
Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

26 CFR 1.902-1: Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

T.D. 8708

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Computation of Foreign Taxes Deemed Paid Under Section 902 Pursuant to a Pooling Mechanism for Undistributed Earnings and Foreign Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final income tax regulations relating to the computation of foreign taxes deemed paid under section 902. Changes to the applicable law were made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). These regulations provide guidance needed to comply with these changes and affect foreign corporations and their United States corporate shareholders.

DATES: These regulations are effective January 7, 1997.

Applicability: For the specific dates of applicability of these regulations, see §§ 1.902-1(g) and 1.902-3(l).

FOR FURTHER INFORMATION CONTACT: Caren S. Shein (202) 622-3850 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number

1545-1458. Responses to these collections of information are required by the IRS to implement the section 902 pooling regime enacted in the Tax Reform Act of 1986.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The burden for the collection of information is reflected in the burden for Form 1118.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attention: IRS Reports Clearance Officer T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to the collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 902 (26 CFR part 1) was amended by section 1202(a) of the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 1085), and section 1012(b) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (Public Law 100-647, 102 Stat. 3242). On January 6, 1995, the IRS published a notice of proposed rulemaking in the **Federal Register** (60 FR 2049 [INTL-933-86 (1995-1 C.B. 959)]). The proposed regulations provide guidance needed to comply with section 902 as amended in 1986 and 1988. No public hearing was requested or held, but numerous written comments were received. The proposed regulations, with certain changes made in response to comments, are adopted in this Treasury decision as final regulations. The principal changes to the regulations, as well as the major comments and suggestions, are discussed below.

Explanation of Provisions

Section 1.902-1

In the preamble to the proposed regulations, the IRS requested comments on

whether the holding of Revenue Ruling 71-141 (1971-1 C.B. 211) should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, beneficiaries of domestic or foreign trusts and estates, or interest holders in other pass-through entities. The revenue ruling held that two 50-percent domestic corporate general partners of a domestic general partnership that owned 40 percent of a foreign corporation were entitled to compute an amount of foreign taxes deemed paid under section 902 with respect to dividends they received from the foreign corporation through the partnership.

The IRS received numerous comments in response to the request in the preamble. The commenters uniformly argue that the aggregate theory of partnerships should apply to allow domestic corporate partners to compute an amount of foreign taxes deemed paid with respect to dividends paid to any partnership by a foreign corporation, provided that the partner owns at least 10 percent of the voting stock of the foreign corporation through the partnership.

The final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity. That issue will be the subject of a future proposed regulations project. However, in recognition of the holding in Revenue Ruling 71-141 (1971-1 C.B. 211) that a general partner of a domestic general partnership may compute an amount of foreign taxes deemed paid with respect to a dividend distribution from a foreign corporation to the partnership, § 1.902-1(a)(1) is amended to define a domestic shareholder as a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. The IRS is still considering under what other circumstances the revenue ruling should apply.

Section 1.902-1(a)(8) is amended to clarify under what circumstances the pool of post-1986 foreign income taxes must be reduced to account for distributions made in prior post-1986 taxable years. The regulations require a reduction in the taxes pool for taxes attrib-

able to earnings distributed to shareholders ineligible for the deemed paid credit (for example, a foreign shareholder, a U.S. individual shareholder, or a domestic corporate shareholder that owns less than 10 percent of the foreign corporation's voting stock) and to shareholders that are eligible for the credit but that choose to deduct foreign taxes under section 164(a) in the year of the distribution rather than claim a credit.

The IRS understands that some taxpayers have taken the position, contrary to the position taken in § 1.902-1(a)(8) of the proposed regulations, that although post-1986 undistributed earnings must be reduced to account for all distributions out of current or accumulated earnings and profits, post-1986 foreign income taxes should be reduced only to account for taxes attributable to distributions with respect to which a shareholder both is eligible to claim a credit for foreign taxes deemed paid under section 902(a) and in fact elects to credit foreign taxes for the taxable year under section 901(a). These taxpayers argue that only in those circumstances are foreign taxes "deemed paid" and thus required to be removed from the taxes pool under a literal reading of sections 902(a) and 902(c)(2)(B).

The IRS has not changed its position as reflected in § 1.902-1(a)(8)(i) of the proposed regulations that the foreign taxes pool must be reduced to account for foreign taxes attributable to all distributions and deemed distributions or inclusions to all shareholders. However, the text of the final regulations has been amended to clarify the rule. The requirement that the foreign taxes pool must be reduced proportionately as the earnings pool is reduced is consistent with the legislative history of the Tax Reform Act of 1986 (Public Law 99-514). The House Report states that under the pooling regime, "[a] dividend or subpart F inclusion is considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary." H.R. Rep. No. 426, 99th Cong., 1st Sess. 357 (1985). In addition, removing taxes attributable to distributions to ineligible shareholders and eligible shareholders that choose to deduct foreign taxes is supported by the general matching principles of section 902, which presume that a dividend distribution will carry with it a ratable share of the foreign corporation's taxes. If taxes paid with respect to distributed earnings remained in the pool, eligible shareholders eventually could receive credits for more than

their ratable share of the foreign corporation's taxes, a result at odds with the statutory scheme.

Section 1.902-1(a)(8)(i) is amended to correct an oversight in the proposed regulation. In the case of a distribution out of current earnings and profits that is treated as a "nimble" dividend under section 316(a)(2) when there is a deficit in accumulated earnings and profits, post-1986 foreign income taxes are not reduced. This rule is not inconsistent with the general rule of paragraph (a)(8)(i) that the foreign taxes pool must be reduced to account for taxes attributable to all distributions and deemed distributions out of post-1986 undistributed earnings. Rather, it reflects the fact that under section 902 and these regulations, no taxes are deemed paid with respect to a nimble dividend under section 316(a)(2) because the post-1986 undistributed earnings pool is zero or less than zero.

Section 1.902-1(a)(9), defining post-1986 undistributed earnings, is amended to clarify that the earnings pool is reduced only to account for distributions or deemed distributions that reduce earnings and profits and inclusions that result in previously-taxed amounts described in sections 959(c)(1) and (c)(2) or 1293(c). Thus, for example, in the case of a controlled foreign corporation owned 60 percent by a domestic corporate shareholder and 40 percent by a foreign shareholder, the earnings and taxes pools are reduced only to account for 60 percent of the foreign corporation's subpart F income.

The rules precluding special allocations of earnings and taxes in § 1.902-1(a)(9)(iv) and (10)(ii) of the proposed regulations have been retained in the final regulations. These regulations are intended to reverse the result in *Vulcan v. Commissioner*, 96 T.C. 410 (1991), aff'd per curiam, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995-1 C.B. 1, for post-1986 taxable years. Several commenters argued that the *Vulcan* decision was correct and should be applied to both pre-1987 and post-1986 taxable years, and the regulations should be revised to reflect the decision. For the reasons stated in the preamble to the proposed regulations, the IRS declines to do so.

Commenters also argued that the rule precluding special allocations of earnings and taxes is inconsistent with § 1.904-6(a)(2). Section 1.904-6(a)(2) is an anti-abuse rule designed to prevent the use of accommodation parties to

improve a United States taxpayer's foreign tax credit position. The rule states that if a taxpayer receives or accrues a dividend from a noncontrolled section 902 corporation and the Commissioner establishes the existence of an express or implied agreement that the dividend is paid out of the foreign corporation's passive or high withholding tax interest earnings, then only taxes imposed on passive or high withholding tax interest earnings will be considered related to the dividend. The IRS may invoke this rule to prevent a shareholder from sheltering investment income from tax by investing it through a noncontrolled section 902 corporation that distributes only the investment earnings to the shareholder, which then treats the distribution as a dividend sheltered by taxes paid on the corporation's high-taxed active business income. The IRS believes that this narrowly defined anti-abuse rule is an appropriate exception to the general rule of § 1.902-1(a)(9)(iv) and (a)(10)(ii) barring special allocations of earnings and taxes.

Section 1.902-1(a)(11) has been amended to clarify that the definition of a dividend in section 316(a) applies for purposes of section 902, and that the section 902 definition of a dividend also includes deemed dividends under sections 551 and 1248. Deemed inclusions under sections 951(a) and 1293 are not dividends for purposes of section 902. However, sections 960(a)(1) and 1293(f) provide that deemed paid taxes with respect to inclusions under sections 951(a) and 1293 are determined under section 902 in the same manner as if a dividend was paid.

Paragraph (a)(11) also has been amended to add a cross-reference to section 1291 and § 1.1291-5 of the proposed regulations, which provide special rules for computing foreign taxes deemed paid with respect to distributions from section 1291 funds. These distributions are treated as dividends solely for foreign tax credit purposes, but the general section 902 computational rules do not apply.

