $200,000 and an adjusted basis of $50,000 for both U.S. and country X purposes. The building contributed by A is used in business M. B, a country X corporation, contributes $800,000 cash. The AB partnership agreement provides that AB will make allocations under section 704(c) using the traditional method under § 1.704-3(b) and that all other items, excluding creditable foreign taxes, will be allocated 20 percent to A and 80 percent to B. The partnership agreement provides that creditable foreign taxes will be allocated in proportion to the partners' distributive shares of net income in each CFTE category, which shall be determined by taking into accounts items allocated pursuant to section 704(c). Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively, and such taxes are CFTEs. In 2007, AB sells the building contributed by A for $200,000, thereby recognizing taxable income of $150,000 for U.S. and country X purposes, and recognizes $250,000 of other income from the operation of business M. AB pays or accrues $80,000 of country X tax on such income. Also in 2007, business N recognizes $100,000 of taxable income for U.S. and country Y purposes and pays or accrues $40,000 of country Y tax. Pursuant to the partnership agreement, A is allocated $200,000 of business M income ($150,000 of taxable income in accordance with section 704(c) and $50,000 of other business M income) and $40,000 of country X tax, and 20 percent of both business N income ($20,000) and country Y tax ($8,000). B is allocated $200,000 of business M income and $40,000 of country X tax and 80 percent of both the business N income ($80,000) and country Y tax ($32,000). Assume that allocations of all items other than CFTEs are valid.

(ii) The net income attributable to business M ($400,000) is allocated 50 percent to A and 50 percent to B while the net income attributable to business N ($100,000) is allocated 20 percent to A and 80 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each activity is income in a separate CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the business M CFTE category is the $400,000 of net income attributable to business M and the net income in the business N CFTE category is the $100,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $80,000 of country X tax is allocated to the business M CFTE category and the $40,000 of country Y tax is allocated to the business N CFTE category. Therefore, the $80,000 of country X tax relates to the $400,000 of net income in the business M CFTE category and the $40,000 of country Y tax relates to the $100,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the $80,000 of country X taxes and $40,000 of country Y taxes in proportion to the distributive tion 721(c) property. If the section 721(c) property remains in the partnership after the acceleration event, the increase in basis of the section 721(c) property may be recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property of the same type placed in service on the date of the acceleration event. The section 721(c) property will no longer be subject to the gain deferral method.

(d) *Applicability dates.*—This section applies to contributions occurring on or after August 6, 2015, and to contributions occurring before August 6, 2015, resulting from an entity classification election made under §301.7701-3 of this chapter that is filed on or after August 6, 2015.

(e) *Expiration date.*—The applicability of this section expires on January 17, 2020. [Temporary Reg. §1.721(c)-4T.]

☐ *T.D.* 9814, 1-18-2017.]

§1.721(c)-5T. Acceleration event exceptions (temporary).—(a) *Scope.*—This section identifies exceptions to the acceleration events, which, like the rules regarding acceleration events provided in §1.721(c)-4T(b), apply on a property-by-property basis. Paragraph (b) of this section identifies the events that terminate the requirement to apply the gain deferral method. Paragraph (c) of this section identifies the successor events that allow for the continued application of the gain deferral method. Paragraph (d) of this section identifies the partial acceleration events. Paragraph (e) of this section provides special rules for transfers of section 721(c) property to a foreign corporation described in section 367. Paragraph (f) of this section allows for the continued application of the gain deferral method if there is a fully taxable disposition of a portion of an interest in a partnership. Paragraph (g) of this section provides the dates of applicability, and paragraph (h) of this section provides the date of expiration. For definitions that apply for purposes of this section, see §1.721(c)-1T(b).

(b) *Termination events.*—(1) *In general.*—Notwithstanding §1.721(c)-4T(b)(1), a termination event with respect to section 721(c) property will not constitute an acceleration event. In these cases, the section 721(c) property will no longer be subject to the gain deferral method.

(2) *Transfers of section 721(c) property (other than a partnership interest) to a domestic corporation described in section 351.*—A termination event occurs if a section 721(c) partnership transfers section 721(c) property (other than an interest in a partnership) to a domestic corporation in a transaction to which section 351 applies.

(3) *Certain incorporations of a section 721(c) partnership.*—A termination event occurs upon an incorporation of a section 721(c) partnership into a domestic corporation by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners, followed by a contribution of that property to a corporation), provided that the section 721(c) partnership is liquidated as part of the incorporation transaction.

(4) *Certain distributions of section 721(c) property.*—A termination event occurs if a section 721(c) partnership distributes section 721(c) property either to the U.S. transferor or, if the U.S. transferor is a member of a consolidated group (as defined in §1.1502-1(h)) at the time of the distribution and the distribution occurs outside the seven-year period described in section 704(c)(1)(B), to a member of the consolidated group.

(5) *Partnership ceases to have a partner that is a related foreign person.*—A termination event occurs when a section 721(c) partnership ceases to have any direct or indirect partners that are related foreign persons with respect to the U.S. transferor, provided there is no plan for a related foreign person to subsequently become a direct or indirect partner in the partnership (or a successor). This paragraph (b)(5) does not apply to a distribution of section 721(c) property in redemption of a related foreign person's interest in a section 721(c) partnership.

(6) *Fully taxable dispositions of section 721(c) property.*—A termination event occurs if a section 721(c) partnership disposes of section 721(c) property in a transaction in which all gain or loss, if any, is recognized.

(7) *Fully taxable dispositions of an entire interest in a section 721(c) partnership.*—A termination event occurs if a U.S. transferor or a partnership in which a U.S. transferor is a direct or indirect partner disposes of its entire interest in a section 721(c) partnership that owns the section 721(c) property in a transaction in which all gain or loss, if any, is recognized. This paragraph (b)(7) does not apply if a U.S. transferor is a member of a consolidated group (as defined in §1.1502-1(h)) and the interest in the section 721(c) partnership is transferred in an intercompany transaction (as defined in §1.1502-13(b)(1)).

(c) *Successor events.*—(1) *In general.*—Notwithstanding §1.721(c)-4T(b)(1), a successor event with respect to section 721(c) property will not constitute an acceleration event. If only a portion of an interest in a partnership is transferred in a successor event described in this paragraph (c), the principles of §1.704-3(a)(7) apply to determine the remaining built-in gain in section 721(c) property that is attributable to the portion of the interest that is transferred and the portion of the interest that is retained.

(2) *Transfers of an interest in a section 721(c) partnership by a U.S. transferor or upper-

954(b)(5) and § 1.904-5(c)(2) for rules concerning the allocation of related person interest payments to the foreign personal holding company income of a controlled foreign corporation.

(e) *Portfolio securities that constitute inventory or generate primarily gains.*—Because gain on the sale of securities is sourced by reference to the residence of the seller, a resident of the United States will generally receive domestic source income (and a foreign resident will generally receive foreign source income) upon sale or disposition of securities that otherwise generate foreign source dividends and interest (or domestic source dividends and interest in the case of a foreign resident). Although under paragraphs (c) and (d) of this section securities are characterized by reference to the source and character of dividends and interest, the source and character of income on gain or disposition must also be taken into account for purposes of characterizing portfolio securities if:

(1) The securities constitute inventory in the hands of the holder, or

(2) 80 percent or more of the gross income generated by a taxpayer's entire portfolio of such securities during a taxable year consists of gains.

For this purpose, a portfolio security is a security in any entity other than a controlled foreign corporation with respect to which the taxpayer is a United States shareholder under section 957, a noncontrolled section 902 corporation with respect to the taxpayer, or a 10 percent owned corporation as defined in § 1.861-12(c)(2)(ii). In taking gains into account, a taxpayer must treat all portfolio securities generating foreign source dividends and interest as a single asset and all portfolio securities generating domestic source dividends as a single asset and shall characterize the total value of that asset based on the source of all income and gain generated by those securities in the taxable year.

(f) *Assets funded by disallowed interest.*—(1) *Rule.*—In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

(2) *Example.*—The rules of this paragraph (f) may be illustrated by the following example.

Example. X is a domestic corporation which uses the tax book value method of apportionment. X has \$1000 of indebtedness and \$100 of interest expense. X constructs an asset with an adjusted basis of \$800 before interest capitalization and is required under the rules of section 263A to capitalize \$80 in interest expense. Because interest on \$800 of debt is capitalized and because the production period is in progress at the end of X's taxable year, \$800 of the principal amount of X's debt is allocable to the building. The \$800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense (\$20).

