26 CFR 1.904–4: Separate application of section 904 with respect to certain categories of income.

T.D. 9141

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the section 904(d) foreign tax credit limitation and to the exclusion of certain export financing interest from foreign personal holding company income. Changes to the applicable law were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Taxpayer Relief Act of 1997, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. These regulations provide guidance needed to comply with these changes and affect individuals and corporations claiming foreign tax credits and reporting subpart F income.

DATES: *Effective Date:* These regulations are effective July 20, 2004.

Applicability Dates: These regulations generally apply for taxable years beginning on or after July 20, 2004. Section 1.904–4(b)(2)(i) applies with respect to rents and royalties paid or accrued more than 60 days after July 20, 2004. Taxpayers may choose to apply §1.904(b)–1 and §1.904(b)–2 to taxable years ending after July 20, 2004.

FOR FURTHER INFORMATION CONTACT: Bethany A. Ingwalson (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 319) a notice of proposed rulemaking (REG–104683–00, 2001–1 C.B. 407) providing guidance with respect to the application of sections 902 and 904. Several comments were received, and a public hearing was held on April 26, 2001. After consideration of the comments, certain portions of the regulations are withdrawn and the remainder of the regulations are finalized substantially as proposed. The discussion below summarizes the comments received and describes the reasons for withdrawing portions of the proposed regulations and the modifications to the remainder of the regulations. A notice of withdrawal (published as Announcement 2004–64) in this issue of the Bulletin withdraws the proposed amendments to §§1.902–0, 1.902–1 and 1.904–4(g).

Summary of Comments Received and Changes Made

I. Effect of Loss of Domestic Corporate Shareholder on Pooling of Earnings and Taxes in Computing Deemed Paid Credits: §1.902–1

Under the proposed amendments to §1.902–1(a), the multi-year pooling of a foreign corporation's post–1986 undistributed earnings and foreign income taxes would have terminated if the ownership requirements of section 902(c)(3)(B) were not met as of the end of any taxable year, and such earnings and earnings subsequently accumulated in periods during which the stock ownership requirements of section 902 were not met would have been treated as pre–1987 accumulated profits subject to the annual layering rules of section 902(c)(6). Prop. §1.902–1(a)(8), (10) and (13). The proposed amendments also provided for the pooling of earnings and taxes to resume in the first subsequent taxable year as of the end of which the foreign corporation again has a qualifying domestic corporate shareholder. The proposed regulations were intended to alleviate the difficulties of reconstructing accumulated earnings and taxes accounts in connection with a U.S. shareholder's acquisition of stock in a foreign corporation previously owned by U.S. shareholders after an intervening period of foreign ownership.

The Treasury Department and the IRS have determined that the potential simplification benefits of the proposed regulations would be outweighed by other administrative difficulties, including those associated with redeterminations of deemed-paid foreign taxes under section 905(c). Accordingly, the Treasury Department and the IRS are withdrawing the proposed amendments to §1.902–1(a) in a notice of withdrawal published in this issue of the Bulletin.

II. Separate Categories: §1.904–4

A. The active rents and royalties exception

The proposed regulations would have expanded the exception from passive income for active rents and royalties to include rents and royalties received from related payors. The proposed regulations provide that this change would apply to rents and royalties paid or accrued more than 60 days after the date that the final regulations are published in the **Federal Register**. Several comments requested that the amendment to the rents and royalties exception apply retroactively. The Treasury Department and the IRS continue to believe this amendment, which modifies existing final regulations, should apply only prospectively. Therefore, the amendment is adopted without change, and the new final regulations are applicable to rents and royalties paid or accrued more than 60 days after the date that the final regulations are published in the **Federal Register**.

B. Effect of intervening period of noncontrolled or less-than–10%-U.S.-owned status on distributions from a controlled foreign corporation or other look-through corporation

Under section 904(d)(3) and the Treasury regulations thereunder, a U.S. shareholder (as defined in section 951(b)) is allowed look-through treatment for dividends received from a controlled foreign corporation (CFC) if paid out of earnings and profits (E&P) accumulated during periods in which the foreign corporation was a CFC. Section 904(d)(4) allows look-through treatment for dividends paid by a noncontrolled section 902 corporation (10/50 corporation) to a domestic corporation that meets the ownership requirements of section 902(a) from E&P accumulated in a taxable year beginning after December 31, 2002. Section 904(d)(4) provides the Secretary with authority to issue regulations addressing the treatment of dividends paid by a 10/50 corporation out of pre-acquisition E&P.

The proposed regulations would not have provided look-through treatment for a dividend paid by a CFC or 10/50 corporation out of E&P accumulated during a post–2002 period in which the corporation was a CFC or 10/50 corporation if paid after an intervening period during which the corporation was a less-than-10%-U.S.-owned corporation. Prop. §1.904–4(g)(3)(i)(C)(2). Similarly, the proposed regulations would not have provided look-through treatment for a dividend from a CFC out of E&P accumulated during a pre-2003 period in which the corporation was a CFC if paid after an intervening pre-2003 period in which the CFC was a 10/50 corporation or less-than-10%-U.S.-owned corporation. Prop. §1.904–4(g)(3)(i)(C)(1) and (2). The proposed regulations also include a transition year rule that treated E&P accumulated and distributions made during the year in which a CFC or 10/50 corporation loses its look-through status (*i.e.*, becomes a non-CFC for pre-2003 tax years or a less-than-10%-U.S.-owned corporation for post-2002 tax years) as E&P accumulated or distributions made after the loss of look-through status. Prop. §1.904–4(g)(3)(i)(C). The effect of this transition year rule would be to deny look-through treatment for a dividend or an amount treated as a dividend under section 1248(a) from a CFC or 10/50 corporation out of E&P accumulated while the corporation was a look-through entity.

Several comments suggested that the proposed regulations were inconsistent with section 904(d)(2)(E), which provides that a CFC is not treated as a 10/50 corporation with respect to any distribution out of its E&P for periods during which it was a CFC. Comments also criticized the effect of the transition year rule described above. After consideration of the comments, the Treasury Department and the IRS are withdrawing the proposed amendments to §1.904–4(g) in a notice of withdrawal published in this issue of the Bulletin.

C. High-Taxed Income

The final regulations correct an error in an example relating to the grouping of items of income for purposes of determining whether the items are high-taxed income within the meaning of section 904(d)(2)(F).

III. Capital Gain and Loss Adjustments: §1.904(b)–1

A. In General

The proposed regulations under section 904(b) provide guidance concerning the application of the capital gain net income limitation of section 904(b)(2)(A) and 904(b)(2)(B)(i). Prop. §1.904(b)–1(a). The proposed regulations require a taxpayer to reduce foreign source capital gains to the extent the taxpayer's capital gain net income from foreign sources (in the aggregate) exceeded the taxpayer's entire capital gain net income. A taxpayer with a capital gain rate differential for the year and capital gain net income in two or more rate groups within a separate category with capital gain net income would be required to allocate such reduction *pro rata* to each such rate group in the separate category. The proposed regulations do not provide specific guidance concerning short-term capital gains for these purposes. The final regulations clarify that short-term amounts are treated as a rate group for purposes of §1.904(b)–1. Specifically, the final regulations clarify that a taxpayer with capital gain net income from foreign sources in a separate category attributable to capital gain net income in the short-term rate group and in one or more long-term rate groups allocates any reduction pursuant to the capital gain net income limitation *pro rata* to the short-term rate group and each applicable long-term rate group. The final regulations add an example involving short-term capital gain to illustrate this rule.