A commenter correctly pointed out that the regulation's inclusion of deemed distributions under section 551 as dividends for purposes of section 902 is contrary to the holding in Revenue Ruling 74-59 (1974-1 C.B. 183) that an amount includible in gross income under section 551 is not considered a dividend received for purposes of the allowance of a foreign tax credit under section 902. The holding of the revenue ruling

is based on language in the 1937 legislative history of the foreign personal holding company provisions. The Report of the Joint Committee on Tax Evasion and Avoidance of the Congress of the United States, H.R. Doc. No. 337, 75th Cong., 1st Sess. 18 (1937), recommended that shareholders of foreign personal holding companies not be allowed a credit for foreign income taxes paid by the foreign corporation with respect to amounts deemed distributed. The Report goes on to state that the committee recommended against allowing a credit because "it is not administratively feasible, although it might seem equitable under the circumstances."

Section 551(b) provides that amounts required to be included in the gross income of a U.S. shareholder under section 551(a) are treated as dividends, and under current law it is administratively feasible to allow deemed paid taxes to be computed with respect to deemed dividends. In addition, the Code now includes other anti-deferral regimes, e.g., the subpart F and passive foreign investment company provisions, the application of which may overlap with the foreign personal holding company rules. Shareholders are permitted to compute deemed paid taxes with respect to subpart F and passive foreign investment company inclusions.

The IRS, therefore, has concluded the revenue ruling is not supported by current law. A shareholder of a foreign personal holding company should be entitled to compute deemed paid taxes with respect to amounts required to be included in gross income as dividends under section 551(a). Revenue Ruling 74-59 (1974-1 C.B. 183) is hereby revoked effective as of the date these regulations are published in the **Federal Register**.

A commenter argued that the rule in § 1.902-1(b)(4), providing that no taxes are deemed paid with respect to dividends out of current earnings and profits when the foreign corporation has no post-1986 undistributed earnings and no accumulated earnings and profits (so-called "nimble" dividends) conflicts with the general purpose of the foreign tax credit to prevent double taxation. The rule is retained in the final regulations for two reasons. First, the legislative history of the Tax Reform Act of 1986 (Public Law 99-514) clearly indicates that Congress was aware of the issue and agreed with the position stated in the regulation. See S. Rep. No. 313, 99th Cong., 2d Sess. 321 (1986). Sec-

ond, because no taxes can be deemed paid under the computational rules of section 902 when post-1986 undistributed earnings are zero or less than zero, no taxes are removed from the post-1986 foreign income taxes pool. Thus, all of the foreign corporation's taxes remain in its post-1986 foreign income taxes pool and are available to be credited if the corporation pays another dividend in a later year in which the post-1986 undistributed earnings pool is positive.

Section 1.902-1(c)(8) of the proposed regulations reserved on the application of section 902 in section 304 exchanges. Commenters suggested that the regulations should address this area by incorporating the holdings in Revenue Ruling 91-5 (1991-1 C.B. 114), and Revenue Ruling 92-86 (1992-1 C.B. 199). In addition, the commenters argued that the regulations should state that a deemed paid credit is available in a section 304 exchange involving a foreign parent corporation. The IRS is still studying the area and the regulations thus continue to reserve on the application of section 902 in a section 304 exchange.

Section 1.902-1(c)(9) of the proposed regulations is reserved in these final regulations. The proposed regulation provided a cross-reference to regulations under section 905(c) with respect to adjustments to post-1986 undistributed earnings and taxes that result from a section 482 allocation of income. There currently are no regulations under section 905(c) addressing section 482 allocations and the IRS, therefore, has reserved this paragraph pending issuance of final regulations under section 905(c).

Section 1.902-1(d)(3)(ii) through (iv) of the proposed regulations is not included in the final regulations. Paragraph (d)(3) set out rules and examples exercising a grant of regulatory authority under the last sentence of section 904(d)(2)(E)(i) to limit beyond the statute the circumstances under which a dividend paid to a new U.S. shareholder by a controlled foreign corporation out of earnings accumulated while it was a controlled foreign corporation will be treated as dividends from a noncontrolled section 902 corporation. Identical rules were proposed in 1992 under section 904(d). See § 1.904-4(g)(3)(ii) through (iv) of the proposed regulations. The rules address the character of a dividend distribution under section 904(d) and are more appropriately placed in the regulations under that section. After considering the comments

received, the rule will be finalized as part of the section 904 regulations.

Section 1.902-2

A commenter suggested that the deficit carryback rules in § 1.902-2(a)(1) should be amended to provide that a deficit in post-1986 undistributed earnings will not be carried back to pre-1987 years on a return of capital or capital gain distribution. The rule states that a deficit will be carried back when "*** a corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, *** ." The commenter suggests that the rule in the proposed regulation can result in "locked-in" taxes when earnings attributable to one or more pre-1987 years are eliminated by the deficit carryback. If the deficit stays in the post-1986 pool there is a chance it can be absorbed by future earnings, leaving the pre-1987 earnings and taxes intact. In support of its position, the commenter argues that section 902 establishes rules that minimize double taxation by allowing a taxpayer to compute a deemed paid credit on a taxable dividend. The legislative history indicates that the pooling provisions of section 902 are to apply solely for purposes of computing the deemed paid credit. Because a return of capital or capital gain distribution is not a taxable dividend and no section 902 credit is allowable, the commenter argues that the pooling rules (including the deficit carryback rules) should not apply.

The IRS declines to adopt the commenter's suggestion. When an amount is distributed in a post-1986 taxable year and there is a deficit in post-1986 undistributed earnings, the deficit must be carried back and reduce earnings and profits in pre-1987 years to determine whether any earnings remain to support treatment of the distribution as a dividend. To the extent there are earnings remaining in one or more pre-1987 years after a deficit is carried back, the distribution is a dividend. Any remaining amount is a return of capital and capital gain. It would be incongruous to adopt a rule providing a different result if a single dollar of pre-1987 accumulated profits remains in a pre-1987 year after a post-1986 deficit is carried back than if the deficit carryback eliminated all pre-1987 accumulated profits and the entire distribution were treated as a return of capital.

Another commenter argued that the interplay among § 1.902-2(b)(1) (pre-1987 accumulated deficit carries over to become the opening balance of post-1986 undistributed earnings pool) and § 1.902-1(b)(4) (no taxes deemed paid if a dividend is a nimble dividend) of the proposed regulations, and section 960 (incorporating the section 902 rules with respect to deemed inclusions under subpart F) results in a denial of deemed paid taxes to a U.S. shareholder if a controlled foreign corporation has both a pre-1987 accumulated deficit and post-1986 earnings and profits that are entirely subpart F income. The commenter suggests that regulations be issued under section 960 to provide, solely for purposes of that section, that accumulated deficits in pre-1987 accumulated profits will not carry over into the post-1986 pool.

The IRS cannot adopt the rule the commenter suggests. Congress amended sections 902 and 960 in 1986 specifically to eliminate different earnings and profits and deemed paid taxes computations for purposes of sections 902 and 960. Further, in the situation the commenter posits, the credits are deferred but not permanently disallowed. If the controlled foreign corporation earns enough post-1986 income to eliminate the accumulated deficit, any distribution or deemed distribution will carry with it a ratable share of post-1986 foreign income taxes.

A commenter argued that § 1.902-2(b)(2) and (3), Example 1, are incorrect because they imply that annual deficits in pre-1987 accumulated profits were required to be carried back under pre-1987 section 902 regardless of how foreign income taxes were determined. The commenter argues that pre-1987 section 902 requires a “correlation” between accumulated profits as determined under U.S. law and the foreign law method by which foreign taxes were determined.

The IRS disagrees with the comment and the proposed regulation has not been amended. The regulation reflects the IRS’ longstanding position that in the case of a deficit in accumulated profits of a foreign corporation for a particular pre-1987 year, the deficit first reduces prior years’ accumulated profits on a LIFO basis to the extent thereof, and then the remaining deficit reduces accumulated profits in subsequent years. That rule applies regardless of whether foreign law permits or requires the carryback or carryforward of losses. See

Revenue Ruling 74-550 (1974-2 C.B. 209) and Revenue Ruling 87-72 (1987-2 C.B. 170).

Effect on Other Documents

The following revenue ruling is revoked as of January 7, 1997.

Revenue Ruling 74-59, 1974-1 C.B. 183.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has 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 notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Caren Silver Shein of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.902-1 also issued under 26 U.S.C. 902(c)(7).

Section 1.902-2 also issued under 26 U.S.C. 902(c)(7). * * *

Par. 2. Sections 1.902-1 and 1.902-2 are redesignated §§ 1.902-3 and 1.902-4, respectively.

Par. 3. Sections 1.902-0, 1.902-1 and 1.902-2 are added to read as follows:

§ 1.902-0 Outline of regulations provisions for section 902.

This section lists the provisions under section 902.

§ 1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) Definitions and special effective date.

- (1) Domestic shareholder.
- (2) First-tier corporation.
- (3) Second-tier corporation.
- (4) Third-tier corporation.
- (5) Example.
- (6) Upper- and lower-tier corporations.

(7) Foreign income taxes.
(8) Post-1986 foreign income taxes.
(i) In general.
(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.

