

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8805]

RIN 1545-AQ43; 1545-AT41

Allocation of Loss with Respect to Stock and Other Personal Property; Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary Income Tax Regulations relating to the allocation of loss recognized on the disposition of stock and other personal property and the computation of the foreign tax credit limitation. The loss allocation regulations primarily will affect taxpayers that claim the foreign tax credit and that incur losses with respect to personal property and are necessary to modify existing guidance with respect to loss allocation. The foreign tax credit limitation regulations will affect taxpayers claiming foreign tax credits that have passive income or losses and are necessary to modify existing guidance with respect to the computation of the limitation.

DATES: Effective dates: These regulations are effective January 11, 1999, except that §1.904-4(c)(2)(ii)(A) and (B) are effective March 12, 1999 and §1.904-4(c)(3)(iv) is effective December 31, 1998.

Dates of applicability: For dates of applicability of §§1.865-1T, 1.865-2, and 1.865-2T, see §§1.865-1T(f), 1.865-2(e), and 1.865-2T(e), respectively. For dates of applicability of §1.904-4(c), see §1.904-4(c)(2)(i).

FOR FURTHER INFORMATION CONTACT: Seth B. Goldstein, (202) 622-3810, regarding section 865(j); and Rebecca Rosenberg, (202) 622-3850, regarding section 904(d) (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On May 14, 1992, the IRS published a notice of proposed rulemaking in the **Federal Register** (REG-209527-92, formerly INTL-1-92 (1992-1 C.B. 1209), 57 FR 20660), proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 904(d). The regulations included proposed amendments to the grouping rules under §1.904-4(c)(3) for purposes of determining whether passive income is high taxed. The amendments were proposed to be effective for taxable years beginning after December 31, 1991. A public hearing was held on September 24, 1992, but no written or oral comments were received with respect to these provisions. These regulations are finalized as proposed. However, as described below, the effective date of the regulations has been modified.

On July 8, 1996, the IRS published proposed amendments (REG-209750-95, formerly INTL-4-95 (1996-2 C.B. 484), 61 FR 35696) to the Income Tax Regulations (26 CFR part 1) under sections 861, 865, and 904 of the Internal Revenue Code in the **Federal**

Register. The regulations addressed the allocation of loss on the disposition of stock (§1.865-2) and other personal property (§1.865-1) and also contained proposed amendments to the grouping rules under §1.904-4(c). The proposed regulations generally allocate loss with respect to stock based upon the residence of the seller (reciprocal to gain), but allocate loss on other personal property based upon the income generated by the property. A public hearing was held on November 6, 1996, and several written comments were received. The written comments endorsed the regulations' general approach with respect to the allocation of stock loss. In addition, on June 18, 1997, the Tax Court held in International Multifoods Corporation v. Commissioner, 108 T.C. 579 (1997), that loss on the disposition of stock is generally allocated based on the residence of the seller, consistent with the approach of the proposed regulations. After consideration of all the comments, the regulations proposed by INTL-4-95 with respect to stock loss and with respect to the grouping rules are adopted as amended by this Treasury decision. The principal changes to these regulations, as well as the major comments and suggestions, are discussed below. An additional anti-abuse rule, not previously proposed, is issued as a proposed and temporary regulation.

The written comments criticized the proposed regulation concerning the allocation of loss on other personal property (§1.865-1). This proposed regulation is withdrawn and replaced with a new proposed and temporary regulation that is more

consistent with the approach of the stock loss allocation rules. The new rules are issued as a temporary regulation because of the need for immediate guidance following the International Multifoods opinion.

Explanation of Provisions

Section 1.861-8T(e)(8): Net Operating Loss

Section 1.861-8T(e)(8) clarifies that a net operating loss deduction allowed under section 172 is allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

Section 1.865-1T: Loss With Respect to Personal Property Other Than Stock

Section 1.865-1T(a) provides the general rule that loss with respect to personal property is allocated in the same manner in which gain on the sale of the property would be sourced. Thus, for example, loss on the sale or worthlessness of a foreign bond held by a U.S. resident generally would be allocated against U.S. source income. Notice 89-58 (1989-1 C.B. 699), which addressed the allocation of loss with respect to certain bank loans, is revoked as inconsistent with this approach. Taxpayers may rely on the Notice for loss recognized prior to the effective date of the temporary regulations (see discussion of effective dates, below). Following the general rule, loss attributable to a foreign office of a U.S. resident is allocated against foreign source income where gain would be foreign source under the foreign branch rule of section 865(e)(1).

Section 1.865-1T(b) provides special rules of application.

Loss on depreciable property generally is allocated based upon the allocation of depreciation deductions taken with respect to the property, consistent with the depreciation-recapture source rule of section 865(c)(1). Similarly, loss with respect to a contingent payment debt instrument subject to Reg. §1.1275-4(b) is allocated against interest income because gain on the instrument generally is treated as interest income.

Section 1.865-1T(c) provides exceptions from the reciprocal-to-gain rule. The regulations do not apply to certain financial products (to be addressed in a future guidance project), loss governed by section 988, inventory (which is not governed by section 865), or trade receivables and certain interest equivalents (which are governed by §1.861-9T(b)). When Prop. §1.863-3(h) (the global dealing sourcing regulation) is finalized, §1.865-1T will not apply to any loss sourced under that regulation. Loss attributable to accrued-but-unpaid interest income is allocated against interest income. Also, loss on a debt instrument is allocated against interest income to the extent the taxpayer did not amortize bond premium to the full extent permitted by the Code. Anti-abuse exceptions are also provided. Section 1.865-1T(c)(6)(i), which prevents taxpayers from manipulating loss allocation through related-party transfers, reorganizations, or similar transactions, and §1.865-1T(c)(6)(ii), which addresses offsetting positions, are similar to the anti-abuse rules previously proposed with respect to stock losses. In addition, section 1.865-1T(c)(6)(iii) has been

included to prevent taxpayers from accelerating foreign source income with respect to property and claiming an offsetting U.S. loss.