(g) *Special rules for FSCs.*—(1) *Treatment of FSC stock.*—No interest expense shall be allocated or apportioned to stock of a foreign sales corporation ("FSC") to the extent that the FSC stock is attributable to the separate limitation for certain FSC distributions described in section 904(d)(1)(H). FSC stock is considered to be attributable solely to the separate limitation category described in section 904(d)(1)(H) unless the taxpayer can demonstrate that more than 20 percent of the FSC's gross income for the taxable year consists of income other than foreign trading income.

(2) *Treatment of assets that generate foreign trade income.*—Assets of the related supplier that generate foreign trade income must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions generating foreign trade income.

(i) *Value of assets attributable to foreign source income.*—The value of assets attributable to foreign source general limitation income is computed by multiplying the value of assets for the taxable year generating foreign trading gross receipts by a fraction:

(A) The numerator of which is foreign source general limitation income for the taxable year derived from transactions giving rise to foreign trading gross receipts, after the application of the limitation provided in section 927(e)(1), and

(B) The denominator of which is total income for the taxable year derived from the transactions giving rise to foreign trading gross receipts.

(ii) *Value of assets attributable to domestic source income.*—The value of assets attributable to domestic source income is computed by subtracting from the total value of assets for the taxable year generating foreign trading gross receipts the value of assets attributable to foreign source general limitation income as computed under paragraph (g)(2)(i) of this section.

(h) *Special rules for DISCs.*—(1) *Treatment of DISC stock.*—No interest shall be allocated or apportioned to stock in a DISC (or stock in a former DISC to the extent that the stock in the former DISC is attributable to the separate limitation category described in section 904(d)(1)(F)).

(2) *Treatment of assets that generate qualified export receipts.*—Assets of the related sup-

right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated, Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support to Corp E but the agreement does not allocate the monthly fee between the right to receive upgrades of Program X and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable at the time the contract is entered into but is expected to be de minimis. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis*. (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Corp A has not provided any services described in paragraph (d) of this section. Based on all the facts and circumstances of the transaction, Corp A has provided de minimis technical services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts*. The facts are the same as in *Example 12*, except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis*. For the reasons stated in *Example 10*, paragraph (ii)(B), the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts*. Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10*.

(ii) *Analysis*. (A) As in *Example 10*, no copyright rights are being transferred under paragraph (c)(2) of this section. In addition, since no copyright rights are being transferred to Corp G, this transaction does not involve the provision of services by Corp A under paragraph (d) of this section. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts*. Corp H, a Country Z corporation, enters into a license agreement for a new computer program. Program Q is to be written by Corp A, a U.S. corporation. Corp A and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis*. Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts*. Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c)(2) and (3) of this section, then, with respect to such taxable years (or portion thereof), no tax shall be deducted or withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.*—The election specified in paragraph (c)(1) of this section shall be made by May 15, 1991.

(3) *Manner of making election.*—The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—

(i) Contain the name, address, and taxpayer identifying number of the electing taxpayer;

(ii) Identify the election as a "Notional Principal Contract Election under § 1.863-7"; and

(iii) Specify each taxable year described in paragraph (c)(1) of this section in which payments were made.

(d) *Example.*—The operation of this section is illustrated by the following example:

(1) On January 1, 1990, X, a calendar year domestic corporation, entered into an interest rate swap contract with FZ, an unrelated foreign corporation. X does not have a qualified business unit outside the United States. Under the contract, X is required to pay FZ fixed rate dollar amounts, and FZ is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract. The contract is a notional principal contract under § 1.863-7(a) because the contract provides for the payment of amounts at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a promise to pay similar amounts.

(2) Assume that during 1990 X had notional principal contract income of $100 in connection with the notional principal contract described in (1) above. Also assume that the contract provides that payments more than 30 days late give rise to a $5 fee, and that X receives such a fee in 1990. Under paragraph (b)(1) of this section, the source of X's $100 of income attributable to the swap agreement is domestic. The $5 fee is not notional principal contract income.

(e) *Cross references.*—See § 1.861-9T(b) for the allocation of expense to certain notional principal contracts. For rules relating to the source of income from nonfunctional currency notional principal contracts, see § 1.988-4T. For rules relating to the taxable amount of notional principal contract income allocable under this section to sources inside or outside the United States, see § 1.863-1(c). [Reg. § 1.863-7.]

☐ [*T.D.* 8330, 1-11-91. *Amended by T.D.* 9572, 1-19-2012 *and T.D.* 9648, 12-4-2013.]

§ 1.863-8. Source of income derived from space and ocean activity under section 863(d).—(a) *In general.*—Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in § 1.1502-13.

(b) *Source of gross income from space and ocean activity.*—(1) *Space and ocean income derived by a United States person.*—Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person.*—(i) *In general.*—Space and ocean income derived by a person other than a United States person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) *Space and ocean income derived by a controlled foreign corporation.*—Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(iii) *Space and ocean income derived by foreign persons engaged in a trade or business within the United States.*—Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§1.872-2(c) and 1.883-1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income.*—(1) *In general.*—(i) For purposes of this section the term "treaty income" shall be construed to mean the gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term "nontreaty income" shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§1.872-1 and 1.872-2, or with §§1.882-3 and 1.883-1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881 (a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.*—In applying this section with respect to income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or foreign corporation, see section 894(b), which provides that with respect to such income the nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year for purposes of applying any exemption from, or reduction in rate of, tax provided by any tax convention.

(c) *Determination of tax.*—(1) *In general.*—If the gross income of a nonresident alien individual or foreign corporation, as the case may be, consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subparagraphs (2) and (3) of this paragraph. In no case, however, may the tax liability so determined exceed the tax liability (tax reduced by allowable credits) with respect to the taxpayer's entire income, determined in accordance with §1.871-7 or §1.871-8, or with §1.881-2 or §1.882-1, as though the tax convention had not come into effect and without reference to the provisions of this section. Determinations under this paragraph shall be made without taking into account any credits allowed by sections 31, 32, 39, and 6402, but such credits shall be allowed against the tax liability determined in accordance with this subparagraph.

(2) *Tax on nontreaty income.*—For purposes of subparagraph (1) of this paragraph, compute a partial tax (determined without the allowance of any credit) upon only the nontreaty income in accordance with §1.871-7 or §1.871-8, or with §1.881-2 or §1.882-1, whichever applies, as though the tax convention had not come into effect. To the extent allowed by paragraph (d) of §1.871-8, or paragraph (c) of §1.882-1, the credits allowed by sections 33, 35, 38, and 40 shall then be allowed, without taking into account any item included in the treaty income, against the tax determined under this subparagraph.

(3) *Tax on treaty income.*—For purposes of subparagraph (1) of this paragraph, compute a tax upon the gross amount, determined without the allowance of any deduction, of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. No credits shall be allowed against the tax determined under this subparagraph.

(d) *Illustration.*—The application of this section may be illustrated by the following example:

Example. (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of $22,000, consisting of the following items:

poration) during the taxable year of the First Corporation beginning before the date on which the First Corporation originally becomes an affiliate with respect to the Second Corporation.

(B) With respect to acquisitions on or before December 7, 1995, an includible corporation acquired from unrelated third parties will not be considered an affiliate of another includible corporation during its taxable year beginning before the date on which the first includible corporation first becomes an affiliate with respect to that other includible corporation.

(C) This exception does not apply where the acquisition of an includible corporation is used to avoid the application of this section.

(2) *Includible corporation.*—The term *includible corporation* has the same meaning it has in section 1504(b).

(c) *Taxable years.*—If all of the affiliates use the same U.S. taxable year, then that taxable year must be used for purposes of applying this section. If, however, the affiliates use more than one U.S. taxable year, then an appropriate taxable year must be used for applying this section. The determination whether a taxable year is appropriate must take into account all of the relevant facts and circumstances, including the U.S. taxable years used by the affiliates for general U.S. income tax purposes. The taxable year chosen by the affiliates for purposes of applying this section must be used consistently from year to year. The taxable year may be changed only with the prior consent of the Commissioner. Those affiliates that do not use the year determined under this paragraph (c) as their U.S. taxable year for general U.S. income tax purposes must, for purposes of this section, use their U.S. taxable year or years ending within the taxable year determined under this paragraph (c). If, however, the stock of an affiliate is disposed of so that it ceases to be an affiliate, then the taxable year of that affiliate will be considered to end on the disposition date for purposes of this section.