The proposed regulations also contain a rule limiting net capital gain from foreign sources (in the aggregate) to worldwide net capital gain. Prop. §1.904(b)–1(a). This rule is intended to limit the amount of capital gains from foreign sources (remaining after application of the capital gain net income limitation of section 904(b)(2)(A) and (b)(2)(B)(i)) subject to the rate differential adjustments of section 904(b)(2)(B)(i) and paragraph (c)(1) of the regulations to the extent a taxpayer has a net long-term capital loss from sources within the United States that does not reduce long-term capital gains from foreign sources pursuant to the capital gain net income limitation. This can occur when a taxpayer has short-term capital gains. The final regulations clarify the operation of the net capital gain limitation. In addition, because the net capital gain limitation applies solely for purposes of determining the amount of capital gains from foreign sources subject to the rate differential adjustments of section 904(b)(2)(B)(i) and paragraph (c)(1) of the regulations, the provisions addressing the net capital gain limitation have been moved to paragraph (c)(1) in the final regulations.

B. Election for Certain Noncorporate Taxpayers

The proposed regulations also provide guidance concerning the rate differential adjustments required by section 904(b)(2)(B). Prop. §1.904(b)–1(c) and (d). The final regulations add a rule that permits qualifying noncorporate taxpayers to elect not to apply the rate differential adjustments for any taxable year. Under the final regulations, a noncorporate taxpayer that is not subject to tax under section 55 for the taxable year may elect not to apply the rate differential adjustments if the highest rate of tax imposed on the taxpayer's taxable income (excluding net capital gain and qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from foreign sources, plus the amount of the taxpayer's qualified dividend income from foreign sources, is less than $20,000. Under the tax rates currently in effect, an individual with less than $20,000 of net capital gain and qualified dividend income from foreign sources would be eligible to make the election if the highest rate of tax applicable to such individual's taxable income (excluding net capital gain and qualified dividend income) under section 1 is 28 percent. For example, taxpayers whose filing status is married filing jointly would be eligible to make the election for the 2004 taxable year if their taxable income (excluding net capital gain and qualified dividend income) for 2004 does not exceed $178,650 and the total of their net capital gain and qualified dividend income, from foreign sources, is less than $20,000. A similar election applies to a noncorporate taxpayer subject to the alternative minimum tax for the taxable year. A qualifying taxpayer is presumed to elect out of the rate differential adjustments unless the taxpayer indicates otherwise on its return for the taxable year. The rule is intended to permit taxpayers to avoid the complexity of computing the rate differential adjustments in cases where the failure to make the adjustments does not result in a significant divergence from the results contemplated by section 904(b)(2)(B).

Because capital gains of corporations are not eligible for reduced rates of tax, the eligibility for the election is limited to noncorporate taxpayers.

C. Coordination with Section 904(f)

The proposed regulations contain rules for coordinating the adjustments pursuant to section 904(b)(2) with section 904(f). Prop. §1.904(b)–1(g). The final regulations provide additional guidance concerning the interaction between section 904(b)(2) and (f). First, the final regulations provide that a capital loss from sources within the United States that reduces capital gains from foreign sources pursuant to section 904(b)(2)(A) (or 904(b)(2)(B)(i)) and paragraph (a) of the regulations is disregarded in determining the amount of a taxpayer's taxable income from sources within the United States for purposes of computing the amount of any additions to the taxpayer's overall foreign loss accounts. This rule is intended to prevent the double-counting of capital losses from sources within the United States. Second, the final regulations provide that a taxpayer's loss from sources in the United States (within the meaning of section 904(f)(5)(D)) is the amount by which the taxpayer's foreign source taxable income (in the aggregate after taking into account adjustments pursuant to section 904(b)(2) and the final regulations) exceeds the taxpayer's entire taxable income (after taking into account adjustments pursuant to section 904(b)(2)(B) and the final regulations). The rule is intended to prevent distortions to the foreign tax credit limitation fraction that would otherwise result when a taxpayer has capital gains or losses from sources within the United States. The final regulations add examples to illustrate the operation of these coordination rules.

D. Qualified Dividend Income

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752), extended the capital gain rates under section 1(h) to qualified dividend income of noncorporate taxpayers. JGTRRA provides that rules similar to the rules of section 904(b)(2)(B) (the rate differential adjustment rules) apply with respect to such qualified dividend income. The final regulations implement the coordination rule contained in JGTRRA by requiring a taxpayer to make rate differential adjustments to the taxpayer's qualified dividend income in a manner similar to the adjustments for a taxpayer's capital gains. The final regulations contain an election for noncorporate taxpayers, similar to the election for capital gains and losses, allowing a qualifying taxpayer to elect out of the rate differential adjustments with respect to the taxpayer's qualified dividend income.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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 regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these final regulations is Bethany A. Ingwalson of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "1.904–4 through 1.904–7" and the entry for "1.904(b)–3", and by adding entries in numerical order to read, in part, as follows:

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

Section 1.904–4 also issued under 26 U.S.C. 904(d)(6).

Section 1.904(b)–1 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).

Section 1.904(b)–2 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).

Section 1.904–5 also issued under 26 U.S.C. 904(d)(6).

Section 1.904–6 also issued under 26 U.S.C. 904(d)(6).

Section 1.904–7 also issued under 26 U.S.C. 904(d)(6). * * *

Par. 2. Section 1.904–0 is amended as follows:

1. The entries for §1.904–4 are amended by:

a. Revising the entry for paragraph (b)(2)(iii).

b. Removing the entry for paragraph (b)(2)(iv).

c. Adding an entry for paragraph (m).

2. The entries for §§1.904(b)–1 and 1.904(b)–2 are revised.

3. Removing all the entries for §§1.904(b)–3 and 1.904(b)–4.

4. Adding entries for §1.904(j)–1.

The revisions and additions read as follows:

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

* * * * *

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

* * * * *

(b) * * *

(2) * * *

(iii) Example.

* * * * *

(m) Income treated as allocable to an additional separate category.

* * * * *

§1.904(b)–1 Special rules for capital gains and losses.

(a) Capital gains and losses included in taxable income from sources outside the United States.

(1) Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States.

(i) In general.

(ii) Allocation of reduction to separate categories or rate groups.

(A) In general.

(B) Taxpayer with capital gain rate differential.

(2) Exclusivity of rules; no reduction by reason of net capital loss from sources outside the United States in a different separate category.

(3) Capital losses from sources outside the United States in the same separate category.

(4) Examples.

(b) Capital gain rate differential.

(1) Application of adjustments only if capital gain rate differential exists.

(2) Determination of whether capital gain rate differential exists.

(3) Special rule for certain noncorporate taxpayers.

(c) Rate differential adjustment of capital gains.

(1) Rate differential adjustment of capital gains in foreign source taxable income.

(i) In general.

(ii) Special rule for taxpayers with a net long-term capital loss from sources within the United States.

(iii) Examples.

(2) Rate differential adjustment of capital gains in entire taxable income.

(d) Rate differential adjustment of capital losses from sources outside the United States.

(1) In general.

(2) Determination of which capital gains are offset by net capital losses from sources outside the United States.

(e) Qualified dividend income.

(1) In general.

(2) Exception.

(f) Definitions.

(1) Alternative tax rate.

(2) Net capital gain.

(3) Rate differential portion.

(4) Rate group.

(i) Short-term capital gains or losses.

(ii) Long-term capital gains.

(iii) Long-term capital losses.