(iii) Foreign income taxes paid or accrued with respect to high withholding tax interest.

- (9) Post-1986 undistributed earnings.
(i) In general.

(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.

(iii) Reduction for foreign income taxes paid or accrued.

- (iv) Special allocations.
(10) Pre-1987 accumulated profits.

(i) Definition.
(ii) Computation of pre-1987 accumulated profits.

(iii) Foreign income taxes attributable to pre-1987 accumulated profits.

- (11) Dividend.
- (12) Dividend received.
- (13) Special effective date.

- (i) Rule.
(ii) Example.

(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation.

- (1) General rule.
- (2) Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits.

(i) Portion of dividend out of post-1986 undistributed earnings.

(ii) Portion of dividend out of pre-1987 accumulated profits.

(3) Dividends paid out of pre-1987 accumulated profits.

(4) Deficits in accumulated earnings and profits.

(5) Examples.

(c) Special rules.

(1) Separate computations required for dividends from each first-tier and lower-tier corporation.

(i) Rule.

(ii) Example.

(2) Section 78 gross-up.

(i) Foreign income taxes deemed paid by a domestic shareholder.

(ii) Foreign income taxes deemed paid by an upper-tier corporation.

(iii) Example.

(3) Creditable foreign income taxes.

(4) Foreign mineral income.

(5) Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.

(6) Foreign oil and gas extraction income.

(7) United States shareholders of controlled foreign corporations.

(8) Credit for foreign taxes deemed paid in a section 304 transaction.

(9) Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.

(d) Dividends from controlled foreign corporations.

(1) General rule.

(2) Look-through.

(i) Dividends.

(ii) Coordination with section 960.

(3) Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation.

(i) General rule.

(ii) Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign corporation was not a United States shareholder of the controlled foreign corporation.

(e) Information to be furnished.

(f) Examples.

(g) Effective date.

§ 1.902-2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid § 1.902-1.

(a) Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years.

(1) Rule.

(2) Examples.

(b) Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902.

(1) General rule.

(2) Effect of pre-effective date deficit.

(3) Examples.

§ 1.902-3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) Definitions.

(1) Domestic shareholder.

(2) First-tier corporation.

(3) Second-tier corporation.

(4) Third-tier corporation.

(5) Foreign income taxes.

(6) Dividend.

(7) Dividend received.

(b) Domestic shareholder owning stock in a first-tier corporation.

(1) In general.

(2) Amount of foreign taxes deemed paid by a domestic shareholder.

(c) First-tier corporation owning stock in a second-tier corporation.

(1) In general.

(2) Amount of foreign taxes deemed paid by a first-tier corporation.

(d) Second-tier corporation owning stock in a third-tier corporation.

(1) In general.

(2) Amount of foreign taxes deemed paid by a second-tier corporation.

(e) Determination of accumulated profits of a foreign corporation.

(f) Taxes paid on or with respect to accumulated profits of a foreign corporation.

(g) Determination of earnings and profits of a foreign corporation.

(1) Taxable year to which section 963 does not apply.

(2) Taxable year to which section 963 applies.

(3) Time and manner of making choice.

(4) Determination by district director.

(h) Source of income from first-tier corporation and country to which tax is deemed paid.

(1) Source of income.

(2) Country to which taxes deemed paid.

(i) United Kingdom income taxes paid with respect to royalties.

(j) Information to be furnished.

(k) Illustrations.

(l) Effective date.

§ 1.902-4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) In general.

(b) Combined distributions.

(c) Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.

(d) Illustrations.

§ 1.902-1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) *Definitions and special effective date.* For purposes of section 902, this section, and § 1.902-2, the definitions provided in paragraphs (a)(1) through (12) of this section and the special effective date of paragraph (a)(13) of this section apply.

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation from a foreign corporation after December 31, 1986, the term domestic shareholder means a domestic corporation, other than an S corporation as defined in section 1361(a), that owns at least 10 percent of the voting stock of the foreign corporation at the time the domestic corporation receives a dividend from that foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder from a foreign corporation in a taxable year beginning after December 31, 1986, the term first-tier corporation means a foreign corporation, at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time the domestic shareholder receives a dividend from that foreign corporation. The term first-tier corporation also includes a DISC or former DISC, but only with respect to dividends from the DISC or former DISC that are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* In the case of dividends paid to a first-tier corporation by a foreign corporation in a taxable year beginning after December

31, 1986, the foreign corporation is a second-tier corporation if, at the time a first-tier corporation receives a dividend from that foreign corporation, the first-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation.

(4) Third-tier corporation. In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(iii) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.

(5) *Example.* The following example illustrates the ownership requirements of paragraphs (a)(1) through (4) of this section:

Example. (i) Domestic corporation M owns 30 percent of the voting stock of foreign corporation A on January 1, 1991, and for all periods thereafter. Corporation A owns 40 percent of the voting stock of foreign corporation B on January 1, 1991, and continues to own that stock until June 1, 1991, when Corporation A sells its stock in Corporation B. Both Corporation A and Corporation B use the calendar year as the taxable year. Corporation B pays a dividend out of its post-1986 undistributed earnings to Corporation A, which Corporation A receives on February 16, 1991. Corporation A pays a dividend out of its post-1986 undistributed earnings to Corporation M, which Corporation M receives on January 20, 1992. Corporation M uses a fiscal year ending on June 30 as the taxable year.

(ii) On February 16, 1991, when Corporation B pays a dividend to Corporation A, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder of Corporation A within the meaning of paragraph (a)(1) of this section. Also on February 16, 1991, Corporation B is a second-tier corporation within the meaning of paragraph (a)(3) of this section because Corporation A owns at least 10 percent of its voting stock,

and the percentage of voting stock owned by Corporation M in Corporation A on February 16, 1991 (30 percent) multiplied by the percentage of voting stock owned by Corporation A in Corporation B on February 16, 1991 (40 percent) equals 12 percent. Corporation A shall be deemed to have paid foreign income taxes of Corporation B with respect to the dividend received from Corporation B on February 16, 1991.

(iii) On January 20, 1992, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder within the meaning of paragraph (a)(1) of this section. Accordingly, for its taxable year ending on June 30, 1992, Corporation M is deemed to have paid a portion of the post-1986 foreign income taxes paid, accrued, or deemed to be paid, by Corporation A. Those taxes will include taxes paid by Corporation B that were deemed paid by Corporation A with respect to the dividend paid by Corporation B to Corporation A on February 16, 1991, even though Corporation B is no longer a second-tier corporation with respect to Corporations A and M on January 20, 1992, and has not been a second-tier corporation with respect to Corporations A and M at any time during the taxable years of Corporations A and M that include January 20, 1992.

(6) *Upper- and lower-tier corporations.* In the case of a third-tier corporation, the term upper-tier corporation means a first- or second-tier corporation. In the case of a second-tier corporation, the term upper-tier corporation means a first-tier corporation. In the case of a first-tier corporation, the term lower-tier corporation means a second- or third-tier corporation. In the case of a second-tier corporation, the term lower-tier corporation means a third-tier corporation.

(7) *Foreign income taxes.* The term foreign income taxes means income, war profits, and excess profits taxes as defined in § 1.901-2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See also paragraphs (c)(4) and (5) of this section (concerning foreign taxes paid with respect to foreign mineral income and in connection with the purchase or sale of oil and gas).

(8) *Post-1986 foreign income taxes—*

(i) *In general.* Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid,

accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid by the foreign corporation on or with respect to earnings that in prior taxable years were distributed to, or otherwise included (e.g., under sections 304, 367(b), 551, 951(a), 1248 or 1293) in the income of, a foreign or domestic shareholder. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by the foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (e.g., an individual or a corporation that owns less than 10% of the foreign corporation's voting stock), or to a foreign person that does not meet the definition of a first- or second-tier corporation under paragraph (a)(2) or (3) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. Further, if a domestic shareholder chooses to deduct foreign taxes paid or accrued for the taxable year of the distribution or inclusion, it shall nonetheless be deemed to have paid a proportionate share of the foreign corporation's post-1986 foreign income taxes under section 902(a), and the foreign taxes deemed paid must be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term

year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Post-1986 foreign income taxes shall include foreign income taxes that are deemed paid by an upper-tier corporation with respect to distributions from a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, provided the upper-tier corporation's earnings and profits in that year are included in its post-1986 undistributed earnings under paragraph (a)(9) of this section. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904-7(a).

(iii) *Foreign income taxes paid or accrued with respect to high withholding tax interest.* Post-1986 foreign income taxes shall not include foreign income taxes paid or accrued by a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)(i)) with respect to high withholding tax interest (as defined in section 904(d)(2)(B)) to the extent the foreign tax rate imposed on such interest exceeds 5 percent. See section 904(d)(2)(E)(ii) and § 1.904-4(g)(2)(iii). The reduction in foreign income taxes paid or accrued by the amount of tax in excess of 5 percent imposed on high withholding tax interest income must be computed in functional currency before foreign income taxes are translated into U.S. dollars and included in post-1986 foreign income taxes.