(d) *Consistent treatment of foreign taxes paid.*—All affiliates must consistently either elect under section 901(a) to claim a credit for foreign income taxes paid or accrued, or deemed paid or accrued, or deduct foreign taxes paid or accrued under section 164. See also § 1.1502-4(a); § 1.905-1(a).

(e) *Effective date.*—Except as provided in paragraph (b)(1)(iii) of this section (relating to newly acquired affiliates), this section is effective for taxable years of affiliates beginning after December 31, 1993. [Reg. § 1.904(i)-1.]

☐ [*T.D.* 8627, 11-6-95.]

§ 1.904(j)-1. Certain individuals exempt from foreign tax credit limitation.—(a) *Election available only if all foreign taxes are creditable foreign taxes.*—A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

(b) *Coordination with carryover rules.*—(1) *No carryovers to or from election year.*—If the taxpayer elects to apply section 904(j) for any taxable year, then no taxes paid or accrued by the taxpayer during such taxable year may be deemed paid or accrued under section 904(c) in any other taxable year, and no taxes paid or accrued in any other taxable year may be deemed paid or accrued under section 904(c) in such taxable year.

(2) *Carryovers to and from other years determined without regard to election years.*—The amount of the foreign taxes paid or accrued, and the amount of the foreign source taxable income, in any year for which the taxpayer elects to apply section 904(j) shall not be taken into account in determining the amount of any carryover to or from any other taxable year. However, an election to apply section 904(j) to any year does not extend the number of taxable years to which unused foreign taxes may be carried under section 904(c) and § 1.904-2(b). Therefore, in determining the number of such carryover years, the taxpayer must take into account years to which a section 904(j) election applies.

(3) *Determination of amount of creditable foreign taxes.*—Otherwise allowable carryovers of foreign tax credits from other taxable years shall not be taken into account in determining whether the amount of creditable foreign taxes paid or accrued by an individual during a taxable year exceeds $300 ($600 in the case of a joint return) for purposes of section 904(j)(2)(B).

(c) *Examples.*—The following examples illustrate the provisions of this section:

Example 1. In 2006, X, a single individual using the cash basis method of accounting for income and foreign tax credits, pays $100 of foreign taxes with respect to general limitation income that was earned and included in income for United States tax purposes in 2005. The foreign taxes would be creditable under section 901 but are not shown on a payee statement furnished to X. X's only income for 2006 from sources outside the United States is qualified passive income, with respect to which X pays $200 of creditable foreign taxes shown on a payee statement. X may not elect to apply section 904(j) for 2006 because some of X's foreign taxes are not creditable foreign taxes within the meaning of section 904(j)(3)(B).

Example 2. (i) In 2009, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of $250 attributable to passive amount of aggregate related income is positive and the related income is taken into account by the payor section 902 corporation or a section 902 shareholder as provided in paragraph (d) of this section.

(f) *Rules relating to partnerships and trusts.*—(1) *Taxes paid or accrued by partnerships.*—In the case of foreign income taxes paid or accrued by a partnership, the taxes will be treated as pre-2011 split taxes to the extent such taxes are allocated to one or more section 902 corporations and would be pre-2011 split taxes if the partner section 902 corporation had paid or accrued the taxes directly on the date such taxes are included by the section 902 corporation under sections 702 and 706(a). Further, any foreign income taxes subject to section 909 will be suspended in the hands of the partner section 902 corporation.

(2) *Section 704(b) allocations.*—Partnership allocations that satisfy the requirements of section 704(b) and the regulations thereunder will not constitute pre-2011 splitter arrangements except to the extent the arrangement is otherwise described in paragraph (b) of this section (for example, a payment or accrual on a disregarded debt instrument that gives rise to a shared loss).

(3) *Trusts.*—Rules similar to the rules of paragraph (f)(1) of this section will apply in the case of any trust with one or more beneficiaries that is a section 902 corporation.

(g) *Interaction between section 909 and other Code provisions.*—(1) *Section 904(c).*—Section 909 does not apply to excess foreign income taxes that were paid or accrued in pre-2011 taxable years and carried forward and deemed paid or accrued under section 904(c) in a post-2010 taxable year.

(2) *Section 905(a).*—For purposes of determining in post-2010 taxable years the allowable deduction for foreign income taxes paid or accrued under section 164(a), the carryover of excess foreign income taxes under section 904(c), and the extended period for claiming a credit or refund under section 6511(d)(3)(A), foreign income taxes to which section 909 applies are first taken into account and treated as paid or accrued in the year in which the related income is taken into account, and not in the earlier year to which the tax relates (determined without regard to section 909).

(3) *Section 905(c).*—If a redetermination of foreign income taxes claimed as a direct credit under section 901 occurs in a post-2010 taxable year and the foreign tax redetermination relates to a pre-2011 taxable year, to the extent such foreign tax redetermination increased the amount of foreign income taxes paid or accrued with respect to the pre-2011 taxable year (for example, due to an additional assessment of foreign tax or a payment of a previously accrued tax not paid within two years), section 909 will not apply to such taxes. If a redetermination of foreign tax paid or accrued by a section 902 corporation occurs in a post-2010 taxable year and increases the amount of foreign income taxes paid or accrued by the section 902 corporation with respect to a pre-2011 taxable year (for example, due to an additional assessment of foreign tax or a payment of a previously accrued tax not paid within two years), such taxes will be treated as pre-2011 taxes. Section 909 will apply to such taxes if they are pre-2011 split taxes and the taxes will be suspended in the post-2010 taxable year in which they would otherwise be taken into account as a prospective adjustment to the section 902 corporation's pools of post-1986 foreign income taxes.

(4) *Other foreign tax credit provisions.*—Section 909 does not affect the applicability of other restrictions or limitations on the foreign tax credit under existing law, including, for example, the substantiation requirements of section 905(b).

(h) *Effective/applicability date.*—This section applies to foreign income taxes paid or accrued by section 902 corporations in pre-2011 taxable years for purposes of computing foreign income taxes deemed paid with respect to distributions or inclusions out of earnings and profits of section 902 corporations in taxable years of the section 902 corporation ending after February 9, 2015. See 26 CFR 1.909-6T (revised as of April 1, 2014) for rules applicable to foreign income taxes paid or accrued by section 902 corporations in pre-2011 taxable years for purposes of computing foreign income taxes deemed paid with respect to distributions or inclusions out of earnings and profits of section 902 corporations in taxable years of the section 902 corporation beginning after December 31, 2010, and ending on or before February 9, 2015. [Reg. § 1.909-6.]

□ [*T.D.* 9710, 2-9-2015.]

Foreign Earned Income Exclusion

§ 1.911-1. Partial exclusion for earned income from sources within a foreign country and foreign housing costs.—(a) *In general.*—Section 911 provides that a qualified individual may elect to exclude the individual's foreign earned income and the housing cost amount from the individual's gross income for the taxable year. Foreign earned income is excludable to the extent of the applicable limitation for the taxable year. The housing cost amount for the taxable year is excludable to the extent attributable to employer provided amounts. If a portion of the housing cost amount for the taxable year is attributable to non-employer provided amounts, such amount may be deductible by the qualified individual eign income taxes that are allocated and apportioned under § 1.960-1(d)(3)(ii) to CFC2's tested income group is \$20 (\$20 x 200u/200u). Therefore, under paragraph (c)(4) of this section, the amount of foreign income taxes properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A-1(b) is \$20. Under paragraph (c)(3) of this section, US1's tested foreign income taxes with respect to CFC2 are \$20. Under paragraph (c)(2) of this section, US1's inclusion percentage is 100% (\$485/\$485). Accordingly, under paragraph (c)(1) of this section, US1 is deemed to have paid \$16 of the foreign income taxes of CFC2 (80% x 100% x \$20).

(*2*) *US2.* US2 is not a United States shareholder of CFC1 or CFC2. Accordingly, under paragraph (c)(1) of this section, US2 is not deemed to have paid any of the foreign income taxes of CFC1 or CFC2. [Prop. Reg. § 1.960-2.]