(5) Terms used in sections 1(h), 904(b) or 1222.

(g) Examples.

(h) Coordination with section 904(f).

(1) In general.

(2) Examples.

(i) Effective date.

§1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) Application of section 904(b)(2)(B) adjustments.

(b) Use of alternative minimum tax rates.

(1) Taxpayers other than corporations.

(2) Corporate taxpayers.

(c) Effective date.

* * * * *

§1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) Election available only if all foreign taxes are creditable foreign taxes.

(b) Coordination with carryover rules.

(1) No carryovers to or from election year.

(2) Carryovers to and from other years determined without regard to election years.

(3) Determination of amount of creditable foreign taxes.

(c) Examples.

(d) Effective date.

Par. 3. Section 1.904–4 is amended as follows:

1. Paragraph (a) is amended by removing the period at the end and adding the language “, or in §1.904–4(m) (additional separate categories).”

2. The first sentence of paragraph (b)(2)(i) is revised.

3. Paragraph (b)(2)(ii) is revised.

4. Paragraph (b)(2)(iii) is removed.

5. Paragraph (b)(2)(iv) is redesignated as paragraph (b)(2)(iii).

6. The last three sentences of the *Example* in newly designated paragraph (b)(2)(iii) are removed and six new sentences are added in their place.

7. The fifth sentence of *Example 4* in paragraph (c)(8) is revised.

8. The language “and” at the end of paragraph (l)(1)(v) is removed.

9. The period at the end of paragraph (l)(1)(vi) is removed and “; and” is added in its place.

10. Paragraph (l)(1)(vii) is added.

11. Paragraph (m) is added.

The revisions and additions read as follows:

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

* * * * *

(b) * * *

(2) * * * (i) * * * For rents and royalties paid or accrued after September 18, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. * * *

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

(iii) * * *

Example. * * * Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations thereunder. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general limitation income to S under §1.904–4(b)(2)(ii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general limitation income to P under the look-through rules of §1.904–5(c)(1)(i) and (c)(3), respectively.

* * * * *

(c) * * *

(8) * * *

Example 4. * * * The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 4 percent and 10 percent withholding tax, respectively. * * *

* * *

(l) * * * (1) * * *

(vii) Income that meets the definitions of a separate category described in paragraph (m) of this section and of any other category of separate limitation income described in section 904(d)(1)(A) through (H) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general limitation income described in section 904(d)(1)(I).

* * * * *

(m) *Income treated as allocable to an additional separate category*. If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(g)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1) and (d)(3)(F)(i).

Par. 4. In §1.904–5, paragraph (a)(1) is revised to read as follows:

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

(a) * * *

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (E), (F), (G), (H), or (I) and in §1.904–4(b), (d), (e), (f), and (g), any category of income described in §1.904–4(m), or any category of earnings and profits to which income described in such provisions is attributable.

* * * * *

Par. 5. In §1.904–6, paragraph (a)(1)(ii) is amended by adding two sentences at the end to read as follows:

§1.904–6 Allocation and apportionment of taxes.

(a) * * * (1) * * *

(ii) * * * If the taxpayer applies the principles of §§1.861–8 through 1.861–14T for purposes of allocating expenses at the level of the taxpayer (or at the level of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes) under this paragraph (a)(1)(ii), such principles shall be applied (for such purposes) in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for United States tax purposes of the taxpayer (or of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes, as the case may be). For example, a taxpayer must use the modified gross income method under §1.861–9T when applying the principles of that section for purposes of this paragraph (a)(1)(ii) to determine the amount of a controlled foreign corporation's income, in each separate category, that is taxed by a foreign country, if the taxpayer applies the modified gross income method under §1.861–9T(f)(3) when applying §1.861–9T to determine the income and earnings and profits of the controlled foreign corporation for United States tax purposes.

* * * * *

Par. 6. Section 1.904(b)–1 is revised to read as follows:

§1.904(b)–1 Special rules for capital gains and losses.

(a) *Capital gains and losses included in taxable income from sources outside the United States*—(1) *Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States*—(i) *In general*. Except as otherwise provided in this section, for purposes of section 904 and this section, taxable income from sources outside the United States (in all of the taxpayer's separate categories in the aggregate) shall include capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) only to the extent of capital gain net income from all sources. Thus, capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) shall be reduced to the extent such amount exceeds capital gain net income from all sources.

(ii) *Allocation of reduction to separate categories or rate groups*—(A) *In general*. If capital gain net income from sources outside the United States exceeds capital gain net income from all sources, and the taxpayer has capital gain net income from sources outside the United States in only one separate category, such excess is allocated as a reduction to that separate category. If a taxpayer has capital gain net income from foreign sources in two or more separate categories, such excess must be apportioned on a *pro rata* basis as a reduction to each such separate category. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of the capital gain net income from sources outside the United States in each separate category.

(B) *Taxpayer with capital gain rate differential*. If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in only one rate group within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be allocated to such rate group. If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in two or more rate groups within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be apportioned on a *pro rata* basis among such rate groups. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of the capital gain net income from sources outside the United States in each rate group within the applicable separate category.

(2) *Exclusivity of rules; no reduction by reason of net capital losses from sources outside the United States in a different separate category*. Capital gains from sources outside the United States in any separate category shall be limited by reason of section 904(b)(2)(A) and the comparable limitation of section 904(b)(2)(B)(i) only to the extent provided in paragraph (a)(1) of this section (relating to limitation on capital gain from sources outside the United States when taxpayer has net capital losses from sources within the United States).

(3) *Capital losses from sources outside the United States in the same separate category*. Except as otherwise provided in paragraph (d) of this section, taxable income from sources outside the United States in each separate category shall be reduced by any capital loss that is allocable or apportionable to income from sources outside the United States in such separate category to the extent such loss is allowable in determining taxable income for the taxable year.

(4) *Examples*. The following examples illustrate the application of this paragraph (a) to taxpayers that do not have a capital gain rate differential for the taxable year. See paragraph (g) of this section for examples that illustrate the application of this paragraph (a) to taxpayers that have a capital gain rate differential for the year. The examples are as follows:

Example 1. Taxpayer A, a corporation, has a \$3,000 capital loss from sources outside the United States in the general limitation category, a \$6,000 capital gain from sources outside the United States in the passive category, and a \$2000 capital loss from sources within the United States. A's capital gain net income from sources outside the United States in the aggregate, from all separate categories, is \$3000 (\$6,000 - \$3,000). A's capital gain net income from all sources is \$1000 (\$6000 - \$3000 - \$2000). Thus, for purposes of section 904, A's taxable income from sources outside the United States in all of A's separate categories in the aggregate includes only \$1000 of capital gain net income from sources outside the United States. See paragraph (a)(1)(i) of this section. Pursuant to paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section, A must reduce the \$6000 of capital gain net income from sources outside the United States in the passive category by \$2000 (\$3000 of capital gain net income from sources outside the United States - \$1000 of capital gain net income from all sources). After the adjustment, A has \$4000 of capital gain from sources outside the United States in the passive category and \$3000 of capital loss from sources outside the United States in the general limitation category.

