

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9521]

RIN 1545-BG54

Reduction of Foreign Tax Credit Limitation Categories under Section 904(d)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide guidance relating to the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Internal Revenue Code. Changes to the applicable law were made by the American Jobs Creation Act of 2004 (AJCA) reducing the number of section 904(d) separate categories from eight to two, effective for taxable years beginning after December 31, 2006. The final regulations provide guidance needed to comply with these changes and affect individuals and corporations claiming foreign tax credits.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability see §§1.904-2(i)(3), 1.904-4(n), 1.904-5(o)(3), 1.904-7(g)(6), and 1.904(f)-12(h)(6).

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 21, 2007, a notice of proposed rulemaking by cross-reference to temporary regulations (REG-114126-07) under section 904 of the Code and temporary regulations (TD 9368) (the 2007 temporary regulations) were published in the **Federal Register** (72 FR 72645) and (72 FR 72582), respectively. Corrections to those temporary regulations were published on March 21, 2008, in the **Federal Register** (73 FR 15063). No written comments were received. A public hearing was not requested and none was held. This Treasury decision adopts the proposed regulation with the changes discussed in this preamble.

Explanation of Changes in this Final Rule

I. Gain from the Sale of a Partnership Interest

Section 954(c)(4), which was enacted by the AJCA, provides a look-through rule for sales of 25-percent-owned partnerships. Because the definition of passive income in section 904(d)(2)(B) refers to section 954(c), §1.904-5T(h)(3)(ii) of the 2007 temporary regulations provides that in the case of a sale of a partnership interest by a 25-percent partner, under the principles of section 954(c)(4)(B) the income recognized on such sale is assigned to the separate category for general category income, to the extent that the gain would not be classified as foreign personal holding company income under the section 954(c)(4) look-through rule. The rule has been revised to clarify that the look-through rule applies to a sale by any 25-percent owner of a partnership (and

not just controlled foreign corporations that are 25-percent partners). The language of this provision has also been revised to be more consistent with the language of the look-through rule as provided under section 954(c)(4).

II. Losses in and Losses with respect to the Pre-2007 Separate Category for High Withholding Tax Interest

Section 1.904(f)-12T(h) of the 2007 temporary regulations provides transition rules for recapture in a taxable year beginning after December 31, 2006 (post-2006 taxable year) of an overall foreign loss (OFL) or separate limitation loss (SLL) in a pre-2007 separate category (as defined in §1.904-7T(g)(ii)) that offset U.S. source income or income in another pre-2007 separate category, respectively. Section 1.904(f)-12T(h)(3) provides that to the extent a taxpayer had an OFL or SLL at the end of the taxpayer's last pre-2007 taxable year in the pre-2007 separate category for high withholding tax interest, the allocation of such OFL or SLL to the taxpayer's post-2006 separate categories follows the taxpayer's allocation of excess taxes in the high withholding tax interest loss category for section 904(c) carryover purposes. If there were no excess taxes in the loss category that carried over to post-2006 taxable years, an OFL or SLL in the pre-2007 separate category for high withholding tax interest is allocated to the post-2006 separate category for passive category income. Similarly, §1.904(f)-12T(h)(3) provides that where a taxpayer had an SLL in a pre-2007 separate category that offset high withholding tax interest (that is, an SLL with respect to a pre-2007 separate category for high withholding tax interest), the SLL will be recaptured in subsequent taxable years pro rata as income in the post-2006 separate categories for general category income and passive category income based on how the taxpayer

allocated excess taxes in the pre-2007 separate category for high withholding tax interest. If no excess taxes in the pre-2007 separate category for high withholding tax interest were carried over to post-2006 taxable years, the SLL will be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income.

A question was raised as to whether it was appropriate, in the case of a financial services entity that had a loss in, or a loss with respect to, a pre-2007 separate category for high withholding tax interest, and no excess taxes in the loss category were carried over to post-2006 taxable years, that the loss be allocated to the post-2006 separate category for passive category income (in the case of a loss in the pre-2007 separate category for high withholding tax interest) or that the loss be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income (in the case of a loss with respect to a pre-2007 separate category for high withholding tax interest).