[Proposed 12-7-2018.]

Proposed Regulation

§ 1.960-3. Foreign income taxes deemed paid under section 960(b).—(a) *Scope.*—Paragraph (b) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation, or by a controlled foreign corporation, under section 960(b). Paragraph (c) of this section provides rules for the establishment and maintenance of PTEP groups within an annual PTEP account. Paragraph (d) of this section defines the term PTEP group taxes. Paragraph (e) of this section provides examples illustrating the application of this section.

(b) *Foreign income taxes deemed paid under section 960(b).*—(1) *Foreign income taxes deemed paid by a domestic corporation with respect to a section 959(a) distribution.*—If a controlled foreign corporation makes a distribution to a domestic corporation that is a United States shareholder with respect to the controlled foreign corporation and that distribution is, in whole or in part, a section 959(a) distribution with respect to a PTEP group within a section 904 category, the domestic corporation is deemed to have paid the amount of the foreign corporation's foreign income taxes that are properly attributable to the section 959(a) distribution with respect to the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.965-5(c)(1)(iii) for rules disallowing credits in relation to a distribution of certain previously taxed earnings and profits resulting from the application of section 965. For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the controlled foreign corporation's foreign income taxes that are properly attributable to section 959(a) distributions with respect to all PTEP groups within the section 904 category. See § 1.904-6(b)(2) for rules on assigning the foreign income tax to a section 904 category.

(2) *Foreign income taxes deemed paid by a controlled foreign corporation with respect to a section 959(b) distribution.*—If a controlled foreign corporation (*distributing controlled foreign corporation*) makes a distribution to another controlled foreign corporation (*recipient controlled foreign corporation*) and the distribution is, in whole or in part, a section 959(b) distribution from a PTEP group within a section 904 category, the recipient controlled foreign corporation is deemed to have paid the amount of the distributing controlled foreign corporation's foreign income taxes that are properly attributable to the section 959(b) distribution from the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.904-6(b)(3) for rules on assigning the foreign income tax to a section 904 category.

(3) *Properly attributable.*—The amount of foreign income taxes that are properly attributable to a section 959 distribution from a PTEP group within a section 904 category equals the domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to the PTEP group within the section 904 category. No other foreign income taxes are considered properly attributable to a section 959 distribution.

(4) *Proportionate share.*—A domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to a PTEP group within a section 904 category is equal to the total amount of the PTEP group taxes with respect to the PTEP group multiplied by a fraction (not to exceed one), the numerator of which is the amount of the section 959 distribution from the PTEP group, and the denominator of which is the total amount of previously taxed earnings and profits in the PTEP group, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the PTEP group taxes with respect to the PTEP group is zero.

(5) *Domestic partnerships.*—For purposes of applying this paragraph (b), in the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of a U.S. shareholder partnership's section 959(a) distribution from the partnership CFC is treated as a section 959(a) distribution received by the U.S. shareholder partner from the partnership CFC.

section 951(a)(1)(A). DP increases its section 959(c)(2) earnings and profits in its earnings and profits account with respect to its stock in FS by $70x pursuant to §1.959-3(e)(2)(i). DP increases its basis in FC from $50x to $120x pursuant to §1.961-1(b). FC increases its basis in FS from $50x to $150x pursuant to paragraph (b)(1) of this section (but only for purposes of determining FC's subpart F income with respect to DP) because if the $100x amount of subpart F income of FS that caused the $70x increase to DP's previously taxed earnings and profits account with respect to its stock in FS had been distributed to FC, the entire $100x would be excluded from FC's gross income pursuant to section 959(b) and §1.959-2(a) for purposes of determining DP's inclusion under section 951(a)(1)(A). In year 2, when FC sells FS, for purposes of determining DP's subpart F inclusion, FC is treated as recognizing $0 on the sale ($150x sale proceeds - $150x basis). Therefore, DP includes $0 in income under section 951(a)(1)(A) as a result of the sale. Although the sale does not generate gain for purposes of determining DP's subpart F inclusion, it does cause FC's non-previously taxed earnings and profits to be increased by $100x ($150x sale proceeds - $50x basis).

(c) *Translation rules.*—Rules similar to those provided in §1.961-1(c)(3) and §1.961-2(b)(3) shall apply for purposes of determining the exchange rates used to reflect any change to the basis of stock or other property under this section. [Prop. Reg. §1.961-3.]

[Proposed 8-29-2006 (corrected 12-8-2006).]

Proposed Regulation

§1.961-4. Section 304 transactions.—(a) *Deemed redemption treated as a distribution.*—(1) *In general.*—In the case of a stock acquisition described in section 304(a)(1) that is treated as a distribution of earnings and profits of a foreign acquiring corporation or a foreign issuing corporation or both, basis adjustments shall be made in accordance with the rules of §§1.961-1, 1.961-2, and 1.961-3.

(2) *Examples.*—The application of this section is illustrated by the following examples:

Example 1. Cross-chain acquisition of first-tier CFC. (i) *Facts.* DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 use the U.S. dollar as their functional currency. During year 1, F1 purchases all of the stock in F2 from DS for $80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2's stock, DP has a previously taxed earnings and profits account consisting of $20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has section 959(c)(2) earnings and profits of $20x and non-previously taxed earnings and profits of $10x. At the end of year 1, before taking into account the purchase of F2's stock, DS has a previously taxed earnings and profits account consisting of $50x of section 959(c)(2) earnings and profits with respect to its stock in F2 and F2 has section 959(c)(2) earnings and profits of $50x and non-previously taxed earnings and profits of $0. Before taking into account the purchase of F2's stock, DP's basis in F1's stock is $30x and DS's basis in F2's stock is $60x.

(ii) *Analysis.* Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for $80x, the F1 stock hypothetically issued to DS. The payment of $80x is treated as a distribution to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits ($30x), and then by F2 to the extent of its earnings and profits ($50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account of $50x with respect to its stock in F2, and DP had a previously taxed earnings and profits account of $20x with respect to its stock in F1. Under §1.959-3(h)(4)(i), DS is deemed to have a previously taxed earnings and profits account with respect to stock in F1. Under §1.959-3(g)(1), the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to F1 stock are reduced from $20x to $0. As a result, DP's basis in F1's stock is reduced from $30x to $10x under §1.961-2(a). The deemed distribution of earnings and profits by F2 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to F2 stock to be reduced from $50x to $0. Under §1.961-2(a) and §1.961-3(a), F1's basis in its newly acquired F2's stock is reduced from $60x to $10x. F1 has a transferred basis of $10x in F2's stock.

Example 2. Cross-chain acquisition of lower-tier CFC. (i) *Facts.* DP, a domestic corporation, owns all of the stock in two CFCs, FX and FY. FX owns all of the stock in FZ, a CFC. FX, FY and FZ use the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for $80x in a transaction described in section 304(a)(1). On December 31 of year 1, before taking into account the purchase of FZ's stock, FY has section 959(c)(2) earnings and profits of $20x and non-previously taxed earnings and profits of $10x, and FZ has section 959(c)(2) earnings and profits of $50x and non-previously taxed earnings and profits of $0. Before taking into account FX's purchase of FZ's stock, DP's basis in FX's stock is $60x; DP's basis in FY's stock is $30x; and FX's basis in FZ's stock, for purposes of determining the amount includible consistent with the application of paragraph (h)(4)(i) of this section.

(5) *Stock or property for which adjustments are made.*—(i) *In general.*—Except as provided in paragraph (h)(5)(ii) of this section, a specified basis adjustment is made solely with respect to section 958(a) stock owned by the section 958(a) U.S. shareholder within the meaning of section 958(a)(1)(A) or applicable property owned directly by the section 958(a) U.S. shareholder.

(ii) *Special rule for an interest in a foreign pass-through entity.*—If the applicable property of the section 958(a) U.S. shareholder described in paragraph (h)(5)(i) of this section is an interest in a foreign pass-through entity, then, for purposes of determining the foreign pass-through entity's basis in section 958(a) stock or applicable property, as applicable, with respect to the section 958(a) U.S. shareholder, a specified basis adjustment is made with respect to section 958(a) stock or applicable property of the section 958(a) U.S. shareholder owned through the foreign pass-through entity in the same manner as if the section 958(a) stock or applicable property were owned directly by the section 958(a) U.S. shareholder. In the case of tiered foreign pass-through entities, this paragraph (h)(5)(ii) applies with respect to each foreign pass-through entity.