(9) *Post-1986 undistributed earnings*—(i) *In general.* Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 undistributed earnings means the amount of the earnings and profits of a foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years of the foreign corporation beginning after December 31, 1986, deter-

mined as of the close of the taxable year of the foreign corporation in which it distributes a dividend. Post-1986 undistributed earnings shall not be reduced by reason of any earnings distributed or otherwise included in income, for example under section 304, 367(b), 551, 951(a), 1248 or 1293, during the taxable year. Post-1986 undistributed earnings shall be reduced to account for distributions or deemed distributions that reduced earnings and profits and inclusions that resulted in previously-taxed amounts described in section 959(c)(1) and (2) or section 1293(c) in prior taxable years beginning after December 31, 1986. Thus, post-1986 undistributed earnings shall not be reduced to the extent of the ratable share of a controlled foreign corporation's subpart F income, as defined in section 952, attributable to a shareholder that is not a United States shareholder within the meaning of section 951(b) or section 953(c)(1)(A), because that amount has not been included in a shareholder's gross income. Post-1986 undistributed earnings shall be reduced as provided herein regardless of whether any shareholder is deemed to have paid any foreign taxes, and regardless of whether any domestic shareholder chose to claim a foreign tax credit under section 901(a) for the year of the distribution. For rules on carrybacks and carryforwards of deficits and their effect on post-1986 undistributed earnings, see § 1.902-2. In the case of a foreign corporation the foreign income taxes of which are computed based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Distributions by a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings of the upper-tier corporation, provided the upper-tier corporation's earnings and profits for that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character

of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904-7(a).

(iii) *Reduction for foreign income taxes paid or accrued.* In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(8)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

(iv) *Special allocations.* The term post-1986 undistributed earnings means the total amount of the earnings of the corporation determined at the corporate level. Special allocations of earnings and taxes to particular shareholders, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. If, however, the Commissioner establishes that there is an agreement to pay dividends only out of earnings in the separate categories for passive or high withholding tax interest income, then only taxes imposed on passive or high withholding tax interest earnings shall be treated as related to the dividend. See § 1.904-6(a)(2).

(10) *Pre-1987 accumulated profits*—(i) *Definition.* The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. If the special effective date of paragraph (a)(13) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to that corporation.

(ii) *Computation of pre-1987 accumulated profits.* Pre-1987 accumulated profits must be computed under United

States principles governing the computation of earnings and profits. Pre-1987 accumulated profits are determined at the corporate level. Special allocations of accumulated profits and taxes to particular shareholders with respect to distributions of pre-1987 accumulated profits in taxable years beginning after December 31, 1986, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. Pre-1987 accumulated profits of a particular year shall be reduced by amounts distributed from those accumulated profits or otherwise included in income from those accumulated profits, for example under sections 304, 367(b), 551, 951(a), 1248 or 1293. If a deficit in post-1986 undistributed earnings is carried back to offset pre-1987 accumulated profits, pre-1987 accumulated profits of a particular taxable year shall be reduced by the amount of the deficit carried back to that year. See § 1.902-2. The amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the Tax Reform Act of 1986. See §§ 1.902-3, 1.902-4 and 1.964-1.

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits.* The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued, or deemed paid by a foreign corporation on or with respect to its pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid by the foreign corporation on or with respect to amounts distributed or otherwise included in income from pre-1987 accumulated profits of that year. Thus, pre-1987 foreign income taxes shall be reduced by the amount of taxes deemed paid by a domestic shareholder (regardless of whether the shareholder chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion) or a first-tier or second-tier corporation, and by the amount of taxes that would have been deemed paid had any other shareholder been eligible to compute an amount of foreign taxes deemed paid under section 902. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at

the spot exchange rate in effect on the date of the distribution.

(11) *Dividend.* For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. Thus, for example, distributions and deemed distributions under sections 302, 304, 305(b) and 367(b) that are treated as dividends within the meaning of section 301(c)(1) also are dividends for purposes of section 902. In addition, the term dividend includes deemed dividends under sections 551 and 1248, but not deemed inclusions under sections 951(a) and 1293. For rules concerning excess distributions from section 1291 funds that are treated as dividends solely for foreign tax credit purposes, (see Regulation Project INTL-656-87 published in 1992-1 C.B. 1124; see § 601.601(d)(2)(ii)(b) of this chapter).

(12) *Dividend received.* A dividend shall be considered received for purposes of section 902 when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301-1(b). A dividend also is considered received for purposes of section 902 when it is deemed received under section 304, 367(b), 551, or 1248.

(13) *Special effective date—(i) Rule.* If the first day on which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to a foreign corporation, without regard to whether a dividend is distributed, is in a taxable year of the foreign corporation beginning after December 31, 1986, then—

(A) The post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met, including subsequent taxable years in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met; and

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met shall be considered pre-1987 accumulated profits.

(ii) *Example.* The following example illustrates the special effective date rules of this paragraph (a)(13):

Example. As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the U.S. dollar. Assume 1u equals \$1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to \$100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u - 200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has \$60 (\$100 - [\$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation—(1) General rule.* If a foreign corporation pays a dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless

the ownership requirements of paragraphs (a)(1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

$$\frac{\text{Foreign income taxes deemed paid by domestic shareholder (or upper-tier corporation)}}{\text{Post-1986 foreign income taxes of first-tier corporation (or lower-tier corporation)}} = \frac{\text{Dividend paid to domestic shareholder (or upper-tier corporation) by first-tier corporation (or lower-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}}$$

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings.* Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Post-1986 Undistributed Earnings}}{\text{Post-1986 Undistributed Earnings}} = \frac{\text{Dividend to Shareholder Total Dividends Paid To all Shareholders}}{\text{Total Dividends Paid To all Shareholders}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits.* After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902-3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987 taxable year and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumu-

lated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Accumulated Profits of a Particular Pre-1987 Taxable Year}}{\text{Dividend Paid Out of Pre-1987 Accumulated Profits with Respect to the Particular Pre-1987 Taxable Year}} = \frac{\text{Dividend to Shareholder}}{\text{Total Dividends Paid to all Shareholders}}$$

(3) *Dividends paid out of pre-1987 accumulated profits.* If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10) and (13) of this section and §§ 1.902-3 and 1.902-4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2), and post-1986 foreign income taxes shall not be reduced, if as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals \$1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and \$40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits of 200u (net of foreign taxes) and paid 60u of foreign income taxes on those earnings. In 1992, Corporation A distributes 150u to Corporation M. Corporation A has 100u of post-1986 undistributed earnings and the dividend, therefore, is treated as paid out of post-1986 undistributed earnings to the

extent of 100u. The first 100u distribution is from post-1986 undistributed earnings, and, because the distribution exhausts those earnings, Corporation M is deemed to have paid the entire amount of post-1986 foreign income taxes of Corporation A (\$40). The remaining 50u dividend is treated as a dividend out of 1986 accumulated profits under paragraph (b)(2) of this section. Corporation M is deemed to have paid \$15 (60u x 50u/200u, translated at the appropriate exchange rates) of Corporation A's foreign income taxes for 1986. As of January 1, 1993, Corporation A's post-1986 undistributed earnings and post-1986 foreign income taxes are 0. Corporation A has 150u of accumulated profits and 45u of foreign income taxes remaining in 1986.

Example 2. Domestic corporation M (incorporated on January 1, 1987) owns 100 percent of foreign corporation A (incorporated on January 1, 1987). Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals \$1 at all relevant times. Corporation A has no pre-1987 accumulated profits. All of Corporation A's post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). On January 1, 1992, Corporation A has a deficit in accumulated earnings and profits and a deficit in post-1986 undistributed earnings of (200u). No foreign taxes have been paid with respect to post-1986 undistributed earnings. During 1992, Corporation A earns 100u (net of foreign taxes), pays \$40 of foreign taxes on those earnings and distributes 50u to Corporation M. As of the end of 1992, Corporation A has a deficit of (100u) ((200u) post-1986 undistributed earnings + 100u current earnings and profits) in post-1986 undistributed earnings. Corporation A, however, has current earnings and profits of 100u. Therefore, the 50u distribution is treated as a dividend in its entirety under section 316(a)(2). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign taxes paid by Corporation A because post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits are (100u). The dividend reduces both post-1986 undistributed earnings and accumulated earnings and profits. Therefore, as of January 1, 1993, Corporation A's post-1986 undistributed earnings are (150u) and its accumulated earnings and profits are (150u). Corporation A's post-1986 foreign income taxes at the start of 1993 are \$40.