Example 2. Taxpayer B, a corporation, has a \$300 capital gain from sources outside the United States in the general limitation category and a \$200 capital gain from sources outside the United States in the passive category. B's capital gain net income from sources outside the United States is \$500 (\$300 + \$200). B also has a \$150 capital loss from sources within the United States and a \$50 capital gain from sources within the United States. Thus, B's capital gain net income from all sources is \$400 (\$300 + \$200 - \$150 + \$50). Pursuant to paragraph (a)(1)(ii)(A) of this section, the \$100 excess of capital gain net income from sources outside the United States over capital gain net income from all sources (\$500 - \$400) must be apportioned, as a reduction, three-fifths (\$300/\$500 of \$100, or \$60) to the general limitation category and two-fifths (\$200/\$500 of \$100, or \$40) to the passive category. Therefore, for purposes of section 904, the general limitation category includes \$240 (\$300 - \$60) of capital gain net income from sources outside the United States and the passive category includes \$160 (\$200 - \$40) of capital gain net income from sources outside the United States.

Example 3. Taxpayer C, a corporation, has a \$10,000 capital loss from sources outside the United States in the general limitation category, a \$4,000 capital gain from sources outside the United States in the passive category, and a \$2,000 capital gain from sources within the United States. C's capital gain net income from sources outside the United States is zero, since losses exceed gains. C's capital gain net income from all sources is also zero. C's capital gain net income from sources outside the United States does not exceed its capital gain net income from all sources, and therefore paragraph (a)(1) of this section does not require any reduction of C's passive category capital gain. For purposes of section 904, C's passive category includes \$4,000 of capital gain net income. C's general limitation category includes a capital loss of \$6,000 because only \$6,000 of capital loss is allowable as a deduction in the current year. The entire \$4,000 of capital loss in excess of the \$6,000 of capital loss that offsets capital gain in the taxable year is carried back or forward under section 1212(a), and none of such \$4,000 is taken into account under section 904(a) or (b) for the current taxable year.

(b) *Capital gain rate differential*—(1) *Application of adjustments only if capital gain rate differential exists*. Section 904(b)(2)(B) and paragraphs (c) and (d) of this section apply only for taxable years in which the taxpayer has a capital gain rate differential.

(2) *Determination of whether capital gain rate differential exists*. For purposes of section 904(b) and this section, a capital gain rate differential is considered to exist for the taxable year only if the taxpayer has taxable income (excluding net capital gain and qualified dividend income) for the taxable year, a net capital gain for the taxable year and—

(i) In the case of a taxpayer other than a corporation, tax is imposed on the net capital gain at a reduced rate under section 1(h) for the taxable year; or

(ii) In the case of a corporation, tax is imposed under section 1201(a) on the taxpayer at a rate less than any rate of tax imposed on the taxpayer by section 11, 511, or 831(a) or (b), whichever applies (determined without regard to the last sentence of section 11(b)(1)), for the taxable year.

(3) *Special rule for certain noncorporate taxpayers*. A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is not subject to alternative minimum tax under section 55 for the taxable year may elect not to apply the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section if the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than \$20,000. A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is subject to alternative minimum tax under section 55 for the taxable year may make such election if the rate of tax imposed on such taxpayer's alternative minimum taxable income (excluding net capital gain and any qualified dividend income) under section 55 does not exceed 26 percent, the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax

in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than $20,000. A taxpayer who makes this election shall apply paragraph (a) of this section as if such taxpayer does not have a capital gain rate differential for the taxable year. An eligible taxpayer shall be presumed to have elected not to apply the rate differential adjustments, unless such taxpayer applies the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section in determining its foreign tax credit limitation for the taxable year.

(c) *Rate differential adjustment of capital gains*—(1) *Rate differential adjustment of capital gains in foreign source taxable income*—(i) *In general*. Subject to paragraph (c)(1)(ii) of this section, in determining taxable income from sources outside the United States for purposes of section 904 and this section, capital gain net income from sources outside the United States in each long-term rate group in each separate category (separate category long-term rate group), shall be reduced by the rate differential portion of such capital gain net income. For purposes of paragraph (c)(1) of this section, references to capital gain net income are references to capital gain net income remaining after any reduction to such income pursuant to paragraph (a)(1) of this section (*i.e.*, paragraph (a)(1) of this section applies before paragraphs (c) and (d) of this section).

(ii) *Special rule for taxpayers with a net long-term capital loss from sources within the United States*. If a taxpayer has a net long-term capital loss from sources within the United States (*i.e.*, the taxpayer's long-term capital losses from sources within the United States exceed the taxpayer's long-term capital gains from sources within the United States) and also has any short-term capital gains from sources within or without the United States, then capital gain net income from sources outside the United States in each separate category long-term rate group shall be reduced by the rate differential portion of the applicable rate differential amount. The applicable rate differential amount is determined as follows:

(A) *Step 1*: *Determine the U.S. long-term capital loss adjustment amount*. The U.S. long-term capital loss adjustment amount is the excess, if any, of the net long-term capital loss from sources within the United States over the amount, if any, by which the taxpayer reduced long-term capital gains from sources without the United States pursuant to paragraph (a)(1) of this section.

(B) *Step 2*: *Determine the applicable rate differential amount*. If a taxpayer has capital gain net income from sources outside the United States in only one separate category long-term rate group, the applicable rate differential amount is the excess of such capital gain net income over the U.S. long-term capital loss adjustment amount. If a taxpayer has capital gain net income from sources outside the United States in more than one separate category long-term rate group, the U.S. long-term capital loss adjustment amount shall be apportioned on a *pro rata* basis to each separate category long-term rate group with capital gain net income. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of capital gain net income from sources outside the United States in each separate category long-term rate group. The applicable rate differential amount for each separate category long-term rate group with capital gain net income is the excess of such capital gain net income over the portion of the U.S. long-term capital loss adjustment amount apportioned to the separate category long-term rate group pursuant to this Step 2.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (c)(1)(ii) of this section. The taxpayers in the examples are assumed to have taxable income (excluding net capital gain and qualified dividend income) subject to a rate of tax under section 1 greater than the highest rate of tax in effect under section 1(h) for the applicable taxable year. The examples are as follows:

Example 1. (i) M, an individual, has $300 of long-term capital gain from foreign sources in the passive category, $200 of which is subject to tax at a rate of 15 percent under section 1(h) and $100 of which is subject to tax at a rate of 28% under section 1(h). M has $150 of short-term capital gain from sources within the United States. M has a $100 long-term capital loss from sources within the United States.

(ii) M's capital gain net income from sources outside the United States ($300) does not exceed M's capital gain net income from all sources ($350). Therefore, paragraph (a)(1) of this section does not require any reduction of M's capital gain net income in the passive category.

(iii) Because M has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($150), M must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $300 of capital gain net income in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $100 ($100 - $0). Under *Step 2*, M must apportion this amount to each rate group in the passive category *pro rata* based on the amount of capital gain net income in each rate group. Thus, $66.67 ($200/$300 of $100) is apportioned to the 15 percent rate group and $33.33 ($100/$300 of $100) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $133.33 ($200 - $66.67). Thus, $133.33 of the $200 of capital gain net income in the 15 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $66.67 is not subject to a rate differential adjustment. The applicable rate differential amount for the 28 percent rate group is $66.67 ($100 - $33.33). Thus, $66.67 of the $100 of capital gain net income in the 28 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $33.33 is not subject to a rate differential adjustment.

Example 2. (i) N, an individual, has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). N has $50 of short-term capital gain from sources within the United States. N has a $100 long-term capital loss from sources within the United States.

(ii) N's capital gain net income from sources outside the United States ($300) exceeds N's capital gain net income from all sources ($250). Pursuant to paragraph (a)(1) of this section, N must reduce the $300 capital gain in the passive category by $50. N has $250 of capital gain remaining in the passive category.