(i) *Definitions.*—This paragraph (i) provides definitions that apply for purposes of this section.

(1) *Applicable property.*—The term *applicable property* means, with respect to a section 958(a) U.S. shareholder and a specified foreign corporation, property owned by the section 958(a) U.S. shareholder (including through one or more foreign pass-through entities) by reason of which the section 958(a) U.S. shareholder is considered under section 958(a)(2) as owning section 958(a) stock of the specified foreign corporation.

(2) *Foreign pass-through entity.*—The term *foreign pass-through entity* means a foreign partnership or a foreign estate or trust (as defined in section 7701(a)(31)) (including a controlled domestic partnership treated as a foreign partnership pursuant to § 1.965-1(e)).

(3) *Property.*—The term *property* has the meaning provided in § 1.961-1(b)(1).

(j) *Examples.*—The following examples illustrate the application of this section.

(1) *Example 1. Determination of accumulated post-1986 deferred foreign income with subpart F income earned before E&P measurement date on November 2, 2017.* (i) *Facts.* USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 all have taxable years ending December 31, 2017. As of January 1, 2017, CFC1 has no earnings and profits, and CFC2 has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC2 was a specified foreign corporation, and $21x of post-1986 foreign income taxes. None of CFC2's earnings and profits are attributable to income treated as effectively connected with the conduct of a trade or business within the United States. On March 1, 2017, CFC1 earns 30u of subpart F income (as defined in section 952), and CFC2 earns 20u of subpart F income. No foreign income tax is imposed on CFC1's or CFC2's subpart F income. For purposes of section 904, the post-1986 undistributed earnings, subpart F income, and post-1986 foreign income taxes are in the general category. On July 1, 2017, CFC2 distributes 40u to CFC1. On November 1, 2017, CFC1 distributes 60u to USP. USP does not have an aggregate foreign E&P deficit. USP includes in gross income all amounts that it is required to include under section 951. No foreign income tax is imposed or withheld on the distribution by CFC2 to CFC1 or the distribution by CFC1 to USP.

(ii) *Analysis.* (A) *Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 965.* The distribution from CFC2 to CFC1 does not give rise to subpart F income to CFC1 due to the application of section 954(c)(6). Accordingly, USP's inclusion under section 951(a)(1)(A) without regard to section 965(a) is 30u with respect to CFC1 and 20u with respect to CFC2 for their taxable years ending December 31, 2017. As a result of the inclusions under section 951(a)(1)(A), CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by 30u and 20u, respectively.

(B) *Distributions between specified foreign corporations before January 1, 2018.* The distribution of 40u from CFC2 to CFC1 is treated as a distribution of 20u out of earnings and profits described in section 959(c)(2) (attributable to inclusions under section 951(a)(1)(A) without regard to section 965(a)) and 20u out of earnings and profits described in section 959(c)(3).

(C) *Section 965(a) inclusion amount.* USP determines whether CFC1 and CFC2 are deferred foreign income corporations and, if so, determines its section 965(a) inclusion amounts with respect to CFC1 and CFC2. CFC1 and CFC2 are specified foreign corporations, and CFC1 and CFC2 each have accumulated post-1986 deferred foreign income greater than zero as of an E&P measurement date. Accordingly, CFC1 and CFC2 are deferred foreign income corporations. USP's section 965(a) inclusion amount with respect to each of CFC1 and CFC2, respectively, equals the section 965(a) earnings amount of CFC1 and CFC2, respectively.

(*1*) *CFC1 section 965(a) earnings amount.* The section 965(a) earnings amount with reforeign corporation's first taxable year following the E&P deficit foreign corporation's last taxable year that begins before January 1, 2018.

(4) *Section 902 fraction.*—The term *section 902 fraction* means, with respect to either a deferred foreign income corporation or an E&P deficit foreign corporation, the fraction that is—

(i) The dividends paid by, or the inclusion under section 951(a)(1) (including a section 965(a) inclusion) with respect to, the foreign corporation, as applicable (the *numerator*), divided by

(ii) The foreign corporation's post-1986 undistributed earnings or pre-1987 accumulated profits, as applicable (the *denominator*).

(c) *Allocation and apportionment of deductions.*—For purposes of allocating and apportioning expenses, a section 965(c) deduction does not result in any gross income, including a section 965(a) inclusion, being treated as exempt, excluded, or eliminated income within the meaning of section 864(e)(3) or §1.861-8T(d). Similarly, a section 965(c) deduction does not result in the treatment of stock as an exempt asset within the meaning of section 864(e)(3) or §1.861-8T(d). In addition, consistent with the general inapplicability of §1.861-8T(d)(2) to earnings and profits described in section 959(c)(1) or 959(c)(2), neither section 965(a) previously taxed earnings and profits nor section 965(b) previously taxed earnings and profits are treated as giving rise to gross income that is exempt, excluded, or eliminated income. Similarly, the asset that gives rise to a section 965(a) inclusion, section 965(a) previously taxed earnings and profits, or section 965(b) previously taxed earnings and profits is not treated as a tax-exempt asset.

(d) *Hovering deficits.*—In the last taxable year that begins before January 1, 2018, of a deferred foreign income corporation that is also a foreign surviving corporation, as defined in §1.367(b)-7(a), solely for purposes of determining the amount of related taxes that are included in post-1986 foreign income taxes under §1.367(b)-7(d)(2)(iii)—

(*1*) The post-transaction earnings described in §1.367(b)-7(d)(2)(ii) that can be offset by a hovering deficit include any post-transaction earnings earned in that year that were not considered accumulated because they were included in income under section 965 and §1.965-1(b)(1) by a section 958(a) U.S. shareholder; and

(*2*) Any offset for purposes of §1.367(b)-7(d)(2)(ii) is treated as occurring on the last day of the foreign surviving corporation's inclusion year. [Reg. §1.965-6.]

☐ [*T.D.* 9846, 2-4-2019.]

§1.965-7. Elections, payment, and other special rules.—(a) *Scope.*—This section provides rules regarding certain elections and payments. Paragraph (b) of this section provides rules regarding the section 965(h) election. Paragraph (c) of this section provides rules regarding the section 965(i) election. Paragraph (d) of this section provides rules regarding the section 965(m) election and a special rule for real estate investment trusts. Paragraph (e) of this section provides rules regarding the section 965(n) election. Paragraph (f) of this section provides rules regarding the election to use the alternative method for calculating post-1986 earnings and profits. Paragraph (g) of this section provides definitions that apply for purposes of this section.

(b) *Section 965(h) election.*—(1) *In general.*—Any person with a section 965(h) net tax liability (that is, a section 958(a) U.S. shareholder or a domestic pass-through owner with respect to a domestic pass-through entity that is a section 958(a) U.S. shareholder, but not a domestic pass-through entity itself) may elect under section 965(h) and this paragraph (b) to pay its section 965(h) net tax liability in eight installments. This election may be revoked only by paying the full amount of the remaining unpaid section 965(h) net tax liability.

(i) *Amount of installments.*—Except as provided in paragraph (b)(3) of this section, if a person makes a section 965(h) election, the amounts of the installments are—

(A) Eight percent of the section 965(h) net tax liability in the case of each of the first five installments;

(B) Fifteen percent of the section 965(h) net tax liability in the case of the sixth installment;

(C) Twenty percent of the section 965(h) net tax liability in the case of the seventh installment; and

(D) Twenty-five percent of the section 965(h) net tax liability in the case of the eighth installment.