The temporary regulations are effective for loss recognized on or after January 11, 1999. A taxpayer may apply the regulations, however, to loss recognized in any taxable year beginning on or after January 1, 1987, subject to certain conditions.

Section 1.865-2: Stock Loss

The proposed regulations issued in 1996 provide that generally loss with respect to stock is allocated to the residence of the seller, but contain three major exceptions: an exclusion for dispositions of portfolio stock and stock in regulated investment companies (RICs) and S corporations, a dividend recapture rule, and a consistency rule for certain dispositions of foreign affiliates. The final regulations modify these exceptions. The principal comments and changes to the regulations are discussed below.

Section 1.865-2(a): General Rule for Allocation of Stock Loss

Commentators criticized the exclusion of portfolio stock and RIC stock from the general residence-based rule, arguing that the rationale for residence-based allocation applies equally to these classes of stock. The final regulations eliminate the exception for portfolio stock and RIC stock.

In response to a comment, the final regulations clarify that §1.865-2 does not apply to stock that constitutes inventory.

The proposed regulations allocate loss recognized on the "sale or other disposition" of stock. Proposed §1.865-2(c)(2) provides that worthlessness giving rise to a deduction under section 165(g)(3) with respect to stock is treated as a disposition. Questions have been raised as to whether the regulations apply to other recognized losses that are not the result of a sale or disposition (for example, loss recognized under the mark-to-market rules of section 475). The final regulations are intended to apply to all recognized stock losses. To avoid confusion, the reference to sales or other dispositions has been deleted in the final regulations. The special reference to worthlessness deductions is therefore unnecessary and also has been deleted.

Section 1.865-2(b)(1): Dividend Recapture Exception

Some commentators questioned the dividend recapture rule of §1.865-2(b)(1) and suggested that the rule should be limited to cases in which the dividends were fully sheltered from U.S. tax by foreign tax credits or the taxpayer did not meet a minimum holding period. Others suggested that the two-year recapture period defined in §1.865-2(d)(5) of the proposed regulations should be shortened. Sections 1.865-2(b)(1)(i) and 1.865-2(d)(3) of the final regulations retain the two-year rule.

Section 1.865-2(b)(1)(iii) of the final regulations provides an exception from dividend recapture for passive-basket dividends. This new exception will exempt most portfolio investors (other than financial services entities) from the

dividend recapture rule. The rule, which will reduce administrative burdens, reflects the fact that passive income is generally subject to residual U.S. tax and the high-tax kick-out of section 904(d)(2)(A)(iii)(III) limits the potential for cross-crediting in the passive basket, thus reducing the need for recapture. In addition, allocation of loss to the passive basket may lead to investment incentives that violate the policies underlying the passive basket. For example, where a loss allocated to the passive basket creates a separate limitation loss under section 904(f)(5) that reduces high-taxed income in other baskets, this creates an incentive in subsequent years for the taxpayer to earn low-taxed foreign passive income to utilize the foreign tax credits in the high-taxed basket (due to the recharacterization rules of section 904(f)(5)(C)).

Commentators also suggested alternatives to the de minimis rule of §1.865-2(b)(1)(ii), which exempts from recapture dividends that are less than 10 percent of the recognized loss. The proposed de minimis rule is retained in the final regulations. The de minimis rule is intended to exempt from recapture, as a matter of administrative convenience, dividends that are relatively insignificant in comparison to the loss.

Two commentators questioned why the dividend recapture rule and the definition of the recapture period in §1.865-2(d)(5) of the proposed regulations refer to realized, rather than recognized, loss. The wording was intended to avoid confusion over the application of the rule to loss that is deferred under

section 267(f). The final regulation refers to "recognized" loss, but examples have been added in §1.865-2(b)(1)(iv) of the final regulations to illustrate the application of the dividend recapture rule in the context of section 267(f) and how the result differs in the context of a consolidated group.

Proposed §1.865-2(b)(2): Consistency Rule

Proposed §1.865-2(b)(2) requires a taxpayer to allocate loss on the sale of a foreign affiliate to passive-basket foreign source income if the taxpayer recognized foreign source gain under section 865(f) at any time during the 5-year period preceding the loss sale. Commentators criticized this rule as producing disproportionate results where the foreign source gain is small in comparison to the subsequent loss. Furthermore, even where the gain and loss are of similar magnitude, the results may be disproportionate because sourcing the gain foreign may provide the taxpayer with minimal tax benefits (because the gain is assigned to the passive basket) but the loss may reduce (sometimes as a separate limitation loss) income that is otherwise sheltered by foreign tax credits. In addition, allocating loss to the passive basket raises the policy concerns described above with respect to passive-basket dividend recapture. After consideration of the comments, the consistency rule has been eliminated from the final regulations.

Section 1.865-2(b)(2): Anti-abuse Rules

The anti-abuse rules of §1.865-2(b)(3) of the proposed regulations, finalized as §1.865-2(b)(4), have been refined and

modified. One commentator requested examples illustrating the anti-abuse rules. Examples have been provided. An additional rule is provided in §1.865-2T, discussed below.

Section 1.865-2(e): Effective Date and Retroactive Election

The proposed regulations are proposed to be effective for taxable years beginning 61 days after final regulations are promulgated. Because of the immediate need for guidance following the International Multifoods opinion, the final regulations are effective for losses recognized on or after January 11, 1999.

Several commentators requested that the regulations clarify the scope of the retroactive election and reduce the administrative burden of making the election. In response to these comments, §1.865-2(e)(2) is amended to provide that a taxpayer need not make a formal election to retroactively apply the regulations to losses recognized in any post-1986 year and all subsequent pre-effective date years. An amended return will be required only if retroactive application results in a change in tax liability.