(iii) Because N has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($50), N must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $250 of capital gain in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $50 ($100 - $50). Under *Step 2*, the applicable rate differential amount is $200 ($250 - $50). Thus, $200 of the capital gain in the passive category is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $50 is not subject to a rate differential adjustment.

Example 3. (i) O, an individual, has a $100 short-term capital gain from foreign sources in the passive category. O has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). O has a $100 long-term capital loss from sources within the United States.

(ii) O's capital gain net income from sources outside the United States ($400) exceeds O's capital gain net income from all sources ($300). Pursuant to paragraph (a)(1) of this section, O must reduce the

$400 capital gain net income in the passive category by $100. Because C has capital gain net income in two or more rate groups in the passive category, O must apportion such amount, as a reduction, to each rate group on a *pro rata* basis pursuant to paragraph (a)(1)(ii)(B) of this section. Thus, $25 ($100/$400 of $100) is apportioned to the short-term capital gain and $75 ($300/$400 of $100) is apportioned to the long-term capital gain in the 15 percent rate group. After application of paragraph (a)(1) of this section, O has $75 of short-term capital gain in the passive category and $225 of long-term capital gain in the 15 percent rate group in the passive category.

(iii) Because O has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from foreign sources ($100), O must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $225 of long-term capital gain in the 15 percent rate group that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $25 ($100 - $75). Under *Step 2*, the applicable rate differential amount is $200 ($225 - $25). Thus, $200 of the long-term capital gain is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $25 of long-term capital gain is not subject to a rate differential adjustment.

(2) *Rate differential adjustment of capital gains in entire taxable income*. For purposes of section 904 and this section, entire taxable income shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income reduced by the sum of the rate differential portions of each rate group of net capital gain.

(d) *Rate differential adjustment of capital losses from sources outside the United States*—(1) *In general*. In determining taxable income from sources outside the United States for purposes of section 904 and this section, a taxpayer with a net capital loss in a separate category rate group shall reduce such net capital loss by the sum of the rate differential portions of the capital gain net income in each long-term rate group offset by such net capital loss. A net capital loss in a separate category rate group is the amount, if any, by which capital losses in a rate group from sources outside the United States included in a separate category exceed capital gains from sources outside the United States in the same rate group and the same separate category.

(2) *Determination of which capital gains are offset by net capital losses from sources outside the United States*. For purposes of paragraph (d)(1) of this section, in order to determine the capital gain net income offset by net capital losses from sources outside the United States, the following rules shall apply in the following order:

(i) Net capital losses from sources outside the United States in each separate category rate group shall be netted against capital gain net income from sources outside the United States from the same rate group in other separate categories.

(ii) Capital losses from sources within the United States shall be netted against capital gains from sources within the United States in the same rate group.

(iii) Net capital losses from sources outside the United States in excess of the amounts netted against capital gains under paragraph (d)(2)(i) of this section shall be netted against the taxpayer's remaining capital gains from sources within and outside the United States in the following order, and without regard to any net capital losses, from any rate group, from sources within the United States—

(A) First against capital gain net income from sources within the United States in the same rate group;

(B) Next, against capital gain net income in other rate groups, in the order in which capital losses offset capital gains for purposes of determining the taxpayer's taxable income and without regard to whether such capital gain net income derives from sources within or outside the United States, as follows:

(*1*) A net capital loss in the short-term rate group is used first to offset any capital gain net income in the 28 percent rate group, then to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*2*) A net capital loss in the 28 percent rate group is used first to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*3*) A net capital loss in the 15 percent rate group is used first to offset capital gain net income in the 5 percent rate group, and then to offset capital gain net income in the 28 percent rate group, and finally to offset capital gain net income in the 25 percent rate group.

(iv) Net capital losses from sources outside the United States in any rate group, to the extent netted against capital gains in any other separate category under paragraph (d)(2)(i) of this section or against capital gains in the same or any other rate group under paragraph (d)(2)(iii) of this section, shall be treated as coming *pro rata* from each separate category that contains a net capital loss from sources outside the United States in that rate group. For example, assume that the taxpayer has $20 of net capital losses in the 15 percent rate group in the passive category and $40 of net capital losses in the 15 percent rate group in the general limitation category, both from sources outside the United States. Further assume that $50 of the total $60 net capital losses from sources outside the United States are netted against capital gain net income in the 28 percent rate group (from other separate categories or from sources within the United States). One-third of the $50 of such capital losses would be treated as coming from the passive category, and two-thirds of such $50 would be treated as coming from the general limitation category.

(v) In determining the capital gain net income offset by a net capital loss from sources outside the United States pursuant to this paragraph (d)(2), a taxpayer shall take into account any reduction to capital gain net income from sources outside the United States pursuant to paragraph (a) of this section and shall disregard any adjustments to such capital gain net income pursuant to paragraph (c)(1) of this section.

(vi) If at any time during a taxable year, tax is imposed under section 1(h) at a rate other than a rate of tax specified in this paragraph (d)(2), the principles of this paragraph (d)(2) shall apply to determine the capital gain net income offset by any net capital loss in a separate category rate group.

(vii) The determination of which capital gains are offset by capital losses from sources outside the United States under this paragraph (d)(2) is made solely in order to determine the appropriate rate-differential-based adjustments to such capital losses under this section and section 904(b), and does not change the source, allocation, or separate category of any such capital gain or loss for purposes of computing taxable income from sources within or outside the United States or for any other purpose.

(e) *Qualified dividend income*—(1) *In general*. A taxpayer that has taxable income (excluding net capital gain and qualified dividend income) for the taxable year and that qualifies for a reduced rate of tax under section 1(h) on its qualified dividend income (as defined in section 1(h)(11)) for the taxable year shall adjust the amount of such qualified dividend income in a manner consistent with the rules of paragraphs (c)(1)(i) (first sentence) and (c)(2) of this section irrespective of whether such taxpayer has a net capital gain for the taxable year. For purposes of making adjustments pursuant to this paragraph (e), the special rule in paragraph (c)(1)(ii) of this section for taxpayers with a net long-term capital loss from sources within the United States shall be disregarded.

(2) *Exception*. A taxpayer that makes the election provided for in paragraph (b)(3) of this section shall not make adjustments pursuant to paragraph (e)(1) of this section. Additionally, a taxpayer other than a corporation that does not have a capital gain rate differential for the taxable year within the meaning of paragraph (b)(2) of this section may elect not to apply paragraph (e)(1) of this section if such taxpayer would have qualified for the election provided for in paragraph (b)(3) of this section had such taxpayer had a capital gain rate differential for the taxable year. Such a taxpayer shall be presumed to make the election provided for in the preceding sentence unless such taxpayer applies the rate differential adjustments provided for in paragraph (e)(1) of this section to the qualified dividend income in determining its foreign tax credit limitation for the taxable year.

(f) *Definitions*. For purposes of section 904(b) and this section, the following definitions apply:

(1) *Alternative tax rate*. The term *alternative tax rate* means, with respect to any rate group, the rate applicable to that rate group under section 1(h) (for taxpayers other than corporations) or section 1201(a) (for corporations). For example, the alternative tax rate for unrecaptured section 1250 gain is 25 percent.

(2) *Net capital gain*. For purposes of this section, net capital gain shall not include any qualified dividend income (as defined in section 1(h)(11)). See paragraph (e) of this section for rules relating to qualified dividend income.

(3) *Rate differential portion*. The term *rate differential portion* with respect to capital gain net income from sources outside the United States in a separate category long-term rate group (or the applicable portion of such amount), net capital gain in a rate group, or capital gain net income in a long-term rate group, as the case may be, means the same proportion of such amount as—

(i) The excess of the highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)) over the alternative tax rate; bears to

(ii) the highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)).