Section 904(d)(2)(C)(i), as amended by the AJCA, provides that financial services income is treated as general category income in the case of a member of a financial services group and any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business (a financial services entity). Financial services income includes passive income that is received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, but does not include specified passive category income. See section 904(d)(2)(D)(i)(II). Accordingly, in post-2006 taxable years, income that otherwise would be treated as passive income (and assigned to the separate category

for passive category income) will instead be treated as general category income in the case of a financial services entity.

The IRS and the Treasury Department believe that, in the case of a financial services entity, the appropriate treatment of a loss in, or a loss with respect to, a pre-2007 separate category for high withholding tax interest, where no excess taxes in the loss category were carried over to post-2006 taxable years, is to allocate the loss to the post-2006 separate category for general category income or to recapture the loss in subsequent years as general category income, as the case may be. Accordingly, the regulations have been revised to provide that if a financial services entity allocated under §1.904(f)-12T(h)(3) an OFL or SLL at the end of its last pre-2007 taxable year in the pre-2007 separate category for high withholding tax interest to the post-2006 separate category for passive category income, and no excess taxes in the loss category were carried over to post-2007 taxable years, the amount of any such loss that has not yet been recaptured will be allocated to the post-2006 separate category for general category income. Similarly, if a financial services entity allocated under §1.904(f)-12T(h)(3) at the end of its last pre-2007 taxable year an SLL with respect to a pre-2007 separate category for high withholding tax interest, and no excess taxes in the separate category for high withholding tax interest were carried over to post-2007 taxable years (that is, the SLL would be subject to recapture as passive category income), the amount of any such SLL that has not yet been recaptured will be recaptured in subsequent taxable years as general category income. The regulations have also been revised to clarify that, in the case of a financial services entity, to the extent an SLL in the post-2006 separate category for general category income is

recaptured as income in the post-2006 separate category for passive category income, the amount that would otherwise be recaptured as passive income (as opposed to specified passive category income) will be recaptured as general category income.

III. Section 952(c) Recapture Accounts

Section 1.904-7(g)(3) of the final regulations clarifies that section 952(c)(2) recapture accounts maintained by a controlled foreign corporation with respect to subpart F income in a separate category that was subject to the earnings and profits limitation of section 952(c)(1)(A) are allocated to separate categories in the same manner as the associated post-1986 undistributed earnings.

IV. Safe Harbors

The 2007 temporary regulations provide several safe harbors that a taxpayer may apply in lieu of generally applicable rules. Section 1.904-2T(i)(1)(ii) provides a safe harbor for the carryover of unused foreign taxes in a pre-2007 separate category to a post-2006 separate category; §1.904-2T(i)(2)(ii) provides a safe harbor for the carryback of unused foreign taxes in a post-2006 separate category to a pre-2007 separate category; §1.904-7T(g)(3)(ii) provides safe harbors for allocating pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the pre-2007 separate categories of controlled foreign corporations and noncontrolled section 902 corporations to the post-2006 separate categories; and §1.904(f)-12T(h)(5) provides an alternative method for determining the recapture in post-2006 taxable years of separate limitation losses and overall foreign losses incurred in pre-2007 taxable years.

A question was raised as to how a safe harbor method election is to be made and the time frame for making the election. The final regulations provide that taxpayers

may choose to use a safe harbor method on a timely filed (original or amended) tax return or during audit. If a taxpayer chooses to use the safe harbor method on an amended return or in the course of an audit, the taxpayer must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by simply employing the method in determining its foreign tax credit limitation. No separate statement need be filed.