One commentator urged that the overall foreign loss transition rule in §1.904(f)-12 be modified to provide that an overall foreign loss account attributable to a stock loss recognized in a pre-1987 year be recomputed under the new regulations in the first election year. This suggestion was rejected because the allocation of a stock loss is governed by the rules in effect in the year the loss is recognized, and the

retroactive election is available only with respect to post-1986 years. Section 1.865-2(e)(3) provides examples to illustrate the effect of the retroactive application of the regulations on overall foreign loss accounts, capital loss carryovers, and foreign tax credit carryovers.

Section 1.865-2T: Stock Loss Matching Rule

Section 1.865-2T(b)(4)(iii) provides a rule intended to prevent taxpayers from avoiding the dividend recapture rule of §1.865-2(b)(1) or from accelerating foreign source income and recognizing an offsetting U.S. loss. This rule is substantially the same as the matching rule of §1.865-1T(c)(6)(iii). The rule is promulgated as a temporary regulation because it is necessary to prevent abuse of the residence-based general allocation rule.

Section 1.904-4(c): Grouping Rules

The high-tax kick-out grouping rules of §1.904-4(c) provide rules for determining when particular groups of passive income are high-taxed and, therefore, treated as general limitation income under sections 904(d)(2)(A)(iii)(III) and 904(d)(2)(F). As described above, the proposed amendments to these rules that were proposed in 1992 are finalized as proposed, but taxpayers are afforded some flexibility with respect to the effective date. The amendments were proposed to be effective for taxable years beginning after December 31, 1991. The final regulations are effective for taxable years ending on or after December 31, 1998, but taxpayers may apply the amended regulations to any taxable year beginning after December 31, 1991 and all subsequent years.

An example is also added to clarify that foreign taxes that are not creditable (e.g., under section 901(k)) are not withholding taxes for purposes of the grouping rules.

The proposed amendments to the grouping rules that were proposed in 1996 are finalized with two clarifications. Proposed §1.904-4(c)(2)(ii)(B) provides guidance where deductions allocated to a group of passive income exceed the income in that group (i.e., a loss group). A question has been raised as to the proper treatment of foreign taxes in a group that has no taxable income or loss (either because the deductions allocated to the group exactly equal the income in the group or because the foreign taxes assigned to the group are imposed on U.S. source income or income that is not currently taken into account under U.S. tax principles). Consistent with the approach taken in the proposed regulations with respect to loss groups, the final regulations clarify that foreign taxes allocated to a group with no foreign source income are "kicked out" and treated as related to general limitation income.

Proposed §1.904-4(c)(2)(ii)(A) provides that foreign tax imposed on sales that result in loss for U.S. tax purposes is allocated to the group of passive income to which the loss is allocated. While this correctly states the result where loss on the disposition of property is allocated to passive income under a reciprocal-to-gain rule, under the temporary and final regulations loss may be allocated to reduce the group of passive income where income from the property was assigned (for example,

dividends or interest under the anti-abuse rules or the accrued-but-unpaid interest rule) or a separate category of income other than passive income. Accordingly, §1.904-4(c)(2)(ii)(A) of the final regulations is clarified to state that foreign tax imposed on a loss sale is allocated to the group of passive income to which a gain would have been assigned. The examples in §1.904-4(c)(8) of the final regulations are modified to reflect the fact that the consistency rule of §1.865-2(b)(2) of the proposed regulations has been deleted.

One commentator inquired whether the rule of §1.904-4(c)(2)(ii)(A) allocating foreign tax on a loss sale to a group of passive income is consistent with the tax allocation rule of §1.904-6(a)(1)(iv). The latter rule provides that a foreign tax imposed on an item of income that does not constitute income under U.S. tax principles (a base difference) shall be treated as imposed with respect to general limitation income, whereas a foreign tax imposed on an item that would be income under U.S. tax principles in another year (a timing difference) will be allocated to the appropriate separate category as if the U.S. recognized the income in the same year. Treasury and the Service believe that a base difference exists within the meaning of §1.904-6(a)(1)(iv) only when a foreign country taxes items that the United States would never treat as taxable income, for example, gifts or life insurance proceeds. A sale that results in gain under foreign law but in loss for U.S. tax purposes is attributable to differences in basis calculations rather than to

a difference in the concept of taxable income and, therefore, does not constitute a base difference. The tax allocation rule of §1.904-4(c)(2)(ii)(A), allocating foreign taxes on a loss sale to the same group of passive income to which gain would have been assigned had the United States recognized gain on the sale, is conceptually consistent with the treatment of timing differences in §1.904-6(a)(1)(iv).

Effect on Other Documents

The following document is obsolete as of January 11, 1999:
Notice 89-58, 1989-1 C.B. 699.

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.

This Treasury Decision finalizes notices of proposed rulemaking published May 14, 1992 (57 FR 20660) and July 8, 1996 (61 FR 35696). It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the final regulations issued pursuant to the notice of proposed rulemaking published on May 14, 1992. Furthermore, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to those regulations, because the notice of proposed rulemaking was issued prior to March 29, 1996.

It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the portion of the notice of proposed rulemaking published on

July 8, 1996, relating to section 904 of the Internal Revenue Code. Because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

A final regulatory flexibility analysis under 5 U.S.C. § 604 has been prepared for the final regulations portion of this Treasury Decision with respect to the regulations issued under section 865 of the Internal Revenue Code. A summary of the analysis is set forth below under the heading 'Summary of Regulatory Flexibility Analysis.' Because no preceding notice of proposed rulemaking is required for the temporary regulations portion of this Treasury Decision relating to sections 861 and 865 of the Code, the provisions of the Regulatory Flexibility Act do not apply. However, an initial Regulatory Flexibility Analysis was prepared for the proposed regulations published elsewhere in this issue of the **Federal Register**.

Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Small Business Administration for comment on their impact on small business.

Summary of Regulatory Flexibility Analysis

It has been determined that a final regulatory flexibility analysis is required under 5 U.S.C. § 604 with respect to the final regulations portion of this Treasury Decision with respect to the regulations issued under section 865 of the Internal Revenue Code. These regulations will affect small entities such

as small businesses but not other small entities, such as local government or tax exempt organizations, which do not pay taxes. The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap or conflict with these regulations. The final regulations address the allocation of loss with respect to stock. These regulations are necessary primarily for the proper computation of the foreign tax credit limitation under section 904 of the Internal Revenue Code. With respect to U.S. resident taxpayers, the regulations generally allocate losses against U.S. source income. Generally, this allocation simplifies the computation of the foreign tax credit limitation. None of the significant alternatives considered in drafting the regulations would have significantly altered the economic impact of the regulations on small entities. There are no alternative rules that are less burdensome to small entities but that accomplish the purposes of the statute.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Section 1.865-1T also issued under 26 U.S.C. 865(j)(1).

Section 1.865-2 also issued under 26 U.S.C. 865(j)(1).

Section 1.865-2T also issued under 26 U.S.C. 865(j)(1). * * *

Par. 2. Section 1.861-8 is amended by adding paragraph (e)(7)(iii) and revising paragraph (e)(8) to read as follows:
§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(7) * * *

(iii) Allocation of loss recognized in taxable years after 1986. See §§1.865-1T, 1.865-2, and 1.865-2T for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) Net operating loss deduction. [Reserved.] For guidance, see §1.861-8T(e)(8).

* * * * *

Par. 3. Section 1.861-8T is amended by adding paragraph (e)(8) and a sentence at the end of paragraph (h) to read as follows:
§1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (Temporary).

* * * * *

(e) * * *

(8) Net operating loss deduction. A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

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(h) * * * Paragraph (e)(8) of this section shall cease to be effective January 8, 2002.

Par. 4. Section 1.865-1T is added immediately following §1.864-8T, to read as follows:

§1.865-1T Loss with respect to personal property other than stock (Temporary).

(a) General rules for allocation of loss--(1) Allocation against gain. Except as otherwise provided in §§1.865-2 and 1.865-2T and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. Thus, for example, loss recognized by a United States resident on the sale of a bond generally is allocated to reduce United States source income.

(2) Loss attributable to foreign office. Except as otherwise provided in §§1.865-2 and 1.865-2T and paragraph (c) of

this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) Loss recognized by United States citizen or resident alien with foreign tax home. Except as otherwise provided in §§1.865-2 and 1.865-2T and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) Allocation for purposes of section 904. For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall

be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of §1.904-4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of §1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) Loss recognized by partnership. A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) Special rules of application--(1) Depreciable property. In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) Contingent payment debt instrument. Except to the extent provided in §1.1275-4(b)(9)(iv), loss recognized with respect to a contingent payment debt instrument to which §1.1275-

4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) Exceptions--(1) Foreign currency and certain financial instruments. This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) Inventory. This section does not apply to loss recognized with respect to property described in section 1221(1).

(3) Interest equivalents and trade receivables. Loss subject to §1.861-9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of §1.861-9T and not under the rules of this section.

(4) Unamortized bond premium. To the extent a taxpayer recognizing loss with respect to a bond (within the meaning of §1.171-1(b)) did not amortize bond premium to the full extent permitted by §§1.171-2 or 1.171-3 (or §1.171-1, as contained in the 26 CFR part 1 edition revised as of April 1, 1997)(as applicable), loss recognized with respect to the bond shall be

allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) Accrued interest. Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§1.61-7(d) and 1.446-2(e).

(6) Anti-abuse rules--(i) Transactions involving built-in losses. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not

occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) Offsetting positions. If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk

of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) Matching rule. To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to personal property, the loss shall be allocated and apportioned against such income. For examples illustrating a similar rule with respect to stock loss, see Examples 3 through 6 of §1.865-2T(b)(4)(iv).

(d) Definitions--(1) Contingent payment debt instrument. A contingent payment debt instrument is any debt instrument that is subject to §1.1275-4.

(2) Depreciable personal property. Depreciable personal property is any property described in section 865(c)(4)(A).

(3) Terms defined in §1.861-8. See §1.861-8 for the meaning of class of gross income, statutory grouping of gross income, and residual grouping of gross income.

(e) Examples. The application of this section may be illustrated by the following examples:

Example 1. On January 1, 1997, A, a domestic corporation, purchases for \$1,000 a machine that produces widgets, which A sells in the United States and throughout the world. Throughout A's holding period, the machine is located and used in Country X. During A's holding period, A incurs depreciation deductions of \$400 with respect to the machine. Under §1.861-8, A allocates and apportions depreciation deductions of \$250 against foreign source general limitation income and \$150 against U.S. source income. On December 12, 1999, A sells the machine and recognizes a loss of \$500. Because the machine was used predominantly outside the United States, under section 865(c)(1)(B) and

(c)(3)(B)(ii), gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire \$500 loss is allocated against foreign source general limitation income.

Example 2. On January 1, 1997, A, a domestic corporation, loans \$2,000 to N, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to §1.1275-4(b). During 1997 through 1999, A accrues and receives interest income of \$630, \$150 of which is foreign source general limitation income and \$480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to §1.1275-4(b)(6) in 1997 through 1999. On January 1, 2000, A disposes of the debt instrument and recognizes a \$770 loss. Under §1.1275-4(b)(8)(ii), \$630 of the loss is treated as ordinary loss and \$140 is treated as capital loss. Assume that \$140 of interest income earned in 2000 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under §1.1275-4(b)(9)(iv), \$150 of the ordinary loss is allocated against foreign source general limitation income and \$480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the \$140 capital loss is allocated against foreign source passive income.