(4) *Rate group*. For purposes of this section, the term *rate group* means:

(i) *Short-term capital gains or losses*. With respect to a short-term capital gain or loss, the rate group is the short-term rate group.

(ii) *Long-term capital gains*. With respect to a long-term capital gain, the rate group is the particular rate of tax to which such gain is subject under section 1(h). Such a rate group is a long-term rate group. For example, the 28 percent rate group of capital gain net income from sources outside the United States consists of the capital gain net income from sources outside the United States that is subject to tax at a rate of 28 percent under section 1(h). Such 28 percent rate group is a long-term rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at one rate of tax under section 1(h), then all of such long-term capital gains shall be treated as long-term capital gains in that one rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate of tax under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at more than one rate pursuant to section 1(h), the taxpayer shall determine the rate group for such long-term capital gains from sources within or outside the United States (and, to the extent from sources outside the United States, from each separate category) ratably based on the proportions of net capital gain and any qualified dividend income taxed at each applicable rate. For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital gain (other than a long-term capital gain described in section 1(h)(4)(A) or (h)(6)) may be subject to tax at 5 percent or 15 percent.

(iii) *Long-term capital losses*. With respect to a long-term capital loss, a loss described in section 1(h)(4)(B)(i) (collectibles loss) or (iii) (long-term capital loss carryover) is a loss in the 28 percent rate group. All other long-term capital losses shall be treated as losses in the highest rate group in effect under section 1(h) for the tax year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6). For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital loss not described in section 1(h)(4)(B)(i) or (iii) shall be treated as a loss in the 15 percent rate group.

(5) *Terms used in sections 1(h), 904(b) or 1222*. For purposes of this section, any term used in this section and also used in section 1(h), section 904(b) or section 1222 shall have the same meaning given such term by section 1(h), 904(b) or 1222, respectively, except as otherwise provided in this section.

(g) *Examples*. The following examples illustrate the provisions of this section. In these examples, the rate differential adjustment is shown as a fraction, the numerator of which is the alternative tax rate percentage and the denominator of which is 35 percent (assumed to be the highest applicable tax rate for individuals under section 1). Finally, all dollar amounts in the examples are abbreviated from amounts in the thousands (for example, $50 represents $50,000). The examples are as follows:

Example 1. (i) AA, an individual, has items from sources outside the United States only in the passive category for the taxable year. AA has $1000 of long-term capital gains from sources outside the United States that are subject to tax at a rate of 15 percent under section 1(h). AA has $700 of long-term capital losses from sources outside the United States, which are not described in section 1(h)(4)(B)(i) or (iii). For the same taxable year, AA has $800 of long-term capital gains from sources within the United States that are taxed at a rate of 28 percent under section 1(h). AA also has $100 of long-term capital losses from sources within the United States, which are not described in section 1(h)(4)(B)(i) or (iii). AA also has $500 of ordinary income from sources within the United States. The highest tax rate in effect under section 1(h) for the taxable year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6) is 15 percent. Accordingly, AA's long-term capital losses are in the 15 percent rate group.

(ii) AA's items of ordinary income, capital gain and capital loss for the taxable year are summarized in the following table:

	U.S. source	foreign source: passive
15% rate group	($100)	$1,000 ($700)
28% rate group	$800	
Ordinary income	$500	

(iii) AA's capital gain net income from sources outside the United States ($300) does not exceed AA's capital gain net income from all sources ($1,000). Therefore, paragraph (a)(1) of this section does not require any reduction of AA's capital gain net income in the passive category.

(iv) In computing AA's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, AA's $300 of capital gain net income in the 15 rate group in the passive category must be adjusted as required under paragraph (c)(1) of this section. AA adjusts the $300 of capital gain net income using 15 percent as the alternative tax rate, as follows: $300(15%/35%).

(v) In computing AA's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, AA combines the $300 of capital gain net income from sources outside the United States and the $100 net capital loss from sources within the United States in the same rate group (15 percent). AA must adjust the resulting $200 ($300 - $100) of net capital gain in the 15 percent rate group as required under paragraph (c)(2) of this section, using 15 percent as the alternative tax rate, as follows: $200(15%/35%). AA must also adjust the $800 of net capital gain in the 28 percent rate group, using 28 percent as the alternative tax rate, as follows: $800(28%/35%). AA must also include ordinary income from sources outside the United States in the numerator, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fraction.

(vi) AA's passive category foreign tax credit limitation fraction is $128.58/$1225.72, computed as follows:

$$\frac{\$300(15\%/35\%)}{\$500 + \$200(15\%/35\%) + \$800(28\%/35\%)}$$

Example 2. (i) BB, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	foreign source: general	foreign source: passive
15% rate group	$300	($500)	$100
25% rate group	$200		
28% rate group	$500	($300)	
Ordinary income	$1,000	$500	$500

(ii) BB's capital gain net income from sources outside the United States in the aggregate (zero, since losses exceed gains) does not exceed BB's capital gain net income from all sources ($300). Therefore, paragraph (a)(1) of this section does not require any reduction of BB's capital gain net income in the passive category.

(iii) In computing BB's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, BB must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) The $100 of capital gain net income in the 15 percent rate group in the passive category is adjusted under paragraph (c)(1) of this section as follows: $100(15%/35%).

(B) BB must adjust the net capital losses in the 15 percent and 28 percent rate groups in the general limitation category in accordance with the ordering rules contained in paragraph (d)(2) of this section. Under paragraph (d)(2)(i) of this section, BB's net capital loss in the 15 percent rate group is netted against capital gain net income from sources outside the United States in other separate categories in the same rate group. Thus, $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of capital gain net income in the 15 percent rate group in the passive category. Accordingly, $100 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100(15%/35%).

(C) Next, under paragraph (d)(2)(iii)(A) of this section, BB's net capital losses from sources outside the United States in any separate category rate group are netted against capital gain net income in the same rate group from sources within the United States. Thus, $300 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $300 of capital gain net income in the 15 percent rate group from sources within the United States. Accordingly, $300 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300(15%/35%). Similarly, the $300 of net capital loss in the 28 percent rate group in the general limitation category offsets $300 of capital gain net income in the 28 percent rate group from sources within the United States. The $300 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300(28%/35%).

(D) Finally, under paragraph (d)(2)(iii)(B) of this section, the remaining net capital losses in a separate category rate group are netted against capital gain net income from other rate groups from sources within and outside the United States. Thus, the remaining $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of the remaining capital gain net income in the 28 percent rate group from sources within the United States. Accordingly, the remaining $100 of net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100(28%/35%).

(iv) In computing BB's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, BB must adjust net capital gain by netting all of BB's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. BB must also include foreign source ordinary income in the numerators, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fractions. The denominator of BB's foreign tax credit limitation fractions reflects $2,000 of ordinary income from all sources, $100 of net capital gain taxed at the 28% rate and adjusted as follows: $100(28%/35%), and $200 of net capital gain taxed at the 25% rate and adjusted as follows: $200(25%/35%).