V. Effective/Applicability Dates

The effective/applicability dates are the same as those in the proposed and temporary regulations with minor clarifying changes.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

The principal author of these regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.904-0 is amended by adding entries for §§1.904-2(i), 1.904-4(a), (b), (h)(3), and (l), 1.904-5(h)(3) and (o)(3), and 1.904-7(g) to read as follows:

§1.904-0 Outline of regulation provisions for section 904.

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§1.904-2 Carryback and carryover of unused foreign tax.

* * * * *

(i) Transition rules for carryovers and carrybacks of pre-2007 and post-2006 unused foreign tax.

(1) Carryover of unused foreign tax.

(i) General rule.

(ii) Safe harbor.

(2) Carryback of unused foreign tax.

(i) General rule.

(ii) Safe harbor.

(3) Effective/applicability date.

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§1.904-4 Separate application of section 904 with respect to certain categories of income.

(a) In general.

(b) Passive category income.

(1) In general.

(2) Passive income.

(i) In general.

(ii) Exceptions.

(iii) Active rents or royalties.

(A) In general.

(B) Active conduct of trade or business.

(iv) Examples.

(3) Specified passive category income.

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(h) * * *

(3) Exception.

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(l) Priority rule.

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§1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.

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(h) * * *

(3) Income from the sale of a partnership interest.

(i) In general.

(ii) Exception for sale by 25-percent owner.

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(o) * * *

(3) Rules for income from the sale of a partnership interest.

§1.904-7 Transition rules.

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(g) Treatment of earnings and foreign taxes of a controlled foreign corporation or a noncontrolled section 902 corporation accumulated in taxable years beginning before January 1, 2007.

(1) Definitions.

(i) Pre-2007 pools.

(ii) Pre-2007 separate categories.

(iii) Post-2006 separate categories.

(2) Treatment of pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation.

(3) Substantiation of post-2006 character of earnings and taxes in a pre-2007 pool.

(i) Reconstruction of earnings and taxes pools.

(ii) Safe harbor method.

(A) In general.

(B) General safe harbor method.

(C) Interest apportionment safe harbor.

(iii) Consistency rule.

(4) Treatment of pre-1987 accumulated profits.

(5) Treatment of earnings and foreign taxes in pre-2007 pools of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation.

(6) Effective/applicability date.

Par. 3. Section 1.904-2(i) is revised to read as follows:

§1.904-2 Carryback and carryover of unused foreign tax.

* * * * *

(i) Transition rules for carryovers and carrybacks of pre-2007 and post-2006 unused foreign tax--(1) Carryover of unused foreign tax--(i) General rule. For purposes of this paragraph (i), the terms post-2006 separate category and pre-2007 separate category have the meanings set forth in §1.904-7(g)(1)(ii) and (iii). The rules of this paragraph (i)(1) apply to reallocate to the taxpayer's post-2006 separate categories for general category income and passive category income any unused foreign taxes (as defined in §1.904-2(b)(2)) that were paid or accrued or deemed paid under section 902 with respect to income in a pre-2007 separate category (other than a category described in §1.904-4(m)). To the extent any such unused foreign taxes are carried forward to a taxable year beginning after December 31, 2006, such taxes shall be allocated to the taxpayer's post-2006 separate categories to which those taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning after December 31, 2006. For example, any foreign taxes paid or accrued or deemed paid with respect to financial services income in a taxable year beginning before January 1, 2007, that are carried forward to a taxable year beginning after December 31, 2006, will be allocated to the general category because the financial services income to which those taxes relate would have been allocated to the general category if it had been earned in a taxable year beginning after December 31, 2006.