(c) *Special rules*—(1) *Separate computations required for dividends from each first-tier and lower-tier corporation*—(i) *Rule.* If in a taxable year dividends are received by a domestic shareholder or an upper-tier corporation from two or more first-tier corporations or two or more lower-tier corporations, the foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under sections 902(a) and (b) and paragraph (b) of this section shall be computed separately with respect to the dividends received from each first-tier corporation or lower-tier corporation. If a domestic shareholder receives dividend distributions from one or more first-tier corporations and in the same taxable year the first-

tier corporation receives dividends from one or more lower-tier corporations, then the amount of foreign income taxes deemed paid shall be computed by starting with the lowest-tier corporation and working upward.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(1):

Example. P, a domestic corporation, owns 40 percent of the voting stock of foreign corporation S. S owns 30 percent of the voting stock of foreign corporation T, and 30 percent of the voting stock of foreign corporation U. Neither S, T, nor U is a controlled foreign corporation. P, S, T and U all use the calendar year as their taxable year. In 1993, T and U both pay dividends to S and S pays a dividend to P. To compute foreign taxes deemed paid, paragraph (c)(1) of this section requires P to start with the lowest tier corporations and to compute foreign taxes deemed paid separately for dividends from each first-tier and lower-tier corporation. Thus, S first will compute foreign taxes deemed paid separately on its dividends from T and U. The deemed paid taxes will be added to S's post-1986 foreign income taxes, and the dividends will be added to S's post-1986 undistributed earnings. Next, P will compute foreign taxes deemed paid with respect to the dividend from S. This computation will take into account the taxes paid by T and U and deemed paid by S.

(2) *Section 78 gross-up*—(i) *Foreign income taxes deemed paid by a domestic shareholder.* Except as provided in section 960(b) and the regulations under that section (relating to amounts excluded from gross income under section 959(b)), any foreign income taxes deemed paid by a domestic shareholder in any taxable year under section 902(a) and paragraph (b) of this section shall be included in the gross income of the domestic shareholder for the year as a dividend under section 78. Amounts included in gross income under section 78 shall, for purposes of section 904, be deemed to be derived from sources within the United States to the extent the earnings and profits on which the taxes were paid are treated under section 904(g) as United States source earnings and profits. Section 1.904-5(m)(6). Amounts included in gross income under section 78 shall be treated for purposes of section 904 as income in a separate category to the extent that the foreign income taxes were allocated and apportioned to income in that separate category. See section 904(d)(3)(G) and § 1.904-6(b)(3).

(ii) *Foreign income taxes deemed paid by an upper-tier corporation.* Foreign income taxes deemed paid by an upper-tier corporation on a distribution from a lower-tier corporation are not included in the earnings and profits of

the upper-tier corporation. For purposes of section 904, foreign income taxes shall be allocated and apportioned to income in a separate category to the extent those taxes were allocated to the earnings and profits of the lower-tier corporation in that separate category. See section 904(d)(3)(G) and § 1.904-6(b)(3). To the extent that section 904(g) treats the earnings of the lower-tier corporation on which those foreign income taxes were paid as United States source earnings and profits, the foreign income taxes deemed paid by the upper-tier corporation on the distribution from the lower-tier corporation shall be treated as attributable to United States source earnings and profits. See section 904(g) and § 1.904-5(m)(6).

(iii) *Example.* The following example illustrates the rules of this paragraph (c)(2):

Example. P, a domestic corporation, owns 100 percent of the voting stock of controlled foreign corporation S. Corporations P and S use the calendar year as their taxable year, and S uses the u as its functional currency. Assume that 1u equals \$1 at all relevant times. As of January 1, 1992, S has -0- post-1986 undistributed earnings and -0- post-1986 foreign income taxes. In 1992, S earns 150u of non-subpart F general limitation income net of foreign taxes and pays 60u of foreign income taxes. As of the end of 1992, but before dividend payments, S has 150u of post-1986 undistributed earnings and \$60 of post-1986 foreign income taxes. Assume that 50u of S's earnings for 1992 are from United States sources. S pays P a dividend of 75u which P receives in 1992. Under § 1.904-5(m)(4), one-third of the dividend, or 25u ($75u \times 50u/150u$), is United States source income to P. P computes foreign taxes deemed paid on the dividend under paragraph (b)(1) of this section of \$30 ($\$60 \times 50\% [75u/150u]$) and includes that amount in gross income under section 78 as a dividend. Because 25u of the 75u dividend is United States source income to P, \$10 ($\$30 \times 33.33\% [25u/75u]$) of the section 78 dividend will be treated as United States source income to P under this paragraph (c)(2).

(3) *Creditable foreign income taxes.* The amount of creditable foreign income taxes under section 901 shall include, subject to the limitations and conditions of sections 902 and 904, foreign income taxes actually paid and deemed paid by a domestic shareholder that receives a dividend from a first-tier corporation. Foreign income taxes deemed paid by a domestic shareholder under paragraph (b) of this section shall be deemed paid by the domestic shareholder only for purposes of computing the foreign tax credit allowed under section 901.

(4) *Foreign mineral income.* Certain foreign income, war profits and excess profits taxes paid or accrued with re-

spect to foreign mineral income will not be considered foreign income taxes for purposes of section 902. See section 901(e) and § 1.901-3.

(5) *Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.* Certain income, war profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country will not be considered foreign income taxes for purposes of section 902. See section 901(f).

(6) *Foreign oil and gas extraction income.* For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations under that section.

(7) *United States shareholders of controlled foreign corporations.* See paragraph (d) of this section and sections 960 and 962 and the regulations under those sections for special rules relating to the application of section 902 in computing foreign income taxes deemed paid by United States shareholders of controlled foreign corporations.

(8) *Credit for foreign taxes deemed paid in a section 304 transaction.* [Reserved].

(9) *Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.* [Reserved].

(d) *Dividends from controlled foreign corporations*—(1) *General rule.* Except as provided in paragraph (d)(3) of this section, if a dividend is received by a domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)(1)(A)) from a first-tier corporation that is a controlled foreign corporation (as defined in section 957(a) or section 953(c)(1)(B)), or by an upper-tier corporation from a lower-tier corporation if the corporations are related look-through entities within the meaning of § 1.904-5(i), the following rule applies. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of the upper- or lower-tier controlled foreign corporation attributable to more than one separate category under section 904(d), the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to the post-1986 undistributed earnings or pre-1987 accumulated

profits in each separate category out of which the dividend is paid. See § 1.904-5(c)(4) and paragraph (d)(2) of this section. The separately computed deemed paid taxes shall be added to other taxes paid by the U.S. shareholder or upper-tier corporation with respect to income in the appropriate separate category.

(2) *Look-through*—(i) *Dividends*. Except as otherwise provided in paragraph (d)(3) of this section, any dividend distribution out of post-1986 undistributed earnings of a look-through entity to a related look-through entity shall be deemed to be paid pro rata out of each separate category of income. See §§ 1.904-5(c)(4) and 1.904-7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

Foreign taxes deemed paid by domestic shareholder or upper-tier corporation with respect to a separate category under section 904(d)	=	Post-1986 foreign income taxes of first-tier or lower-tier corporation allocated and apportioned to a separate category under § 1.904-6	x	Dividend amount attributable to a separate category <hr style="width: 100%; border: 0.5px solid black; margin: 0;"/> Post-1986 undistributed earnings of first-tier or lower-tier corporation attributable to the separate category
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(ii) *Coordination with section 960*. For rules coordinating the computation of foreign taxes deemed paid with respect to amounts included in gross income under section 951(a) and dividends distributed by a controlled foreign corporation, see section 960 and the regulations under that section.

(3) *Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation*—(i) *General rule*. Any dividend distributed by a controlled foreign corporation out of earnings accumulated before the controlled foreign corporation became a controlled foreign corporation shall be treated as a dividend from a noncontrolled section 902 corporation regardless of whether the earnings were accumulated in a taxable year beginning before January 1, 1987, or after December 31, 1986.

(ii) *Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign cor-*

poration was not a United States shareholder of the controlled foreign corporation. [Reserved].

(e) *Information to be furnished*. If the credit for foreign income taxes claimed under section 901 includes foreign income taxes deemed paid under section 902 and paragraph (b) of this section, the domestic shareholder must furnish the same information with respect to the foreign income taxes deemed paid as it is required to furnish with respect to the foreign income taxes it directly paid or accrued and for which the credit is claimed. See § 1.905-2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within the shareholder's taxable year, and for reduction in the amount of foreign income taxes paid, accrued, or deemed paid for failure to furnish the required information, see section 6038 and the regulations under that section.