Example 3. On January 1, 1997, A, a domestic corporation, purchases for \$1,000 a bond maturing January 1, 2009, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 1997 and 2001, A accrues and receives foreign source interest income of \$500 with respect to the bond. On January 1, 2002, A sells the bond and recognizes a \$500 loss. Under paragraph (a)(1) of this section, the \$500 loss is allocated against U.S. source income. Paragraph (c)(6)(iii) of this section is not applicable because A's recognition of the foreign source income did not result in the creation of a corresponding loss with respect to the bond.

Example 4. On January 1, 1999, A, a domestic corporation on the accrual method of accounting, purchases for \$1,000 a bond maturing January 1, 2009, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 1999, after A has accrued \$44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. A sells the bond (including the accrued interest) for \$20. Assuming that A properly accrued \$44 interest income, A

treats the \$20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a \$1000 loss with respect to the bond principal and a \$24 loss with respect to the accrued interest. See §1.61-7(d). Under paragraph (a)(1) of this section, the \$1000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the \$24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) Effective date--(1) In general. Except as provided in paragraph (f)(2) of this section, this section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) Application to prior periods. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that--

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) Examples. See §1.865-2(e)(3) for examples illustrating an effective date provision similar to the effective date provided in this paragraph (f).

Par. 5. Section 1.865-2 is added immediately after §1.865-

1T, to read as follows:

§1.865-2 Loss with respect to stock.

(a) General rules for allocation of loss with respect to stock--(1) Allocation against gain. Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) Stock attributable to foreign office. Except as otherwise provided in paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) Loss recognized by United States citizen or resident alien with foreign tax home--(i) In general. Except as otherwise

provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(ii) Bona fide residents of Puerto Rico. Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income.

(4) Stock constituting a United States real property interest. Loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) Allocation for purposes of section 904. For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to

which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of §1.904-4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of §1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) Exceptions--(1) Dividend recapture exception--(i) In general. If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) Exception for de minimis amounts. Paragraph (b)(1)(i) of this section shall not apply to a loss recognized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts (other than dividend recapture amounts eligible for the exception described in paragraph (b)(1)(iii) of this section (passive limitation dividends)) included in income by the taxpayer (or a person described in section 1059(c)(3)(C)) with

respect to such stock during the recapture period is less than 10 percent of the recognized loss.

(iii) Exception for passive limitation dividends. Paragraph (b)(1)(i) of this section shall not apply to the extent of a dividend recapture amount that is treated as income in the separate category for passive income described in section 904(d)(2)(A) (without regard to section 904(d)(2)(A)(iii)(III)). The exception provided for in this paragraph (b)(1)(iii) shall not apply to any dividend recapture amount that is treated as income in the separate category for financial services income described in section 904(d)(2)(C).

(iv) Examples. The application of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. (i) P, a domestic corporation, is a United States shareholder of N, a controlled foreign corporation. N has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On May 5, 1998, N distributes a dividend to P in the amount of \$100. The dividend gives rise to a \$5 foreign withholding tax, and P is deemed to have paid an additional \$45 of foreign income tax with respect to the dividend under section 902. Under the look-through rules of section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 2000, P sells its shares of N and recognizes a \$110 loss. In 2000, P has the following taxable income, excluding the loss on the sale of N:

(A) \$1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I);

(B) \$1,000 of foreign source capital gain from the sale of stock in a foreign affiliate that is sourced under section 865(f) and is passive income described in section 904(d)(1)(A); and

(C) \$1,000 of U.S. source income.

(iii) The \$100 dividend paid in 1998 is a dividend recapture amount that was included in P's income within the recapture

period preceding the disposition of the N stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the \$100 dividend recapture amount exceeds 10 percent of the \$110 loss. Therefore, to the extent of the \$100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) P's remaining \$10 loss on the disposition of the N stock is allocated to U.S. source income under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, P's foreign source taxable income in 2000 consists of \$900 of foreign source general limitation income and \$1,000 of foreign source passive income.

Example 2. (i) P, a domestic corporation, owns all of the stock of N1, which owns all of the stock of N2, which owns all of the stock of N3. N1, N2, and N3 are controlled foreign corporations. All of the corporations use the calendar year as their taxable year. On February 5, 1997, N3 distributes a dividend to N2. The dividend is foreign personal holding company income of N2 under section 954(c)(1)(A) that results in an inclusion of \$100 in P's income under section 951(a)(1)(A)(i) as of December 31, 1997. Under section 904(d)(3)(B) the inclusion is general limitation income described in section 904(d)(1)(I). The income inclusion to P results in a corresponding increase in P's basis in the stock of N1 under section 961(a).

(ii) On March 5, 1999, P sells its shares of N1 and recognizes a \$110 loss. The \$100 1997 subpart F inclusion is a dividend recapture amount that was included in P's income within the recapture period preceding the disposition of the N1 stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the \$100 dividend recapture amount exceeds 10 percent of the \$110 loss. Therefore, to the extent of the \$100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend recapture amount was assigned (general limitation income). The remaining \$10 loss is allocated to U.S. source income under paragraph (a)(1) of this section.

Example 3. (i) P, a domestic corporation, owns all of the stock of N1, which owns all of the stock of N2. N1 and N2 are controlled foreign corporations. All the corporations use the calendar year as their taxable year and the U.S. dollar as their functional currency. On May 5, 1998, N2 pays a dividend of \$100 to N1 out of general limitation earnings and profits.