(ii) Safe harbor. In lieu of applying the rules of paragraph (i)(1)(i) of this section, a taxpayer may allocate all unused foreign taxes in the pre-2007 separate category for passive income to the post-2006 separate category for passive category income, and allocate all other unused foreign taxes described in paragraph (i)(1)(i) of this section to the post-2006 separate category for general category income. A taxpayer may choose

to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(2) Carryback of unused foreign tax--(i) General rule. The rules of this paragraph (i)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to income in a post-2006 separate category (other than a category described in §1.904-4(m)). To the extent any such unused foreign taxes are carried back to a taxable year beginning before January 1, 2007, a credit for such taxes shall be allowed only to the extent of the excess limitation in the pre-2007 separate category, or categories, to which the taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning before January 1, 2007. For example, any foreign taxes paid or accrued or deemed paid with respect to income in the general category in a taxable year beginning after December 31, 2006, that are carried back to a taxable year beginning before January 1, 2007, will be allocated to the same separate categories to which the income would have been allocated if such income had been earned in a taxable year beginning before January 1, 2007.

(ii) Safe harbor. In lieu of applying the rules of paragraph (i)(2)(i) of this section, a taxpayer may allocate all unused foreign taxes in the post-2006 separate category for passive category income to the pre-2007 separate category for passive income, and may allocate all other unused foreign taxes described in paragraph (i)(2)(i) of this

section to the pre-2007 separate category for general limitation income. A taxpayer may choose to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(3) Effective/applicability date. This paragraph (i) applies to taxable years beginning after December 31, 2006 and ending on or after December 21, 2007.

§1.904-2T [Removed].

Par. 4. Section 1.904-2T is removed.

Par. 5. In §1.904-4, paragraphs (a), (b), (h)(3), and (l) are revised, paragraphs (f) and (g) are removed and reserved, and a new sentence is added immediately after the heading of paragraph (n) to read as follows:

§1.904-4 Separate application of section 904 with respect to certain categories of income.

(a) In general. A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive category income), 904(d)(1)(B) (general category income), or §1.904-4(m) (additional separate categories).

(b) Passive category income--(1) In general. The term passive category income means passive income and specified passive category income.

(2) Passive income--(i) In general. The term passive income means any--

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 1293.

(ii) Exceptions. Passive income does not include any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high-taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the look-through rules of section 904(d)(3), (d)(4), and (d)(6)(C) and the regulations under those provisions. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d)(5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related person factoring income may be eligible for the exception for export financing interest.

(iii) Active rents or royalties--(A) In general. For rents and royalties paid or accrued after September 20, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of

whether such rents or royalties are received from a related or an unrelated person. Except as provided in paragraph (b)(2)(iii)(B) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term taxpayer shall be substituted for the term controlled foreign corporation if the recipient of the rents or royalties is not a controlled foreign corporation.

(B) Active conduct of trade or business. Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(iii)(B), an affiliated group includes only domestic corporations and foreign corporations that are controlled foreign corporations in which domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock. For purposes of this paragraph (b)(2)(iii)(B), indirect ownership shall be determined under section 318 and the regulations under that section.

(iv) Examples. The following examples illustrate the application of paragraph (b)(2) of this section.

Example 1. P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 2008, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign corporation because the gain is directly related to the business needs

of P. The currency gain is, therefore, general category income to P because it is not income of a kind that would be foreign personal holding company income.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of §1.904-5 to the royalties S receives from the franchisees. Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general category income to S under §1.904-4(b)(2)(iii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general category income to P under the look-through rules of §1.904-5(c)(1)(i) and (c)(3), respectively.

(3) Specified passive category income means--

(i) Dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States;

(ii) Taxable income attributable to foreign trade income (within the meaning of section 923(b)); or

(iii) Distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b)).

* * * * *

(f) [Reserved].

(g) [Reserved].

(h) * * *

(3) Exception. Unless it is received or accrued by a financial services entity, export financing interest shall be treated as passive category income if that income is also related person factoring income. For this purpose, related person factoring income is--

(i) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(ii) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

* * * * *

(l) Priority rule. Income that meets the definitions of a separate category described in paragraph (m) of this section and another category of income described in section 904(d)(2)(A)(i) and (ii) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general category income described in section 904(d)(2)(A)(ii).

* * * * *

(n) * * * Paragraphs (a), (b), (h)(3), and (l) of this section shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its

domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007. * * *

§1.904-4T [Removed].