(v) BB's foreign tax credit limitation fraction for the general limitation category is $8.56/$2222.86, computed as follows:

$$\frac{\$500 - \$100(15\%/35\%) - \$300(15\%/35\%) - \$300(28\%/35\%) - \$100(28\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100(28\%/35\%) + \$200(25\%/35\%)}$$

(vi) BB's foreign tax credit limitation fraction for the passive category is $542.86/$2222.86, computed as follows:

$$\frac{\$500 + \$100(15\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100(28\%/35\%) + \$200(25\%/35\%)}$$

Example 3. (i) CC, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

		foreign source:	
	U.S. source	**general**	**passive**
15% rate group	$300	($720)	($80)
25% rate group	$200		
28% rate group	$500	($150)	$50
Ordinary income	$1,000	$1,000	$500

(ii) CC's capital gain net income from sources outside the United States (zero, since losses exceed gains) does not exceed CC's capital gain net income from all sources ($100). Therefore, paragraph (a)(1) of this section does not require any adjustment.

(iii) In computing CC's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, CC must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) CC must adjust the $50 of capital gain net income in the 28 percent rate group in the passive category pursuant to paragraph (c)(1) of this section as follows: $50(28%/35%).

(B) Under paragraph (d)(2)(i) of this section, $50 of CC's $150 net capital loss in the 28 percent rate group in the general limitation category offsets $50 of capital gain net income in the 28 percent rate group in the passive category. Thus, $50 of the $150 net capital loss is adjusted as follows: $50(28%/35%). Next, under paragraph (d)(2)(iii)(A) of this section, the remaining $100 of net capital loss in the 28 percent rate group in the general limitation category offsets $100 of capital gain net income in the 28 percent rate group from sources within the United States. Thus, the remaining $100 of net capital loss is adjusted as follows: $100(28%/35%).

(C) Under paragraphs (d)(2)(iii)(A) and (d)(2)(iv) of this section, the net capital losses in the 15 percent rate group in the passive and general limitation categories offset on a *pro rata* basis the $300 of capital gain net income in the 15 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $300, or $270) is adjusted as follows: $270(15%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $300, or $30) is adjusted as follows $30(15%/35%).

(D) Of the remaining $500 of net capital loss in the 15 percent rate group in the general limitation and passive categories, $400 offsets the remaining $400 of capital gain net income in the 28 percent rate group from sources within the United States under paragraph (d)(2)(iii)(B)(*3*) of this section. The proportionate amount of the $720 net capital loss ($720/$800 of $400, or $360) is adjusted as follows: $360(28%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $400, or $40) is adjusted as follows: $40(28%/35%).

(E) Under paragraph (d)(2)(iii)(B)(*3*) of this section, the remaining $100 of net capital loss in the 15 percent rate group in the general limitation and passive limitation categories offsets $100 of capital gain net income in the 25 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $100, or $90) is adjusted as follows: $90(25%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $100 of $10) is adjusted as follows: $10(25%/35%).

(iv) In computing CC's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, CC must adjust capital gain net income by netting all of CC's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. The denominator of CC's foreign tax credit limitation fractions reflects $2,500 of ordinary income from all sources and $100 of net capital gain taxed at the 25% rate and adjusted as follows: $100(25%/35%).

(v) CC's foreign tax credit limitation fraction for the general limitation category is $424.87/$2571.42, computed as follows:

$$\frac{\$1{,}000 - \$50\ (28\%/35\%) - \$100(28\%/35\%) - \$270(15\%/35\%) - \$360(28\%/35\%) - \$90(25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100(25\%/35\%)}$$

(vi) CC's foreign tax credit limitation fraction for the passive category is $488.00/$2571.42, computed as follows:

$$\frac{\$500 + \$50(28\%/35\%) - \$30(15\%/35\%) - \$40(28\%/35\%) - \$10(25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100(25\%/35\%)}$$

Example 4. (i) DD, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general	foreign source: passive
15% rate group	($80)	($100)	$300
Short-term		$500	$100
Ordinary income	$500		

(ii) DD's capital gain net income from outside the United States ($800) exceeds DD's capital gain net income from all sources ($720). Pursuant to paragraph (a)(1)(ii)(A) of this section, DD must apportion the $80 of excess of capital gain net income from sources outside the United States between the general limitation and passive categories based on the amount of capital gain net income in each separate category. Thus, one-half ($400/$800 of $100, or $40) is apportioned to the general limitation category and one-half ($400/$800 of $80, or $40) is apportioned to the passive category. The $40 apportioned to the general limitation category reduces DD's $500 short-term capital gain in the general limitation category to $460. Pursuant to paragraph (a)(1)(ii)(B) of this section, the $40 apportioned to the passive category must be apportioned further between the capital gain net income in the short-term rate group and the 15 percent rate group based on the relative amounts of capital gain net income in each rate group. Thus, one-fourth ($100/$400 of $40 or $10) is apportioned to the short-term rate group and three-fourths ($300/$400 of $40 or $30) is apportioned to the 15 percent rate group. DD's passive category includes $90 of short-term capital gain and $270 of capital gain net income in the 15% rate group.

(iii) Because DD has a net long-term capital loss from sources within the United States ($80) and also has short-term capital gains, DD must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of DD's $270 of capital gain net income in the 15% rate group that is subject to a rate differential adjustment under paragraph (c)(1) of this section. Under Step 1, the U.S. long-term capital loss adjustment amount is $50 ($80 - $30). Under Step 2, the applicable rate differential amount is the excess of the remaining capital gain net income over the U.S. long-term adjustment amount. Thus, the applicable rate differential amount is $220 ($270 - $50). In computing DD's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, DD must adjust this amount as follows: $220(15%/35). DD does not adjust the remaining $50 of capital gain net income in the 15% rate group.

(iv) The amount of capital gain net income in the 15% rate group in the passive category, taking into account the adjustment pursuant to paragraph (a)(1) of this section and disregarding the adjustment pursuant to paragraph (c)(1) of this section, is $270. Under paragraphs (d)(2)(i) and (d)(2)(v) of this section, DD's $100 net capital loss in the 15% rate group in the general limitation category offsets capital gain net income in the 15% rate group in the passive category. Accordingly, the $100 of net capital loss is adjusted as follows: $100(15%/35%).

(v) In computing DD's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, DD must adjust capital gain net income by netting all of DD's capital gains and losses from sources within and outside the United States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of DD's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $600 of short-term capital gain and $120 of net capital gain in the 15 percent rate group adjusted as follows: $120(15%/35%).

(vi) DD's foreign tax credit limitation fraction for the general limitation category is $417.14/$1151.43, computed as follows:

$$\frac{\$460 - \$100(15\%/35\%)}{\$500 + \$600 + \$120(15\%/35\%)}$$

(vii) DD's foreign tax credit limitation fraction for the passive category is $234.29/$1151.43, computed as follows:

$$\frac{\$90 + \$220(15\%/35\%) + \$50}{\$500 + \$600 + \$120(15\%/35\%)}$$

Example 5. (i) EE, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: passive
15% rate group	($150)	$300
28% rate group		$200
Short-term	$30	$100
Ordinary income	$500	

(ii) EE's capital gain net income from sources outside the United States ($600) exceeds EE's capital gain net income from all sources ($480). Pursuant to paragraph (a)(1)(ii) of this section, the $120 of excess capital gain net income from sources outside the United States is allocated as a reduction to the passive category and must be apportioned *pro rata* to each rate group within the passive category with capital gain net income. Thus, $20 ($100/$600 of $120) is apportioned to the short-term rate group, $60 ($300/$600 of $120) is apportioned to the 15 percent rate group and $40($200/$600 of $120) is apportioned to the 28 percent rate group. After application of paragraph (a)(1) of this section, EE has $80 of capital gain net income in the short-term rate group, $240 of capital gain net income in the 15 percent rate group and $160 of capital gain net income in the 28 percent rate group.