(ii) On February 5, 2000, N1 sells its N2 stock to an unrelated purchaser. The sale results in a loss to N1 of \$110 for U.S. tax purposes. In 2000, N1 has the following current

earnings and profits, excluding the loss on the sale of N2:

(A) \$1,000 of non-subpart F foreign source general limitation earnings and profits described in section 904(d)(1)(I);

(B) \$1,000 of foreign source gain from the sale of stock that is taken into account in determining foreign personal holding company income under section 954(c)(1)(B)(i) and which is passive limitation earnings and profits described in section 904(d)(1)(A);

(C) \$1,000 of foreign source interest income received from an unrelated person that is foreign personal holding company income under section 954(c)(1)(A) and which is passive limitation earnings and profits described in section 904(d)(1)(A).

(iii) The \$100 dividend paid in 1998 is a dividend recapture amount that was included in N1's income within the recapture period preceding the disposition of the N2 stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the \$100 dividend recapture amount exceeds 10 percent of the \$110 loss. Therefore, to the extent of the \$100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation earnings and profits).

(iv) N1's remaining \$10 loss on the disposition of the N2 stock is allocated to foreign source passive limitation earnings and profits under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, N1's current earnings and profits for 1998 consist of \$900 of foreign source general limitation earnings and profits and \$1,990 of foreign source passive limitation earnings and profits.

(vi) After allocation of the stock loss, N1's subpart F income for 2000 consists of \$1,000 of foreign source interest income that is foreign personal holding company income under section 954(c)(1)(A) and \$890 of foreign source net gain that is foreign personal holding company income under section 954(c)(1)(B)(i). P includes \$1,890 in income under section 951(a)(1)(A)(i) as passive income under sections 904(d)(1)(A) and 904(d)(3)(B).

Example 4. P, a foreign corporation, has two wholly-owned subsidiaries, S, a domestic corporation, and B, a foreign corporation. On January 1, 2000, S purchases a one-percent interest in N, a foreign corporation, for \$100. On January 2, 2000, N distributes a \$20 dividend to S. The \$20 dividend is foreign source financial services income. On January 3, 2000, S

sells its N stock to B for \$80 and recognizes a \$20 loss that is deferred under section 267(f). On June 10, 2008, B sells its N stock to an unrelated person for \$55. Under section 267(f) and §1.267(f)-1(c)(1), S's \$20 loss is deferred until 2008. Under this paragraph (b)(1), the \$20 loss is allocated to reduce foreign source financial services income in 2008 because the loss was recognized (albeit deferred) within the 24-month recapture period following the receipt of the dividend. See §§1.267(f)-1(a)(2)(i)(B) and 1.267(f)-1(c)(2).

Example 5. The facts are the same as in Example 4, except P, S, and B are domestic corporations and members of the P consolidated group. Under the matching rule of §1.1502-13(c)(1), the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation and the intercompany transaction was a transaction between divisions. If S and B were divisions of a single corporation, the transfer of N stock on January 3, 2000 would be ignored for tax purposes, and the corporation would be treated as selling that stock only in 2008. Thus, the corporation's entire \$45 loss would have been allocated against U.S. source income under paragraph (a)(1) of this section because a dividend recapture amount was not received during the corporation's recapture period. Accordingly, S's \$20 loss and B's \$25 loss are allocated to reduce U.S. source income.

(2) Exception for inventory. This section does not apply to loss recognized with respect to stock described in section 1221(1).

(3) Exception for stock in an S corporation. This section does not apply to loss recognized with respect to stock in an S corporation (as defined in section 1361).

(4) Anti-abuse rules--(i) Transactions involving built-in losses. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock by transferring the stock to another person, qualified business unit (within the meaning of section 989(a)), office or other fixed place of business, or branch that subsequently recognizes the

loss, the loss shall be allocated by the transferee as if it were recognized with respect to the stock by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to stock, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock (or other personal property) by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, or transfers to or from a qualified business unit, office or other fixed place of business. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) Offsetting positions. If a taxpayer recognizes loss with respect to stock and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held)

offsetting positions with respect to such stock with a principal purpose of recognizing foreign source income and United States source loss, the loss will be allocated and apportioned against such foreign source income. For purposes of this paragraph (b)(4)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) Matching rule. [Reserved] For further guidance, see §1.865-2T(b)(4)(iii).

(iv) Examples. The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Example 1. (i) Facts. On January 1, 2000, P, a domestic corporation, owns all of the stock of N1, a controlled foreign corporation, which owns all of the stock of N2, a controlled foreign corporation. N1's basis in the stock of N2 exceeds its fair market value, and any loss recognized by N1 on the sale of N2 would be allocated under paragraph (a)(1) of this section to reduce foreign source passive limitation earnings and profits of N1. In contemplation of the sale of N2 to an unrelated purchaser, P causes N1 to liquidate with principal purposes of recognizing the loss on the N2 stock and allocating the loss against U.S. source income. P sells the N2 stock and P recognizes a loss.

(ii) Loss allocation. Because one of the principal purposes of the liquidation was to transfer the stock to P in order to change the allocation of the built-in loss on the N2 stock, under paragraph (b)(4)(i) of this section the loss is allocated against P's foreign source passive limitation income.

Example 2. (i) Facts. On January 1, 2000, P, a domestic corporation, forms N and F, foreign corporations, and contributes \$1,000 to the capital of each. N and F enter into offsetting positions in financial instruments that produce financial

services income. Holding the N stock substantially diminishes P's risk of loss with respect to the F stock (and vice versa). P holds N and F with a principal purpose of recognizing foreign source income and U.S. source loss. On March 31, 2000, when the financial instrument held by N is worth \$1,200 and the financial instrument held by F is worth \$800, P sells its F stock and recognizes a \$200 loss.

(ii) Loss allocation. Because P held an offsetting position with respect to the F stock with a principal purpose of recognizing foreign source income and U.S. source loss, the \$200 loss is allocated against foreign source financial services income under paragraph (b)(4)(ii) of this section.