(ii) *Increased installments due to a deficiency or a timely filed or amended return.*—(A) *In general.*—If a person makes a section 965(h) election, except as provided in paragraph (b)(1)(ii)(C) of this section, any deficiency or additional liability will be prorated to the installments described under paragraph (b)(1)(i) of this section if any of the following occur:

(*1*) A deficiency is assessed with respect to the person's section 965(h) net tax liability;

(*2*) The person files a return by the due date of the return (taking into account extensions, if any) increasing the amount of its section 965(h) net tax liability beyond that taken into account in paying the first installment described under paragraph (b)(1)(i) of this section; or

(*3*) The person files an amended return that reflects an increase in the amount of its section 965(h) net tax liability.

section 958(a) U.S. shareholder. CFC1's allocable share of the aggregate foreign E&P deficit is $333.33x, which is the product of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($500x ($400x + $100x)) and .67, which is the ratio determined by dividing its pro rata share of the section 965(a) earnings amount of CFC1 ($600x) by the amount described in § 1.965-1(f)(9)(ii) with respect to the single section 958(a) U.S. shareholder ($900x ($600x + $300x)). Therefore, USS1's section 965(a) inclusion amount with respect to CFC1 is $266.67 (its pro rata share of the section 965(a) earnings amount of CFC1 ($600) less CFC1's allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($333.33x)). Similarly, under § 1.965-1(b)(2), in determining the section 965(a) inclusion amount of USS2, the single section 958(a) U.S. shareholder decreases its pro rata share of the U.S. dollar amount of the section 965(a) earnings amount of CFC3 by CFC3's allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder. CFC3's allocable share of the aggregate foreign E&P deficit is $166.67x, which is the product of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($500x) and .33, which is the ratio determined by dividing its pro rata share of the section 965(a) earnings amount of CFC3 ($300x) by the amount described in § 1.965-1(f)(9)(ii) with respect to the single section 958(a) U.S. shareholder ($900x ($600x + $300x)). Therefore, USS2's section 965(a) inclusion amount with respect to CFC3 is $133.33x (its pro rata share of the section 965(a) earnings amount of CFC3 ($300x) less CFC3's allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($166.67x)).

(B) *Consolidated group aggregate foreign cash position*. Because USS1 and USS2 are members of a consolidated group, the aggregate foreign cash position of each of USS1 and USS2 is determined under paragraph (e)(3) of this section. Under paragraph (e)(3) of this section, the aggregate foreign cash position of each of USS1 and USS2 is equal to the aggregate section 965(a) inclusion amount of USS1 and USS2, respectively, multiplied by the group cash ratio of the USP Group, as determined pursuant to paragraph (f)(8) of this section. The group cash ratio of the USP Group is .50, which is the ratio of the USP Group's consolidated group aggregate foreign cash position ($200x ($50x + $100x + $50x)) and the sum of the aggregate section 965(a) inclusion amounts of all members of the USP Group ($400x ($266.67x + $133.33x)). Therefore, under paragraph (e)(3) of this section, the aggregate foreign cash positions of USS1 and USS2 are, respectively, $133.34x ($266.67x x ($200x/$400x)) and $66.67 ($133.33x x ($200x/400x)).

(C) *Section 965(c) deduction amount*. The section 965(c) deduction amount of USS1 is $177.14x, which is equal to (i) USS1's 8 percent rate equivalent percentage (77.1428571%) of its 8 percent rate amount for USS1's 2017 year ($133.33x ($266.67x - $133.34x)), plus USS1's 15.5 percent rate equivalent percentage (55.7142857%) of its 15.5 percent rate amount for USS1's 2017 year ($133.34x). The section 965(c) deduction amount of USS2 is $88.56x, which is equal to (i) USS2's 8 percent rate equivalent percentage (77.1428571%) of its 8 percent rate amount for USS2's 2017 year ($66.66x ($133.33x - $66.67x)), plus USS2's 15.5 percent rate equivalent percentage (55.7142857%) of its 15.5 percent rate amount for USS2's 2017 year ($66.67x). Because USS3 has no section 965(a) inclusion amount, it has no section 965(c) deduction amount and therefore is not allowed a section 965(c) deduction. [Reg. § 1.965-8.]

☐ [*T.D.* 9846, 2-4-2019 (*corrected* 4-9-2019).]

§ 1.965-9. Applicability dates.—(a) *In general*.—Sections 1.965-1 through 1.965-8 apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends.

(b) *Applicability dates for rules disregarding certain transactions*.—Section 1.965-4 applies regardless of whether, with respect to a foreign corporation, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in § 1.965-4 occurred before the first day of the foreign corporation's last taxable year that begins before January 1, 2018, or, with respect to a United States person, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in § 1.965-4 occurred before the first day of the taxable year of the United States person in which or with which the taxable year of the foreign corporation ends. [Reg. § 1.965-9.]

☐ [*T.D.* 9846, 2-4-2019.]

Foreign Currency

§ 1.985-1. Functional currency.—(a) *Applicability and effective date*.—(1) *Purpose and scope*.—These regulations provide guidance with respect to defining the functional currency of a taxpayer and each qualified business unit (QBU), as defined in section 989 (a). Generally, a taxpayer and each QBU must make all determinations under subtitle A of the Code (relating to income taxes) in its respective functional currency. This section sets forth rules for determining when the functional currency is the United States dollar (dollar) or a

(ii) The percentage determined in subdivision (ii) of example (2)	80%	80%
Multiplied by:		
(iii) The percentage determined in subdivision (iii) of example (3)	81%	81%
Multiplied by:		
(iv) Number of days in Z's taxable year which fall within 1969, divided by total number of days in Z's taxable year:		
181/365	49.6%	
184/365		50.4%
Totals	$9.64	$6.53

(v) Sum of tentative ratable shares of Z attributable to X's 1969 calendar year:

For Z's taxable year ending	
June 30, 1969	$ 9.64
June 30, 1970	6.53
Sum	$16.17

(4) *Deficit in tentative ratable share of lower tier corporation attributable to a taxable year of first tier corporation.*—(i) If there is a deficit in the earnings and profits accumulated for a taxable year of a lower tier corporation beginning after December 31, 1962 (computed under paragraph (b) of this section), the person's tentative ratable share for such taxable year of such lower tier corporation attributable to a taxable year of a first tier corporation shall not be computed under subparagraph (2) of this paragraph but shall be an amount equal to the sum of the partial tentative ratable shares computed under subdivisions (ii) and (iii) of this subparagraph.

(ii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustments for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year of such lower tier corporation. Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if such deficit were the amount referred to in subparagraph (2)(i)*(a)* of this paragraph.

(iii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute and treat as a deficit the portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under paragraph (d)(4) of this section to distributions of earnings and profits accumulated during prior taxable years of the lower tier corporation beginning after December 31, 1962, during the period or periods such lower tier corporation was a controlled foreign corporation and the percentage of the stock of such lower tier corporation (which the person owns within the meaning of section 958(a)(2)) was owned within the meaning of section 958(a) by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if *(a)* such deficit were the amount referred to in subparagraph (2)(i)*(a)* of this paragraph, and *(b)* such lower tier corporation were a controlled foreign corporation on each day of such taxable year.

(5) *Ratable share of lower tier corporation attributable to a first tier corporation.*—(i) If the provisions of this paragraph apply in respect of a share of stock in a first tier corporation, a person's ratable share of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be an amount equal to the tentative ratable share computed under subparagraph (2) or (4) of this paragraph, adjusted in the manner prescribed in this subparagraph.

(ii) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the excess of *(a)* the amount, if any, included (in respect of such lower tier corporation for its taxable year) under section 951 in the gross income of such person or (during the period such stock was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8) in the gross income of any other person who held such stock, over *(b)* the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1). For an illustration of the principles in the preceding sentence, see the example in paragraph (e)(2)(ii) of this section.

(iii) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be an excess average amount of the distributions with respect to the share during the three taxable years of the shareholder's holding period (or during the lesser number of taxable years in the shareholder's holding period) that immediately precede the current shareholder year. Distributions in any of the preceding three (or fewer) taxable years of the shareholder included in the shareholder's holding period that began before 1987 are included in determining the nonexcess distribution.

(ii) *Amount not included in income.*—The portion of an excess distribution in a prior taxable year that was not included in income pursuant to § 1.1291-2 (e) (2) (iii) is not treated as a distribution in that prior year for purposes of paragraph (c) (2) (i) or (iii) of this section. For an illustration of the rule of this paragraph (c) (2) (ii), *see* paragraph (e) (4), *Example 1*, of this section.

(iii) *Distributions received by predecessors.*—If a shareholder's holding period of the stock of a section 1291 fund includes the period the stock was held by another person, distributions made during the holding period of such other person with respect to the stock will be treated as if they had been received by the shareholder for purposes of paragraph (c) (2) (i) of this section.