(f) *Examples*. The following examples illustrate the application of this section:

Example 1. Since 1987, domestic corporation M has owned 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation. Corporation A uses the u as its functional currency, and 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. In 1992, Corporation A pays a 30u dividend out of post-1986 undistributed earnings, 3u to Corporation M and 27u to Corporation Z. Corporation M is deemed, under paragraph (b) of this section, to have paid a portion of the post-1986 foreign income taxes paid by Corporation A and includes the amount of foreign taxes deemed paid in gross income under section 78 as a dividend. Both the foreign taxes deemed paid and the dividend would be subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Under paragraph (a)(9)(i) of this section, Corporation A must reduce its post-1986 undistributed earnings as of January 1, 1993, by the total amount of dividends paid to Corporation M and Corporation Z in 1992. Under paragraph (a)(8)(i) of this section, Corporation A must reduce its post-1986 foreign income taxes as of January 1, 1993, by the amount of foreign income taxes that were deemed paid by Corporation M and by the amount of foreign income taxes that would have been deemed paid by Corporation Z had Corporation Z been eligible to compute an amount of foreign income taxes deemed paid with respect to the dividend received from Corporation A. Foreign income taxes deemed paid by Corporation M and Corporation A's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1. Assumed post-1986 undistributed earnings of Corporation A at start of 1992.....	25u
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2. Assumed post-1986 foreign income taxes of Corporation A at start of 1992.....	\$25
3. Assumed pre-tax earnings and profits of Corporation A for 1992.....	50u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992.....	15u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).....	60u
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).....	\$40
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1992.....	3u
8. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M (Line 7 divided by Line 5)...	5%
9. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902 (a) (Line 6 multiplied by Line 8).....	\$2
10. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992.....	30u
11. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5).....	50%
12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).....	\$20
13. Corporation A's post-1986 undistributed earnings at the start of 1993 (Line 5 minus Line 10) .	30u
14. Corporation A's post-1986 foreign income taxes at the start of 1993 (Line 6 minus Line 12).....	\$20

Example 2. (i) The facts are the same as in *Example 1*, except that Corporation M has also owned 10 percent of the one class of stock of foreign corporation B since 1987. Corporation B uses the calendar year as the taxable year. The remaining 90 percent of Corporation B's stock is owned by Corporation Z. Corporation B is not a controlled foreign corporation. Corporation B uses the u as its functional currency, and 1u equals \$1 at all relevant times. In 1992, Corporation B has earnings and profits and pays foreign income taxes, a portion of which are attributable to high withholding tax interest, as defined in section 904(d)(2)(B)(i). Corporation B must reduce its pool of post-1986 foreign income taxes by the amount of tax imposed on high withholding tax interest in excess of 5 percent because that amount is not treated as a tax for purposes of section 902. See section 904(d)(2)(E)(ii) and paragraph (a)(8)(iii) of this section. Corporation B pays 50u in dividends in 1992, 5u to Corporation M and 45u to Corporation Z. Corporation M must compute its section 902(a) deemed paid taxes separately for the dividends it receives in 1992 from

Corporation A (as computed in *Example 1*) and from Corporation B. Foreign income taxes of Corporation B deemed paid by Corporation M, and Corporation B's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1.	Assumed post-1986 undistributed earnings of Corporation B at start of 1992.....	(100u)
2.	Assumed post-1986 foreign income taxes of Corporation B at start of 1992.....	\$0
3.	Assumed pre-tax earnings and profits of Corporation B for 1992 (including 50u of high withholding tax interest on which 5u of tax is withheld) ..	302.50u
4.	Assumed foreign income taxes paid or accrued by Corporation B in 1992	102.50u
5.	Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).....	100u
6.	Amount of foreign income tax of Corporation B imposed on high withholding tax interest in excess of 5% (5u withholding tax - [5% x 50u high withholding tax interest]).....	2.50u
7.	Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus [Line 4 minus Line 6 translated at the appropriate exchange rate]).....	\$100
8.	Dividends paid out of post-1986 undistributed earnings to Corporation M in 1992	5u
9.	Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation M (Line 8 divided by Line 5) ...	5%
10.	Foreign income taxes of Corporation B deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9)	\$5
11.	Total dividends paid out of post-1986 undistributed earnings of Corporation B to all shareholders in 1992.....	50u
12.	Percentage of Corporation B's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 5).....	50%
13.	Post-1986 foreign income taxes of Corporation B paid on or with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12)	\$50
14.	Corporation B's post-1986 undistributed earnings at start of 1993 (Line 5 minus Line 11) .	50u
15.	Corporation B's post-1986 foreign income taxes at start of 1993 (Line 7 minus Line 13) .	\$50

(ii) For 1992, as computed in *Example 1*, Corporation M is deemed to have paid \$2 of the post-1986 foreign income taxes paid by Corporation A and includes \$2 in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate

limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Corporation M also is deemed to have paid \$5 of the post-1986 foreign income taxes paid by Corporation B and includes \$5 in gross income as a deemed dividend under section 78. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation B, a noncontrolled section 902 corporation.

Example 3. (i) Since 1987, domestic corporation M has owned 50 percent of the one class of stock of foreign corporation A. The remaining 50 percent of Corporation A is owned by foreign corporation Z. For the same time period, Corporation A has owned 40 percent of the one class of stock of foreign corporation B, and Corporation B has owned 30 percent of the one class of stock of foreign corporation C. The remaining 60 percent of Corporation B is owned by foreign corporation Y, and the remaining 70 percent of Corporation C is owned by foreign corporation X. Corporations A, B, and C are not controlled foreign corporations. Corporations A, B, and C use the u as their functional currency, and 1u equals \$1 at all relevant times. Corporation B uses a fiscal year ending June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1992, Corporation C pays a 500u dividend out of post-1986 undistributed earnings, 150u to Corporation B and 350u to Corporation X. On February 15, 1992, Corporation B pays a 300u dividend out of post-1986 undistributed earnings computed as of the close of Corporation B's fiscal year ended June 30, 1992, 120u to Corporation A and 180u to Corporation Y. On August 15, 1992, Corporation A pays a 200u dividend out of post-1986 undistributed earnings, 100u to Corporation M and 100u to Corporation Z. In computing foreign taxes deemed paid by Corporations B and A, section 78 does not apply and Corporations B and A thus do not have to include the foreign taxes deemed paid in earnings and profits. See paragraph (c)(2)(ii) of this section. Foreign income taxes deemed paid by Corporations B, A and M, and the foreign corporations' opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation B's fiscal year beginning July 1, 1992, and Corporation C's and Corporation A's 1993 calendar years are computed as follows:

A. Corporation C (third-tier corporation):

1.	Assumed post-1986 undistributed earnings in Corporation C at start of 1992.....	1300u
2.	Assumed post-1986 foreign income taxes in Corporation C at start of 1992.....	\$500
3.	Assumed pre-tax earnings and profits of Corporation C for 1992.....	500u
4.	Assumed foreign income taxes paid or accrued in 1992.....	300u
5.	Post-1986 undistributed earnings in Corporation C for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).....	1500u
6.	Post-1986 foreign income taxes in Corporation C for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates)	\$800
7.	Dividends paid out of post-1986 undistributed earnings of Corporation C to Corporation B in 1992	150u

8.	Percentage of Corporation C's post-1986 undistributed earnings paid to Corporation B (Line 7 divided by Line 5) ...	10%
9.	Foreign income taxes of Corporation C deemed paid by Corporation B under section 902(b)(2) (Line 6 multiplied by Line 8).....	\$80
10.	Total dividends paid out of post-1986 undistributed earnings of Corporation C to all shareholders in 1992.....	500u
11.	Percentage of Corporation C's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5)	33.33%
12.	Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).....	\$266.66
13.	Post-1986 undistributed earnings in Corporation C at start of 1993 (Line 5 minus Line 10)	1000u
14.	Post-1986 foreign income taxes in Corporation C at start of 1993 (Line 6 minus Line 12) .	\$533.34

B. Corporation B (second-tier corporation):

1.	Assumed post-1986 undistributed earnings in Corporation B as of July 1, 1991.....	0
2.	Assumed post-1986 foreign income taxes in Corporation B as of July 1, 1991	0
3.	Assumed pre-tax earnings and profits of Corporation B for fiscal year ended June 30, 1992, (including 150u dividend from Corporation B)....	1000u
4.	Assumed foreign income taxes paid or accrued by Corporation B in fiscal year ended June 30, 1992.....	200u
5.	Foreign income taxes of Corporation C deemed paid by Corporation B in its fiscal year ended June 30, 1992 (Part A, Line 9 of paragraph (i) of this <i>Example 3</i>)	\$80
6.	Post-1986 undistributed earnings in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).....	800u
7.	Post-1986 foreign income taxes in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5)	\$280
8.	Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A on February 15, 1992.....	120u
9.	Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to Corporation A (Line 8 divided by Line 6) .	15%