(c) Loss recognized by partnership. A partner's distributive share of loss recognized by a partnership shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(d) Definitions--(1) Terms defined in §1.861-8. See §1.861-8 for the meaning of class of gross income, statutory grouping of gross income, and residual grouping of gross income.

(2) Dividend recapture amount. A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and

an inclusion described in section 951(a)(1)(B).

(3) Recapture period. A recapture period is the 24-month period preceding the date on which a taxpayer recognizes a loss with respect to stock, increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired.

(4) United States resident. See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) Effective date--(1) In general. This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) Application to prior periods. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that--

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and §1.865-2T for each such year for which the statute of limitations does not preclude the filing of an amended return on

June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) Examples. The rules of this paragraph (e) may be illustrated by the following examples:

Example 1. (i) P, a domestic corporation, has a calendar taxable year. On March 10, 1985, P recognizes a \$100 capital loss on the sale of N, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1985 and is carried over to the 1990 taxable year. The loss is allocated against foreign source income under §1.861-8(e)(7). In 1999, P chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years.

(ii) Allocation of the loss on the sale of N is not affected by the rules of this section because the loss was recognized in a taxable year that did not begin after December 31, 1986.

Example 2. (i) P, a domestic corporation, has a calendar taxable year. On March 10, 1988, P recognizes a \$100 capital loss on the sale of N, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1988 and is carried back to the 1985 taxable year. The loss is allocated against foreign source income under §1.861-8(e)(7) on P's federal income tax return for 1985 and increases an overall foreign loss account under §1.904(f)-1.

(ii) In 1999, P chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years. Consequently, the loss on the sale of N is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income reduces P's overall foreign loss account and increases P's tax liability in 2 years: 1990, a year that will not be open for assessment on June 30, 1999, and 1997, a year that will be open for assessment on June 30, 1999. Pursuant to paragraph (e)(2)(i) of this section, P must file an amended federal income tax return that reflects the rules of this section for 1997, but not for 1990.

Example 3. (i) P, a domestic corporation, has a calendar taxable year. On March 10, 1989, P recognizes a \$100 capital loss on the sale of N, a foreign corporation. The loss is allocated against foreign source income under §1.861-8(e)(7) on P's federal income tax return for 1989 and results in excess foreign tax credits for that year. The excess credit is carried

back to 1988, pursuant to section 904(c). In 1999, P chooses to apply this section to all losses recognized in its 1989 taxable year and in all subsequent years. On June 30, 1999, P's 1988 taxable year is closed for assessment, but P's 1989 taxable year is open with respect to claims for refund.

(ii) Because P chooses to apply this section to its 1989 taxable year, the loss on the sale of N is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income would have permitted the foreign tax credit to be used in 1989, reducing P's tax liability in 1989. Nevertheless, under paragraph (e)(2)(ii) of this section, because the credit was carried back to 1988, P may not claim the foreign tax credit in 1989.

Par. 6. Section 1.865-2T is added immediately after §1.865-2, to read as follows:

§1.865-2T Loss with respect to stock (Temporary).

(a) through (b)(4)(ii) [Reserved] For further guidance, see §1.865-2(a) through (b)(4)(ii).

(b)(4)(iii) Matching rule. To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock, the loss shall be allocated and apportioned against such income. This paragraph (b)(4)(iii) shall not apply to the extent a loss is related to a dividend recapture amount and §1.865-2(b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) exempts the loss from §1.865-2(b)(1)(i) (dividend recapture rule), unless the stock is held with a principal purpose of producing foreign source income and corresponding loss.

(iv) Examples. The application of this paragraph (b)(4) may

be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Examples 1 and 2. [Reserved] For further guidance, see §1.865-2(b)(4)(iv).

Example 3. (i) Facts. On January 1, 1999, P and Q, domestic corporations, form R, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. P contributes \$900 to R in exchange for a 90-percent partnership interest and Q contributes \$100 to R in exchange for a 10-percent partnership interest. R purchases a dance studio in country X for \$1,000. On January 2, 1999, R enters into contracts to provide dance lessons in Country X for a 5-year period beginning January 1, 2000. These contracts are prepaid by the dance studio customers on December 31, 1999, and R recognizes foreign source taxable income of \$500 from the prepayments (R's only income in 1999). P takes into income its \$450 distributive share of partnership taxable income. On January 1, 2000, P's basis in its partnership interest is \$1,350 (\$900 from its contribution under section 722, increased by its \$450 distributive share of partnership income under section 705). On September 22, 2000, P contributes its R partnership interest to S, a newly-formed domestic corporation, in exchange for all the stock of S. Under section 358, P's basis in S is \$1,350. On December 1, 2000, P sells S to an unrelated party for \$1050 and recognizes a \$300 loss.

(ii) Loss allocation. Because P recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the S stock, the \$300 loss is allocated against foreign source income under paragraph (b)(4)(iii) of this section.

Example 4. (i) Facts. On January 1, 2000, P, a domestic corporation that uses the calendar year as its taxable year forms N, a foreign corporation. P contributes \$1,000 to the capital of N in exchange for 100 shares of common stock. P contributes an additional \$1,000 to the capital of N in exchange for 100 shares of preferred stock. Each preferred share is entitled to 15-percent dividend but is redeemable by N on or after January 1, 2010, for \$1. Prior to January 10, 2005, P receives a total of \$750 of distributions from N with respect to its preferred shares, which P treats as foreign source general limitation dividends. On January 10, 2005, P sells its 100 preferred shares in N to an unrelated purchaser for \$600. Assume that this

arrangement is not recharacterized under Notice 97-21 (1997-1 C.B. 407).