(3) *Total excess distribution.*—(i) *In general.*—The total excess distribution with respect to a share of stock of a section 1291 fund is the excess, if any, of—

(A) The total amount of all distributions during the current shareholder year with respect to the share, over

(B) The nonexcess distribution with respect to that stock.

(ii) *Exception.*—Notwithstanding paragraph (c) (3) (i) of this section, the total excess distribution is zero for the taxable year of the shareholder in which the shareholder's holding period of the stock begins. The following example illustrates the rule of this paragraph (c) (3) (ii).

Example. On January 1, 1989, X, a U.S. person, gave his son Y, also a U.S. person, one share of stock of FC, a section 1291 fund, that X had purchased in 1986. Y purchased another share of FC stock on January 3, 1989. Y did not make the section 1295 election with respect to FC. In 1989, FC distributed $100 for each outstanding share of its stock. Pursuant to § 1.1291-2(c) (3) (ii), no portion of the distribution in respect of the share Y purchased in 1989 is treated as an excess distribution. However, the distribution paid to Y with respect to the stock given to him by his father may be wholly or partly an excess distribution. Although Y first held that share of FC stock in 1989, Y's holding period includes the period X held that share of stock, as provided in section 1223(2), and therefore does not begin in 1989.

(4) *Ratable portion.*—The total excess distribution is allocated ratably to each distribution received with respect to a share of stock during the current shareholder year. A distribution's ratable portion of the total excess distribution is the product of the total excess distribution and the ratio of the distribution to the total distribution with respect to the share of stock during the current shareholder year. Each ratable portion of the total excess distribution is an excess distribution.

(d) *Special rules.*—The following rules apply for purposes of calculating the nonexcess distribution and the total excess distribution—

(1) *Stock acquired during the year.*—In general, a distribution in a prior taxable year with respect to a share of stock may only be taken into account in determining a nonexcess distribution under paragraph (c) (2) (i) of this section if the shareholder was a shareholder at the time of such distribution, or the distribution was received by a person whose holding period of the stock is included in the shareholder's holding period. However, with respect to a prior taxable year during which a person became a shareholder, the shareholder may instead take into account the total amount (or portion thereof) that the shareholder determines was actually paid by the section 1291 fund with respect to that share of stock during that taxable year. No other annualization rule will apply under section 1291(b) (3) (C). The following example illustrates the rule of this paragraph (d) (1).

Example. R, a U.S. person, became an indirect shareholder of one share of FC stock on August 1, 1991. R did not elect under section 1295 to treat FC, a PFIC, as a QEF. R and FC both use the calendar year as their taxable years. R determines, based on dividend information provided in FC's 1991 annual report, that FC distributed $100 with respect to each outstanding share of its stock at the end of each quarter during that year. For purposes of calculating nonexcess distributions in 1992, 1993, and 1994, R may treat $400 as the amount received in 1991. If R had been unable to determine the amount distributed in 1991 before August 1, the 1991 distribution would have been limited to the $200 actually distributed after August 1 with respect to the one share of FC stock attributed to R.

(2) *Calculations for shares with same holding period.*—The calculation of the nonexcess distribution and the total excess distribution may be made on an aggregate basis for shares of stock having the same holding period (block of stock). The following example illustrates the rule of this paragraph (d) (2).

Example. (i) *Facts.* X, a U.S. person that is a calendar year taxpayer, owns 12 shares of stock of FC, a PFIC. X has not elected under section 1295 to treat FC as a QEF. X acquired two of the 12 shares on December 31, 1986 missioner's sole discretion, grant consent to make the election provided the shareholder enters into a closing agreement with the Commissioner that requires the shareholder to pay an amount sufficient to eliminate any prejudice to the United States government as a consequence of the shareholder's inability to file amended returns for closed taxable years.

(4) *Procedural requirements.*—(i) *Filing instructions.*—A shareholder requests consent under paragraph (f) of this section to make a retroactive election by filing with the Office of the Associate Chief Counsel (International) a ruling request that includes the affidavits required by this paragraph (f)(4). The ruling request must satisfy the requirements, including payment of the user fee, for ruling requests filed with that office.

(ii) *Affidavit from shareholder.*—The shareholder, or a person authorized to sign a federal income tax return on behalf of the shareholder, must submit a detailed affidavit describing the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. The shareholder's affidavit must describe the engagement and responsibilities of the qualified tax professional as well as the extent to which the shareholder relied on the tax professional. The shareholder must sign the affidavit under penalties of perjury. An individual who signs for an entity must have personal knowledge of the facts and circumstances at issue.

(iii) *Affidavits from other persons.*—The shareholder must submit detailed affidavits from individuals having knowledge or information about the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. These individuals must include the qualified tax professional upon whose advice the shareholder relied, as well as any individual (including an employee of the shareholder) who made a substantial contribution to the return's preparation, and any accountant or attorney, knowledgeable in tax matters, who advised the shareholder with regard to its ownership of the stock of the foreign corporation. Each affidavit must describe the individual's engagement and responsibilities as well as the advice concerning the tax treatment of the foreign corporation that the individual provided to the shareholder. Each affidavit also must include the individual's name, address, and taxpayer identification number, and must be signed by the individual under penalties of perjury.

(iv) *Other information.*—In connection with a request for consent under this paragraph (f), a shareholder must provide any additional information requested by the Commissioner.

(v) *Notification of Internal Revenue Service.*—The shareholder must notify the branch of the Associate Chief Counsel (International) considering the request for relief under this paragraph (f) if, while the shareholder's request for consent is pending, the Internal Revenue Service begins an examination of the shareholder's return for the retroactive election year or for any subsequent taxable year during which the shareholder holds stock of the foreign corporation.

(vi) *Who requests special consent under this paragraph (f) and who enters into a closing agreement.*—The person that requests consent under this paragraph (f) is the person that makes the section 1295 election, as provided in §1.1295-1(d). If a shareholder is required to enter into a closing agreement with the Commissioner, as described in paragraph (f)(3)(ii) of this section, rules similar to those under paragraphs (c)(4)(i)(B) through (E) of this section apply for purposes of determining the person that enters into the closing agreement.

(g) *Time for and manner of making a retroactive election.*—(1) *Time for making a retroactive election.*—(i) *In general.*—Except as otherwise provided in paragraph (g)(1)(ii) of this section, a shareholder must make a retroactive election, in the manner provided in paragraph (g)(2) of this section, on or before the due date, as extended, for the shareholder's return—

(A) In the case of a shareholder that makes a retroactive election pursuant to paragraph (b) or (e) of this section, for the taxable year in which the shareholder determines or reasonably should have determined that the foreign corporation was a PFIC; or

(B) In the case of a shareholder that obtains the consent of the Commissioner pursuant to paragraph (f) of this section, for the taxable year in which such consent is granted.

(ii) *Transition rule.*—A shareholder that files a Protective Statement for a taxable year described in paragraph (c)(5)(ii) of this section may make a retroactive election by the due date, as extended, for the return for the first taxable year ended after January 2, 1998, even if the shareholder determined or should have determined that the foreign corporation was a PFIC for a year described in paragraph (c)(5)(ii) of this section at any time on or before January 2, 1998.

(iii) *Ownership not required at time retroactive election is made.*—The shareholder need not own shares of the foreign corporation at the time the shareholder makes a retroactive election with respect to the foreign corporation.

(2) *Manner of making a retroactive election.*—A shareholder that has satisfied the requirements of paragraph (b) or (e) of this section, or a shareholder that has been granted consent under paragraph (f) of this section, must make a retroactive election in the manner provided in Form 8621 for making a section 1295 election, and must attach Form 8621 to an amended return for the later of the retroactive election year or the earliest open taxable year

tion 957). A is a United States shareholder (within the meaning of section 951(b)) with respect to FC. In 2012, A includes $40,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. On December 31, 2012, A's basis in the stock of FC for chapter 1 purposes is $500,000, which includes an increase to basis under section 961(a) of $40,000. The amount of FC's earnings and profits that are described in section 959(c)(2) is $40,000, the amount of FC's earnings and profits that are described in section 959(c)(3) is $20,000, and FC does not have any earnings and profits that are described in section 959(c)(1). No election is made under paragraph (g) of this section. During 2013, A does not include any amounts in income under section 951(a) with respect to FC, A does not receive any distributions from FC, and there is no change in the amount of FC's earnings and profits. In 2014, A includes $10,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by $10,000 to $510,000 pursuant to section 961(a). During 2015, FC distributes $30,000 to A, which is not treated as a dividend for purposes of chapter 1 under section 959(d). As a result, A's basis in the stock of FC for chapter 1 purposes is decreased by $30,000 to $480,000 pursuant to section 961(b).