Par. 6. Section 1.904-4T is removed.

Par. 7. In §1.904-5, paragraphs (h)(3) and (o)(3) are revised to read as follows:

§1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.

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(h) * * *

(3) Income from the sale of a partnership interest--(i) In general. To the extent a partner recognizes gain on the sale of a partnership interest, that income shall be treated as passive category income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(B)(iii)(II) and §1.904-4(c).

(ii) Exception for sale by 25-percent owner. In the case of a sale of an interest in a partnership by a partner that is a 25-percent owner of the partnership, determined by applying section 954(c)(4)(B) and substituting “controlled foreign corporation” with “partner” every place it appears, for purposes of determining the separate category to which the income recognized on the sale of the partnership interest is assigned such partner shall be treated as selling the proportionate share of the assets of the partnership attributable to such interest.

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(o) * * *

(3) Rules for income from the sale of a partnership interest. Paragraph (h)(3) of this section shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

§1.904-5T [Removed].

Par. 8. Section 1.904-5T is removed.

Par. 9. Section 1.904-7, paragraph (g) is revised to read as follows:

§1.904-7 Transition rules.

* * * * *

(g) Treatment of earnings and foreign taxes of a controlled foreign corporation or a noncontrolled section 902 corporation accumulated in taxable years beginning before January 1, 2007--(1) Definitions--(i) Pre-2007 pools means the pools in each separate category of post-1986 undistributed earnings (as defined in §1.902-1(a)(9)) that were accumulated, and post-1986 foreign income taxes (as defined in §1.902-1(a)(8)) paid, accrued, or deemed paid, in taxable years beginning before January 1, 2007.

(ii) Pre-2007 separate categories means the separate categories of income described in section 904(d) as applicable to taxable years beginning before January 1, 2007, and any other separate category of income described in §1.904-4(m).

(iii) Post-2006 separate categories means the separate categories of income described in section 904(d) as applicable to taxable years beginning after December 31, 2006, and any other separate category of income described in §1.904-4(m).

(2) Treatment of pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation. Any post-1986 undistributed earnings in a pre-2007 pool of a controlled foreign corporation or a noncontrolled section 902 corporation shall be treated in taxable years beginning after December 31, 2006, as if they were accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Post-1986 foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories (including the rules of section 904(d)(3)(E)) applied as well. Any such earnings and taxes in pre-2007 pools shall constitute the opening balance of the foreign corporation's post-1986 undistributed earnings and post-1986 foreign income taxes on the first day of the foreign corporation's first taxable year beginning after December 31, 2006, in accordance with the rules of paragraph (g)(3) of this section. Similar rules shall apply to characterize any deficits in the pre-2007 pools and previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to earnings in the pre-2007 pools. Any section 952(c)(2) recapture account with respect to a separate category shall be allocated in the same manner as the post-1986 undistributed earnings in the associated pre-2007 pool.

(3) Substantiation of post-2006 character of earnings and taxes in a pre-2007 pool--(i) Reconstruction of earnings and taxes pools. In order to substantiate the post-2006 characterization of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation, the

taxpayer shall make a reasonable, good-faith effort to reconstruct the pre-2007 pools of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes following the rules governing the determination of post-2006 separate categories for each taxable year beginning before January 1, 2007, beginning with the first year in which post-1986 undistributed earnings were accumulated in the pre-2007 pool. Reconstruction shall be based on reasonably available books and records and other relevant information. To the extent any pre-2007 separate category includes earnings that would be allocated to more than one post-2006 separate category, the taxpayer must account for earnings distributed and taxes deemed paid in these years for such category as if they were distributed and deemed paid pro rata from the amounts that were added to that category during each taxable year beginning before January 1, 2007.