10.	Foreign income taxes paid and deemed paid by Corporation B as of June 30, 1992, deemed paid by Corporation A under section 902(b)(1) (Line 7 multiplied by Line 9)	\$42
11.	Total dividends paid out of post-1986 undistributed earnings of Corporation B for fiscal year ended June 30, 1992	300u
12.	Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to all shareholders (Line 11 divided by Line 6)	37.5%
13.	Post-1986 foreign income taxes paid and deemed paid with respect to post-1986 undistributed earnings distributed to all shareholders during Corporation B's fiscal year ended June 30, 1992 (Line 7 multiplied by Line 12)	\$105
14.	Post-1986 undistributed earnings in Corporation B as of July 1, 1992 (Line 6 minus Line 11)	500u
15.	Post-1986 foreign income taxes in Corporation B as of July 1, 1992 (Line 7 minus Line 13)	\$175
C. Corporation A (first-tier corporation):		
1.	Assumed post-1986 undistributed earnings in Corporation A at start of 1992	250u
2.	Assumed post-1986 foreign income taxes in Corporation A at start of 1992	\$100
3.	Assumed pre-tax earnings and profits of Corporation A for 1992 (including 120u dividend from Corporation B)	250u
4.	Assumed foreign income taxes paid or accrued by Corporation A in 1992	100u
5.	Foreign income taxes paid or deemed paid by Corporation B as of June 30, 1992, that are deemed paid by Corporation A in 1992 (Part B, Line 10 of paragraph (i) of this Example 3)	\$42
6.	Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	400u
7.	Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5)	\$242
8.	Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M on August 15, 1992	100u
9.	Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M in 1992 (Line 8 divided by Line 6)	25%
10.	Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9)	\$60.50

11.	Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992	200u
12.	Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 6)	50%
13.	Post-1986 foreign income taxes paid and deemed paid by Corporation A with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12)	\$121
14.	Post-1986 undistributed earnings in Corporation A at start of 1993 (Line 6 minus Line 11)	200u
15.	Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 13)	\$121

(ii) Corporation M is deemed, under section 902(a) and paragraph (b) of this section, to have paid \$60.50 of post-1986 foreign income taxes paid, or deemed paid, by Corporation A on or with respect to its post-1986 undistributed earnings (Part C, Line 10) and Corporation M includes that amount in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation.

Example 4. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A, and Corporation A has owned 100 percent of the voting stock of controlled foreign corporation B. Corporations M, A and B use the calendar year as the taxable year. Corporations A and B are organized in the same foreign country and use the u as their functional currency. 1u equals \$1 at all relevant times. Assume that all of the earnings of Corporations A and B are general limitation earnings and profits within the meaning of section 904(d)(2)(I), and that neither Corporation A nor Corporation B has any previously taxed income accounts. In 1992, Corporation B pays a dividend of 150u to Corporation A out of post-1986 undistributed earnings, and Corporation A computes an amount of foreign taxes deemed paid under section 902(b)(1). The dividend is not subpart F income to Corporation A because section 954(c)(3)(B)(i) (the same country dividend exception) applies. Pursuant to paragraph (c)(2)(ii) of this section, Corporation A is not required to include the deemed paid taxes in earnings and profits. Corporation A has no pre-1987 accumulated profits and a deficit in post-1986 undistributed earnings for 1992. In 1992, Corporation A pays a dividend of 100u to Corporation M out of its earnings and profits for 1992 (current earnings and profits). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign income taxes paid or deemed paid by Corporation A because Corporation A has a deficit in post-1986 undistributed earnings as of December 31, 1992, and the sum of its current plus accumulated profits is less than zero. Note that if instead of paying a dividend to Corporation A in 1992, Corporation B had made an additional investment of \$150 in United States property under section 956, that amount would have been included in gross income by Corporation M under section 951(a)(1)(B) and Corporation M would have been deemed to have paid \$50 of foreign income taxes paid by Corporation B. See sections 951(a)(1)(B) and 960. Foreign

income taxes of Corporation B deemed paid by Corporation A and the opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation A and Corporation B for 1993 are computed as follows:

A. Corporation B (second-tier corporation):

1.	Assumed post-1986 undistributed earnings in Corporation B at start of 1992	200u
2.	Assumed post-1986 foreign income taxes in Corporation B at start of 1992	\$50
3.	Assumed pre-tax earnings and profits of Corporation B for 1992	150u
4.	Assumed foreign income taxes paid or accrued in 1992	50u
5.	Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	300u
6.	Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates)	\$100
7.	Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A in 1992	150u
8.	Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation A (Line 7 divided by Line 5)	50%
9.	Foreign income taxes of Corporation B deemed paid by Corporation A under section 902(b)(1) (Line 6 multiplied by Line 8)	\$50
10.	Post-1986 undistributed earnings in Corporation B at start of 1993 (Line 5 minus Line 7)	150u
11.	Post-1986 foreign income taxes in Corporation B at start of 1993 (Line 6 minus Line 9)	\$50

B. Corporation A (first-tier corporation):

1.	Assumed post-1986 undistributed earnings in Corporation A at start of 1992	(200u)
2.	Assumed post-1986 foreign income taxes in Corporation A at start of 1992	0
3.	Assumed pre-tax earnings and profits of Corporation A for 1992 (including 150u dividend from Corporation B)	200u
4.	Assumed foreign income taxes paid or accrued by Corporation A in 1992	40u
5.	Foreign income taxes paid by Corporation B in 1992 that are deemed paid by Corporation A (Part A, Line 9 of paragraph (i) of this Example 4)	\$50
6.	Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	(40u)
7.	Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5)	\$90

8.	Dividends paid out of current earnings and profits of Corporation A for 1992	100u
9.	Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1992 (Line 8 divided by the greater of Line 6 or zero)	0
10.	Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9)	0
11.	Post-1986 undistributed earnings in Corporation A at start of 1993 (line 6 minus line 8)	(140u)
12.	Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 10)	\$90

(ii) For 1993, Corporation A has 500u of earnings and profits on which it pays 160u of foreign income taxes. Corporation A receives no dividends from Corporation B, and pays a 100u dividend to Corporation M. The 100u dividend to Corporation M carries with it some of the foreign income taxes paid and deemed paid by Corporation A in 1992, which were not deemed paid by Corporation M in 1992 because Corporation A had no post-1986 undistributed earnings. Thus, for 1993, Corporation M is deemed to have paid \$125 of post-1986 foreign income taxes paid and deemed paid by Corporation A and includes that amount in gross income as a dividend under section 78, determined as follows:

1.	Post-1986 undistributed earnings in Corporation A at start of 1993	(140u)
2.	Post-1986 foreign income taxes in Corporation A at start of 1993	\$90
3.	Pre-tax earnings and profits of Corporation A for 1993	500u
4.	Foreign income taxes paid or accrued by Corporation A in 1993	160u
5.	Post-1986 undistributed earnings in Corporation A for 1993 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	200u
6.	Post-1986 foreign income taxes in Corporation A for 1993 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates)	\$250
7.	Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1993	100u
8.	Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1993 (Line 7 divided by Line 5)	50%
9.	Foreign income taxes paid and deemed paid by Corporation A that are deemed paid by Corporation M in 1993 (Line 6 multiplied by Line 8)	\$125
10.	Post-1986 undistributed earnings in Corporation A at start of 1994 (Line 5 minus Line 7)	100u
11.	Post-1986 foreign income taxes in Corporation A at start of 1994 (Line 6 minus Line 9)	\$125

Example 5. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A. Corporation M also conducts operations through a foreign branch. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A uses the u as its functional currency and 1u equals \$1 at all relevant times. Corporation A has no subpart F income, as defined in section 952, and no increase in earnings invested in United States property under section 956 for 1992. Corporation A also has no previously taxed income accounts. Corporation A has general limitation income and high withholding tax interest income that, by operation of section 954(b)(4), does not constitute foreign base company income under section 954(a). Because Corporation A is a controlled foreign corporation, it is not required to reduce post-1986 foreign income taxes by foreign taxes paid or accrued with respect to high withholding tax interest in excess of 5 percent. See § 1.902-1(a)(8)(iii). Corporation A pays a 60u dividend to Corporation M in 1992. For 1992, Corporation M is deemed, under paragraph (b) of this section, to have paid \$24 of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend, determined as follows:

1.	Assumed post-1986 undistributed earnings in Corporation A at start of 1992 attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest	20u
	(b) Section 904(d)(1)(I) general limitation income	55u
2.	Assumed post-1986 foreign income taxes in Corporation A at start of 1992 attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest	\$5
	(b) Section 904(d)(1)(I) general limitation income	\$20
3.	Assumed pre-tax earnings and profits of Corporation A for 1992 attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest	20u
	(b) Section 904(d)(1)(I) general limitation income	20u
4.	Assumed foreign income taxes paid or accrued in 1992 on or with respect to:	
	(a) Section 904(d)(1)(B) high withholding tax interest	10u
	(b) Section 904(d)(1)(I) general limitation income	5u
5.	Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest (Line 1(a) + Line 3(a) minus Line 4(a))	30u
	(b) Section 904(d)(1)(I) general limitation income (Line 1(b) + Line 3(b) minus Line 4(b))	70u
	(c) Total	100u
6.	Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest (Line 2(a) + Line 4(a) translated at the appropriate exchange rates)	\$15