(ii) *Results for section 1411 purposes.* In 2014, A does not include the $10,000 section 951(a) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and §1.1411-4(a)(1)(i). Pursuant to paragraph (e)(1)(iii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by $10,000 in 2014, and pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis is not increased by $10,000 and remains at $500,000. In 2015, pursuant to paragraph (c)(2)(i) of this section, A includes $10,000 of the distribution of previously taxed earnings and profits as a dividend for purposes of determining A's net investment income because $10,000 of the $30,000 distribution is attributable to amounts that A included in gross income for chapter 1 purposes under section 951(a) in a tax year that began after December 31, 2012. Pursuant to paragraph (e)(1)(i) of this section, A increases A's modified adjusted gross income for section 1411 purposes by $10,000 in 2015. Under paragraph (d)(1)(i) of this section, A's adjusted basis is not decreased by the $10,000 that is treated as a dividend for section 1411 purposes, and thus, A's adjusted basis in FC for section 1411 purposes is decreased under section 961 only by $20,000 to $480,000.

Example 2. (i) *Facts.* Same facts as *Example 1.* In addition, during 2016, A includes $15,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by $15,000 to $495,000 pursuant to section 961(a). During 2017, A sells all of A's shares of FC for $550,000 and, prior to the application of section 1248, recognizes $55,000 ($550,000 minus $495,000) of long-term capital gain for chapter 1 purposes. For purposes of calculating the amount included in income as a dividend pursuant to section 1248(a) for chapter 1 purposes, the earnings and profits of FC attributable to A's shares in FC which were accumulated after December 31,1962 and during the period which A held the stock while FC was a controlled foreign corporation is $55,000, $35,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for chapter 1 purposes, upon the sale of the FC stock, A recognizes $35,000 of long-term capital gain and a $20,000 dividend.

(ii) *Results for section 1411 purposes.* (A) In 2016, A does not include the $15,000 section 951(a)(1)(A) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and §1.1411-1(a)(1)(i). Pursuant to paragraph (e)(1)(ii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by $15,000, and, pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis remains at $480,000.

(B) During 2017, prior to the application of section 1248, A recognizes $70,000 ($550,000 minus $480,000) of gain for section 1411 purposes. Pursuant to paragraph (c)(3) of this section, for section 1411 purposes, section 1248(a) applies to the gain on the sale of FC calculated for section 1411 purposes ($70,000) and section 1248(d)(1) does not apply, except with respect to the $20,000 of earnings and profits of FC that are attributable to amounts previously included in income for chapter 1 purposes under section 951 for a taxable year beginning before December 31, 2012. Accordingly, for purposes of calculating the amount of income includible as a dividend under section 1248(a), A has $55,000 of earnings and profits, $20,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for section 1411 purposes A has $35,000 of long-term capital gain and a $35,000 dividend. For purposes of calculating net investment income in 2017, A includes $35,000 as a dividend under section 1411(c)(1)(A)(i) and §1.1411-4(a)(1)(i) and $35,000 as a gain under section 1411(c)(1)(A)(iii) and §1.1411-4(a)(1)(iii).

Example 3. (i) *Facts.* Same facts as *Example 2,* except that A timely makes an election under paragraph (g)(4)(i) of this section for 2014 (and thus for all subsequent years).

(ii) *Results for section 1411 purposes.* A does not have any adjustments to A's modified adjusted gross income for section 1411 purposes for 2014, 2015, 2016 or 2017 because the election under paragraph (g)(4)(i) of this section was timely made. Pursuant to paragraph (g)(2) of this section, for purposes of calculating A's under this paragraph (c)(6) as if the amount were income.

(ii) *Special rules.*—(A) *General rule.*—The beneficial owners of income paid to an entity described in this paragraph (c)(6)(ii) are those persons described in paragraphs (c)(6)(ii)(B) through (D) of this section.

(B) *Foreign partnerships.*—The beneficial owners of income paid to a foreign partnership (whether a nonwithholding or a withholding foreign partnership) are the partners in the partnership, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6). For example, a partnership (first tier) that is a partner in another partnership (second tier) is not the beneficial owner of income paid to the second tier partnership since the first tier partnership is not the owner of the income under U.S. tax principles. Rather, the partners of the first tier partnership are the beneficial owners (to the extent they are not themselves persons that are not beneficial owners under this paragraph (c)(6)). See §1.1441-5(b) for applicable withholding procedures for payments to a domestic partnership. See also §1.1441-5(c)(3)(ii) for applicable withholding procedures for payments to a foreign partnership where one of the partners (at any level in the chain of tiers) is a domestic partnership.

(C) *Foreign simple trusts and foreign grantor trusts.*—The beneficial owners of income paid to a foreign simple trust, as described in paragraph (c)(23) of this section, are the beneficiaries of the trust, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6). The beneficial owners of income paid to a foreign grantor trust, as described in paragraph (c)(26) of this section, are the persons treated as the owners of the trust, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6).

(D) *Other foreign trusts and foreign estates.*—The beneficial owner of income paid to a foreign complex trust as defined in paragraph (c)(25) of this section or to a foreign estate is the foreign complex trust or estate itself.

(7) *Withholding agent.*—For a definition of the term *withholding agent* and applicable rules, see §1.1441-7.

(8) *Person.*—For purposes of the regulations under chapter 3 of the Code, the term *person* shall mean a person described in section 7701(a)(1) and the regulations under that section and a U.S. branch to the extent treated as a U.S. person under paragraph (b)(2)(iv) of this section. For purposes of the regulations under chapter 3 of the Code, the term *person* does not include a wholly-owned entity that is disregarded for federal tax purposes under §301.7701-2(c)(2) of this chapter as an entity separate from its owner. See paragraph (b)(2)(iii) of this section for procedures applicable to payments to such entities.

(9) *Source of income.*—The source of income is determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code and the regulations under those provisions.

(10) *Chapter 3 of the Code (or chapter 3).*—For purposes of the regulations under sections 1441, 1442, and 1443, any reference to chapter 3 of the Code (or chapter 3) shall not include references to sections 1445 and 1446, unless the context indicates otherwise.

(11) *Reduced rate.*—For purposes of regulations under chapter 3 of the Code, and other withholding provisions of the Code, the term *reduced rate*, when used in regulations under chapter 3 of the Code, shall include an exemption from tax.

(12) *Payee.*—For purposes of chapter 3 of the Code, the term payee of a payment is determined under paragraph (b)(2) of this section, §1.1441-5(c)(1) (relating to partnerships), and §1.1441-5(e)(2) and (3) (relating to trusts and estates) and includes foreign persons, U.S. exempt recipients, and U.S. non-exempt recipients. A nonqualified intermediary and a qualified intermediary (to the extent it does not assume primary withholding responsibility) are not payees if they are acting as intermediaries and not the beneficial owner of income. In addition, a flow-through entity (other than a withholding foreign partnership, withholding foreign trust, or qualified intermediary that assumes primary withholding responsibility) is not a payee unless the income is (or is deemed to be) effectively connected with the conduct of a trade or business in the United States. See §1.6049-5(d)(1) for rules to determine the payee for purposes of chapter 61 of the Code. See §§1.1441-1(b)(3), 1.1441-5(d), and (e)(6) and §1.6049-5(d)(3) for presumption rules that apply if a payee's identity cannot be determined on the basis of valid documentation. For purposes of chapter 4, the term payee has the meaning set forth in §1.1471-3(a) with respect to a withholdable payment.

(13) *Intermediary.*—An *intermediary* means, with respect to a payment that it receives, a person that, for that payment, acts as a custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether such other person is the beneficial owner of the amount paid, a flow-through entity, or another intermediary.

(14) *Nonqualified intermediary.*—A *nonqualified intermediary* means any intermediary that is not a U.S. person and not a qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, or a qualified intermediary that is not acting in its capacity as a qualified intermediary with respect to a payment. For example, to the extent an entity that is a qualified