(ii) Safe harbor method--(A) In general. Subject to the rules of paragraph (g)(3)(iii) of this section, a taxpayer may allocate the post-1986 undistributed earnings and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation (as well as deficits and previously-taxed earnings, if any) under one of the safe harbor methods described in paragraphs (g)(3)(ii)(B) and (g)(3)(ii)(C) of this section. A taxpayer may choose to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to

use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(B) General safe harbor method--(1) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC shall be allocated to the post-2006 separate category for passive category income.

(2) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for financial services income, shipping income or general limitation income shall be allocated to the post-2006 separate category for general category income.

(3) Except as provided in paragraph (g)(3)(ii)(B)(4) of this section, any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for high withholding tax interest shall be allocated to the post-2006 separate category for passive category income.

(4) If a controlled foreign corporation has positive post-1986 undistributed earnings and post-1986 foreign income taxes in a pre-2007 separate category for high withholding tax interest, such earnings and taxes shall be allocated to the post-2006

separate category for general category income if the earnings would qualify as income subject to high foreign taxes under section 954(b)(4) if the entire amount of post-1986 undistributed earnings were treated as a net item of income subject to the rules of §1.954-1(d). If the high withholding tax interest earnings would not qualify as income subject to high foreign taxes under section 954(b)(4), then the earnings and taxes shall be allocated to the post-2006 separate category for passive category income.

(C) Interest apportionment safe harbor. A taxpayer may allocate the post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation following the principles of paragraph (f)(4)(ii) of this section.

(iii) Consistency rule. The election to apply a safe harbor method under paragraph (g)(3)(ii) of this section in lieu of the rules described in paragraph (g)(3)(i) of this section may be made on a separate category by separate category basis. However, if a taxpayer elects to apply a safe harbor to allocate pre-2007 pools of more than one pre-2007 separate category of a controlled foreign corporation or a noncontrolled section 902 corporation, such safe harbor (the general safe harbor described in paragraph (g)(3)(ii)(B) of this section or the interest apportionment safe harbor described in paragraph (g)(3)(ii)(C) of this section) shall apply to allocate post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes for the pre-2007 pools in each pre-2007 separate category of the foreign corporation for which the taxpayer elected to apply a safe harbor method in lieu of reconstructing the pre-2007 pools.

(4) Treatment of pre-1987 accumulated profits. Any pre-1987 accumulated profits (as defined in §1.902-1(a)(10)) of a noncontrolled section 902 corporation or a controlled foreign corporation shall be treated in taxable years beginning after December 31, 2006, as if they had been accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories applied as well. The taxpayer must substantiate the post-2006 characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes in accordance with the rules of paragraph (g)(3) of this section, including the safe harbor provisions. Similar rules shall apply to characterize any deficits or previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to pre-1987 accumulated profits.

(5) Treatment of earnings and foreign taxes in pre-2007 pools of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation. The rules of paragraphs (g)(1) through (4) of this section apply to post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools, and pre-1987 accumulated profits and pre-1987 foreign income taxes, of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation.

(6) Effective/applicability date. This paragraph (g) shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of

a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

§1.904-7T [Removed].

Par. 10. Section 1.904-7T is removed.

Par. 11. Section 1.904(f)-0 is amended by adding an entry for §1.904(f)-12(h) to read as follows:

§1.904(f)-0 Outline of regulation provisions.

* * * * *

§1.904(f)-12 Transition rules.

* * * * *

(h) Recapture in years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2007.

(1) Losses related to pre-2007 separate categories for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(2) Losses related to pre-2007 separate categories for shipping, financial services income or general limitation income.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for shipping income, financial services income or general limitation income.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income.

(3) Losses related to a pre-2007 separate category for high withholding tax interest.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for high withholding tax interest.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for high withholding tax interest.

(4) Elimination of certain separate limitation loss accounts.

(5) Alternative method.

(6) Effective/applicability date.

Par. 12. Section 1.904(f)-12(h) is revised to read as follows:

§1.904(f)-12 Transition rules.