(ii) Loss allocation. Because P recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the N stock, the \$400 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 5. (i) Facts. On January 1, 2000, P, a domestic corporation that uses the calendar year as its taxable year, and F, a newly-formed controlled foreign corporation wholly-owned by P, form N, a foreign corporation. P contributes \$1,000 to the capital of N in exchange for 100 shares of common stock and \$1,000 to the capital of F in exchange for 100 shares of common stock. F contributes LC1,000 to the capital of N in exchange for 100 shares of preferred stock. Each preferred share is entitled to a 65-percent LC dividend. At the time of the contributions, \$1=LC1. The LC is expected to depreciate significantly in relation to the U.S. dollar. Prior to June 10, 2005, P receives a total of \$1,900 of distributions from F, which it treats as foreign source general limitation dividends. On June 10, 2005, the N preferred stock has a fair market value of \$25 and P sells F for \$25 to an unrelated person. Assume that this arrangement is not recharacterized under Notice 97-21 (1997-1 C.B. 407).

(ii) Loss allocation. Because P recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the F stock, the \$975 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 6. (i) Facts. On January 1, 1998, P, a domestic corporation, purchases N, a foreign corporation, for \$1000. On March 1, 1998, N sells its operating assets, distributes a \$400 general limitation dividend to P, and invests its remaining \$600 in short term government securities. N earns interest income from the securities. The income constitutes subpart F income that is included in P's income under section 951, increasing P's basis in the N stock under section 961(a). On March 1, 2002, P sells N and recognizes a \$400 loss.

(ii) Loss allocation. The \$400 dividend received by P resulted in a \$400 built-in loss in the N stock, which was locked in for P's four-year holding period. Because P recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the N stock, under paragraph (b)(4)(iii) of this section the \$400 loss is allocated against foreign source general limitation income.

(e) Effective date--(1) In general. This section is

effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) Application to prior periods. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that--

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and §1.865-2 for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

Par. 7. Section 1.904-0 is amended by revising the entry for §1.904-4(c)(2)(i) and (ii) and adding entries for paragraphs (c)(2)(i)(A), (c)(2)(i)(B), (c)(2)(ii)(A) and (c)(2)(ii)(B) to read as follows:

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

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

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(c) * * *

(2) * * *

(i) Effective dates.

(A) In general.

(B) Application to prior periods.

(ii) Grouping rules.

- (A) Initial allocation and apportionment of deductions and taxes.
 (B) Reallocation of loss groups.

* * * * *

Par. 8. Section 1.904-4 is amended by:

1. Revising paragraphs (c)(1) and (c)(2),
2. Revising paragraph (c)(3)(iii),
3. Adding paragraph (c)(3)(iv), and
4. Amending paragraph (c)(8) by adding Example 11, Example 12 and Example 13.

5. The additions and revisions read as follows:

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

* * * * *

(c) High-taxed income--(1) In general. Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount

of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under §1.904-6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general limitation income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) Examples 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section.

(2) Grouping of items of income in order to determine whether passive income is high-taxed income--(i) Effective dates--(A) In general. For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3)(i) and (ii), (c)(4), and (c)(5) of this section

apply to taxable years beginning after December 31, 1987. Except as provided in paragraph (c)(2)(i)(B) of this section, the rules of paragraph (c)(3)(iii) apply to taxable years beginning after December 31, 1987, and ending before December 31, 1998, and the rules of paragraph (c)(3)(iv) apply to taxable years ending on or after December 31, 1998. See Notice 87-6 (1987-1 C.B.417) for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. The fourth sentence of paragraph (c)(2)(ii)(A) and paragraph (c)(2)(ii)(B) of this section are effective for taxable years beginning after March 12, 1999.

(B) Application to prior periods. A taxpayer may apply the rules of paragraph (c)(3)(iv) to any taxable year beginning after December 31, 1991, and all subsequent years, provided that--

(1) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(2) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(ii) Grouping rules--(A) Initial allocation and apportionment of deductions and taxes. For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in

paragraphs (c)(3), (4), and (5) of this section) under the rules of §§1.861-8 through 1.861-14T and 1.865-1T through 1.865-2T. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of §1.904-6(a)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) Reallocation of loss groups. If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) * * *

(iii) For taxable years ending before December 31, 1998 (except as provided in paragraph (c)(2)(i)(B) of this section), all passive income received during the taxable year that is subject to no withholding tax shall be treated as one item of

income.

(iv) For taxable years ending on or after December 31, 1998, all passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income, and all passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

* * * * *

(8) * * *

Example 11. In 2001, P, a U.S. citizen with a tax home in Country X, earns the following items of gross income: \$400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country X income tax of \$100, \$200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is \$10), \$1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is \$325), \$500 of foreign source, general limitation income that gives rise to a \$250 foreign tax, and \$2,000 of U.S. source capital gain that is not subject to any foreign tax. P has a \$900 deduction allocable to its passive rental income. P's only other deduction is a \$700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under §1.865-2(a)(3)(i). The \$700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The \$300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The royalty income is thus reduced by \$100 to \$100 ($\$200 - (\$300 \times (200/600))$) and the rental income is thus reduced by \$200 to \$200 ($\$400 - (\$300 \times (400/600))$). The \$100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the \$200 of rental income and the \$325 of associated foreign tax are assigned to the general limitation category.

Example 12. The facts are the same as in Example 11 except the amount of the capital loss that is allocated under §1.865-2(a)(3)(i) and paragraph (c)(2) of this section to the group of

foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is \$1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of \$800 must be reapportioned to the \$200 of net royalty income subject to a 5 percent withholding tax and the \$400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of \$200 constitutes a separate limitation loss with respect to passive income.

Example 13. In 2001, P, a domestic corporation, earns a \$100 dividend that is foreign source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether P's passive income is high-taxed, the \$100 dividend and the \$30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

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Robert E. Wenzel

Deputy Commissioner of Internal Revenue

Approved: December 15, 1998

Donald C. Lubick

Assistant Secretary of the Treasury