	(b) Section 904(d)(1)(I) general limitation income (Line 2(b) + Line 4(b) translated at the appropriate exchange rates)	\$25
7.	Dividends paid to Corporation M in 1992	60u
8.	Dividends paid to Corporation M in 1992 attributable to section 904(d) separate categories pursuant to § 1.904-5(d):	
	(a) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(B) high withholding tax interest (Line 7 multiplied by Line 5(a) divided by Line 5(c))	18u
	(b) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(I) general limitation income (Line 7 multiplied by Line 5(b) divided by Line 5(c))	42u
9.	Percentage of Corporation A's post-1986 undistributed earnings for 1992 paid to Corporation M attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest (Line 8(a) divided by Line 5(a))	60%
	(b) Section 904(d)(1)(I) general limitation income (Line 8(b) divided by Line 5(b))	60%
10.	Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) attributable to:	
	(a) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(B) high withholding tax interest (Line 6(a) multiplied by Line 9(a))	\$9
	(b) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(I) general limitation income (Line 6(b) multiplied by Line 9(b))	\$15
11.	Post-1986 undistributed earnings in Corporation A at start of 1993 attributable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest (Line 5(a) minus Line 8(a))	12u
	(b) Section 904(d)(1)(I) general limitation income (Line 5(b) minus Line 8(b))	28u
12.	Post-1986 foreign income taxes in Corporation A at start of 1989 allocable to:	
	(a) Section 904(d)(1)(B) high withholding tax interest (Line 6(a) minus Line 10(a))	\$6
	(b) Section 904(d)(1)(I) general limitation income (Line 6(b) minus Line 10(b))	\$10

(ii) For purposes of computing Corporation M's foreign tax credit limitation, the post-1986 foreign income taxes of Corporation A deemed paid by Corporation M with respect to income in separate categories will be added to the foreign income taxes paid or accrued by Corporation M associated with income derived from Corporation M's branch operation in the same separate categories. The dividend (and the section 78 inclusion with respect

to the dividend) will be treated as income in separate categories and added to Corporation M's other income, if any, attributable to the same separate categories. See section 904(d) and § 1.904-6.

(g) *Effective date.* This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987.

§ 1.902-2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902-1.

(a) *Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years—(1) Rule.* For purposes of computing foreign income taxes deemed paid under § 1.902-1(b) with respect to dividends paid by a first-, second-, or third-tier corporation,

when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first-, second-, or third-tier corporation with positive accumulated profits computed under section 902. See § 1.902-3(e). For purposes of this § 1.902-2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of § 1.902-1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective date year to the extent thereof, and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-

1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1985	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	150u	150u	(100u)	100u	-0-	-0-
Current Plus Accumulated E & P of Corp. A	150u	300u	200u	250u	250u	200u
Post-'86 Undistributed Earnings of Corp. A		(100u)	100u	100u	50u	
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback)		-0-	100u	50u	50u	
Foreign Income Taxes of Corp. A (Annual)	120u	120u	\$10	\$50	-0-	-0-
Post-'86 Foreign Income Taxes of Corp. A			\$10	\$60	\$60	\$30
12/31 Distributions to Corp. M	-0-	-0-	5u	-0-	5u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	45u	-0-	45u	-0-

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and \$10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u - 100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u x (5u/50u)). See § 1.902-1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No accumulated profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and \$60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are \$3 (\$60 x 5%[5u/100u]). Corporation M must include \$3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u - 50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes. Section 1.902-1(a)(8)(i). The amount of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend distributed by Corporation A is \$30 (\$60 x

50%[50u/100u]). Thus, post-1986 foreign income taxes as of January 1, 1990, are \$30 (\$60 - \$30).

Example 2. The facts are the same as in *Example 1*, except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u (120u x 5u/150u). See § 1.902-1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u (150u - 50u) of accumulated profits and 80u (120u reduced by 40u[120u x 50u/150u]) of foreign taxes that would have been deemed paid had all of Corporation A's shareholders been eligible to compute an amount of foreign taxes deemed paid with respect to the dividend paid out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

Example 3. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining

90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all

relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in

post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pay dividends as summarized below:

Taxable Year	1986	1987	1988	1989	1990	1991
Current E & P (Deficits) of Corp. A	100u	(50u)	150u	75u	25u	-0-
Current Plus Accumulated E & P of Corp. A	100u	50u	200u	175u	200u	80u
Post-'86 Undistributed Earnings of Corp. A		(50u)	100u	75u	100u	-0-
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback)		(50u)	-0-	75u	-0-	-0-
Foreign Income Taxes (Annual) of Corp. A	80u	-0-	\$120	\$20	\$20	-0-
Post-'86 Foreign Income Taxes of Corp. A		-0-	\$120	\$20	\$40	-0-
12/31 Distributions to Corp. M	-0-	-0-	10u	-0-	12u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	90u	-0-	108u	-0-

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902-1(b)(1), to have paid \$12 ($\$120 \times 10\%$ [10u/100u]) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are -0- (100u - 100u). Its post-1986 foreign taxes as of January 1, 1989, also are -0-, \$120 reduced by \$120 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of foreign taxes deemed paid on the dividend from Corporation A ($\$120 \times 100\%$ [100u/100u]).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902-1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u ($100u \times 12u/120u$) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u ($100u \times 108u/120u$) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are \$4 ($\$40 \times 10\%$ [10u/100u]), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u ($80u \times 2u/100u$). Corporation M must include \$4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a

separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are -0- (100u - 100u). 80u (100u - 20u) of accumulated profits remain with respect to 1986. Post-1986 foreign income taxes as of January 1, 1991, are -0-, \$40 reduced by \$40 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($\$40 \times 100\%$ [100u/100u]). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [$80u \times 20u/100u$] of foreign income taxes that would have been deemed paid if Corporations M and Z both were eligible to compute an amount of deemed paid taxes on the 20u dividend distributed by Corporation A out of 1986 accumulated profits.

(b) *Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902—(1) General rule.* For purposes of computing foreign income taxes deemed paid under § 1.902-1(b) with respect to dividends paid by a first-, second-, or third-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits of the foreign corporation determined under section 902 as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902-1(a)(1) through (4) are met if the special effective date of § 1.902-1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-

1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985-6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. (i) From 1984 through 1988, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation

A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corpora-

tion M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 un-

distributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1984	1985	1986	1987	1988
Current E & P (Deficits) of Corp. A	25u	(100u)	(25u)	200u	100u
Current Plus Accumulated E & P (Deficits) of Corp. A	25u	(75u)	(100u)	100u	50u
Post-'86 Undistributed Earnings of Corp. A				100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward)				(50u)	50u
Foreign Income Taxes (Annual) of Corp. A	20u	5u	-0-	\$100	\$50
Post-'86 Foreign Income Taxes of Corp. A				\$100	\$50
12/31 Distributions to Corp. M	-0-	-0-	-0-	15u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	-0-	135u	-0-

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has \$100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under § 1.902-1(b), are \$10 (\$100 x 10%[10u/100u]). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from

noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u - 150u) and -0- post-1986 foreign income taxes, \$100 reduced by \$100 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings (\$100 x 100%[100u/100u]).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not

deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902-1(b)(4).

Example 2. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	(100u)	150u	(150u)	100u	250u
Current Plus Accumulated E & P (Deficits) of Corp. A	(100u)	50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A		50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward)		(50u)	(200u)	(200u)	-0-
Foreign Income Taxes (Annual) of Corp. A	-0-	\$120	-0-	\$50	\$100
Post-'86 Foreign Income Taxes of Corp. A		\$120	-0-	\$50	\$150
12/31 Distributions to Corp. M	-0-	10u	-0-	10u 5u	
12/31 Distributions to Corp. Z	-0-	90u	-0-	90u	45u

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902-1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumu-

lated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has \$120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are \$12 (\$120 x 10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u - 100u) and -0- in its post-1986 foreign income taxes, \$120 reduced by \$120 of foreign taxes that would have

been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the dividend distributed by Corporation A out of post-1986 undistributed earnings (\$120 x 100%[50u/50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, Corporation M is deemed to have paid no post-1986 foreign income taxes. See § 1.902-1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u) - 100u). Corporation A's post-1986 foreign income

taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and \$150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are \$15 (\$150 x 10%[5u/50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u - 50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, \$150 reduced by \$150 (\$150 x 100%[50u/50u]) of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend.

Par. 4. Newly designated § 1.902-3 is amended by revising the section heading and paragraph (a) introductory text, and by designating the last paragraph as paragraph (l) and revising it to read as follows:

§ 1.902-3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) *Definitions.* For purposes of section 902 and §§ 1.902-3 and 1.902-4:

*_ *_ *_ *_ *

(l) *Effective date.* Except as provided in § 1.902-4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and § 1.902-1(a)(1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corpora-

tion beginning after December 31, 1986, then this section shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902-1(a)(13)(iii). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902-5 as contained in the 26 CFR part 1 edition revised April 1, 1976.

Par. 5. Newly designated § 1.902-4, paragraph (b), in the last sentence, the language “§ 1.902-1” is removed and “§ 1.902-3” is added in its place.

PART 602—OMB CONTROL NUMBERS UNDER

THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In § 602.101, paragraph (c) is amended by adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control Numbers.

*_ *_ *_ *_ *
(c) * * *

CFR part or section where identified and described	Current OMB control No.
*_ *_ *_ *_ *	*_ *_ *_ *_ *
1.902-1	1545-1458
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Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

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