* * * * *

(h) Recapture in years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2007--

(1) Losses related to pre-2007 separate categories for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC--(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category (as defined in §1.904-7(g)(1)(ii)) for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC, at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category (as defined in §1.904-7(g)(1)(iii)) for passive category income.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or

former FSC. To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income.

(2) Losses related to pre-2007 separate categories for shipping, financial services income or general limitation income--(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for shipping income, financial services income or general limitation income. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category for general category income.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income. To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be

recaptured in subsequent taxable years as income in the post-2006 separate category for general category income.

(3) Losses related to a pre-2007 separate category for high withholding tax interest--(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for high withholding tax interest. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for high withholding tax interest at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year on a pro rata basis to the taxpayer's post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the same pre-2007 separate category for high withholding tax interest are allocated under §1.904-2(i)(1). If the taxpayer, other than a financial services entity as defined in §1.904-4(e)(3), has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then any loss account balance in that category shall be allocated to the post-2006 separate category for passive category income. If the taxpayer is a financial services entity, as defined in §1.904-4(e)(3), and has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then any loss account balance in that category shall be allocated to the post-2006 separate category for general category income.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for high withholding tax interest. To the extent that a taxpayer has a balance in a separate limitation loss account in any pre-2007 separate category with respect to a

pre-2007 separate category for high withholding tax interest at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years on a pro rata basis as income in the post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the pre-2007 separate category for high withholding tax interest are allocated under §1.904-2(i)(1). If the taxpayer, other than a financial services entity as defined in §1.904-4(e)(3), has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then the loss account balance shall be recaptured in subsequent taxable years solely as income in the post-2006 separate category for passive category income. If the taxpayer is a financial services entity, as defined in §1.904-4(e)(3), and has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then the loss account balance shall be recaptured in subsequent taxable years solely as income in the post-2006 separate category for general category income.

(4) Elimination of certain separate limitation loss accounts. After application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for passive category income for which income is to be recaptured as passive category income, as determined under those same provisions, shall be eliminated. Similarly, after application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for general category income for which income is to be recaptured as general category income, as determined under those same provisions, shall be eliminated.

(5) Alternative method. In lieu of applying the rules of paragraphs (h)(1) through (h)(3) of this section, a taxpayer may apply the principles of paragraphs (g)(1) and (g)(2) of this section to determine recapture in taxable years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in taxable years beginning before January 1, 2007. A taxpayer may choose to use the alternative method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the alternative method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the alternative method to years that are not open for assessment. A taxpayer's choice to use the alternative method is evidenced by employing the method. The taxpayer need not file any separate statement.

(6) Effective/applicability date. This paragraph (h) shall apply to taxable years beginning after December 31, 2006, and ending on or after December 21, 2007. However, taxpayers may choose to apply 26 CFR 1.904(f)-12T(h) as it appeared in the Code of Federal Regulations as of April 1, 2010, in lieu of this paragraph (h) to taxable years beginning after December 31, 2006 and ending on or after December 21, 2007, but ending before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** provided that appropriate adjustments are made to eliminate duplicate benefits arising from application of 26 CFR 1.904(f)-12T(h) to taxable years that are not open for assessment. In addition, if a taxpayer that is a financial services entity (as defined in §1.904-4(e)(3)) chooses to apply 26 CFR 1.904(f)-12T(h) to taxable years ending before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, then as of the beginning of the taxpayer's first taxable year

ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** any remaining balance in a passive category loss account that is attributable to a loss account in a pre-2007 separate category for high withholding tax interest shall be allocated to the general category or eliminated pursuant to §1.904(f)-12(h)(4), and any remaining balance in a separate limitation loss account with respect to passive category income that is attributable to a loss account with respect to a pre-2007 separate category for high withholding tax interest will be recaptured in such year and subsequent taxable years as general category income or eliminated pursuant to §1.904(f)-12(h)(4).

§1.904(f)-12T [Removed].

Par.13. Section 1.904(f)-12T is removed.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: March 29, 2011

Michael Mundaca
Assistant Secretary of the Treasury (Tax Policy).