(iii) Because EE has a net long-term capital loss from sources within the United States ($150) and also has short-term capital gains, EE must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of EE's remaining $400 ($240 + $160) of capital gain net income in long-term rate groups in the passive category that is subject to a rate differential adjustment. Under Step 1, the U.S. long-term capital loss adjustment amount is $50 ($150 - $100). Under Step 2, EE must apportion this amount *pro rata* to each long-tem rate group within the passive category with capital gain net income. Thus, $30 ($240/$400 of $50) is apportioned to the 15 percent rate group and $20 ($160/$400 of $50) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $210 ($240 - $30). The applicable rate differential amount for the 28 percent rate group is $140 ($160 - $20).

(iv) Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $210 of the $240 capital gain in the 15 percent rate group as follows: $210 (15%/35%). EE does not adjust the remaining $30. Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $140 of the $160 capital gain in the 28 percent rate group as follows: $140 (28%/35%). EE does not adjust the remaining $20.

(v) In computing EE's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, EE must adjust capital gain net income by netting all of EE's capital gains and losses from sources within and outside the United States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of EE's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $130 of short-term capital gain, $150 of net capital gain in the 15 percent rate group adjusted as follows: $150(15%/35%), and $200 of net capital gain in the 28 percent rate group adjusted as follows: $200(28%/35%).

(vi) EE's foreign tax credit limitation fraction for the passive category is $332/$854.29, computed as follows:

$$\frac{\$80 + \$210\ (15\%/35\%) + \$30 + \$140\ (28\%/35\%) + \$20}{\$500 + \$130 + \$150\ (15\%/35\%) + \$200\ (28\%/35\%)}$$

(h) *Coordination with section 904(f)*—(1) *In general*. Section 904(b) and this section shall apply before the provisions of section 904(f) as follows:

(i) The amount of a taxpayer's separate limitation income or loss in each separate category, the amount of overall foreign loss, and the amount of any additions to or recapture of separate limitation loss or overall foreign loss accounts pursuant to section 904(f) shall be determined after applying paragraphs (a), (c)(1), (d) and (e) of this section to adjust capital gains and losses and qualified dividend income from sources outside the United States in each separate category.

(ii) To the extent a capital loss from sources within the United States reduces a taxpayer's foreign source taxable income under paragraph (a)(1) of this section, such capital loss shall be disregarded in determining the amount of a taxpayer's taxable income from sources within the United States for purposes of computing the amount of any additions to the taxpayer's overall foreign loss accounts.

(iii) In determining the amount of a taxpayer's loss from sources in the United States under section 904(f)(5)(D) (section 904(f)(5)(D) amount), the taxpayer shall make appropriate adjustments to capital gains and losses from sources within the United States to reflect adjustments pursuant to section 904(b)(2) and this section. Therefore, for purposes of section 904, a taxpayer's section 904(f)(5)(D) amount shall be equal to the excess of the taxpayer's foreign source taxable income in all separate categories in the aggregate for the taxable year (taking into account any adjustments pursuant to paragraphs (a)(1), (c)(1), (d) and (e) of this section) over the taxpayer's entire taxable income for the taxable year (taking into account any adjustments pursuant to paragraphs (c)(2) and (e) of this section).

(2) *Examples*. The following examples illustrate the application of paragraph (h) of this section:

Example 1. (i) W, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$500	$100	($400)
Ordinary income	$900	$100	

(ii) In computing W's taxable income from sources outside the United States for purposes of section 904 and this section, W must adjust the capital gain net income and net capital loss in each separate category as provided in paragraphs (c)(1) and (d) of this section. Thus, W must adjust the $100 of capital gain net income in the general limitation category and the $400 of net capital loss in the passive category as follows: $100(15%/35%) and $400(15%/35%).

(iii) After the adjustment to W's net capital loss in the passive category, W has a $171.43 separate limitation loss in the passive category. After the adjustment to W's capital gain in the general limitation category, W has $142.86 of foreign source taxable income in the general limitation category. Thus, $142.86 of the separate limitation loss reduces foreign source taxable income in the general limitation category. See section 904(f)(5)(B). W adds $142.86 to the separate limitation loss account for the passive category. The remaining $28.57 of the separate limitation loss reduces income from sources within the United States. See section 904(f)(5)(A). Thus, W adds $28.57 to the overall foreign loss account for the passive category.

Example 2. (i) X, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general
Capital gain	($550)	$700
Ordinary income	$1100	($1000)

(ii) X's capital gain net income from sources outside the United States ($700) exceeds X's capital gain net income from all sources ($200). Pursuant to paragraph (a)(1) of this section, X must reduce the $700 capital gain in the general limitation category by $500. After the adjustment, X has $200 of capital gain net income remaining in the general limitation category. Thus, X has an overall foreign loss attributable to the general limitation category of $800.

(iii) For purposes of computing the amount of the addition to X's overall foreign loss account for the general limitation category, the $500 capital loss from sources within the United States is disregarded and X's taxable income from sources within the United States is $1100. Accordingly, X must increase its overall foreign loss account for the general limitation category by $800.

Example 3. (i) Y, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general
Capital gain	($100)	$200
Ordinary income	($200)	$500

(ii) Y's capital gain net income from sources outside the United States ($200) exceeds Y's capital gain net income from all sources ($100). Pursuant to paragraph (a)(1) of this section, Y must reduce the $200 capital gain in the passive category by $100. Y has $100 of capital gain net income remaining in the passive category.

(iii) Y is not required to make adjustments pursuant to paragraph (c), (d) or (e) of this section. See paragraphs (b) and (e) of this section. Y's foreign source taxable income in the passive category after the adjustment pursuant to paragraph (a)(1) of this section is $600. Y's entire taxable income for the taxable year is $400.

(iv) Y's section 904(f)(5)(D) amount is the excess of Y's foreign source taxable income in all separate categories in the aggregate for the taxable year after taking into account the adjustment pursuant to paragraph (a)(1) of this section ($600) over Y's entire taxable income for the taxable year ($400). Therefore, Y's section 904(f)(5)(D) amount is $200 and Y's foreign source taxable income in the passive category is reduced to $400. See section 904(f)(5)(D).

Example 4. (i) Z, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$100		
Ordinary income	($200)	$300	$300

(ii) Z's foreign source taxable income in all of Z's separate categories in the aggregate for the taxable year is $600. (There are no adjustments to Z's foreign source taxable income pursuant to paragraph (a)(1), (c)(1), (d) or (e) of this section.)

(iii) In computing Z's entire taxable income in the denominator of the section 904(d) foreign tax credit limitation fractions, Z must adjust the $100 of net capital gain in the 15 percent rate group pursuant to paragraph (c)(2) of this section as follows: $100(15%/35%). Thus, Z's entire taxable income for the taxable year, taking into account the adjustment pursuant to paragraph (c)(2) of this section, is $442.86.

(iv) Z's section 904(f)(5)(D) amount is the excess of Z's foreign source taxable income in all separate categories in the aggregate for the taxable year ($600) over Z's entire taxable income for the taxable year after the adjustment pursuant to paragraph (c)(2) of this section ($442.86). Therefore, Z's section 904(f)(5)(D) amount is $157.32. This amount must be allocated *pro rata* to the passive and general limitation categories in accordance with section 904(f)(5)(D).

Example 5. (i) O, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$1100	($500)	
Ordinary income	($1000)	$1000	$500

(ii) In determining O's taxable income from sources outside the United States, O must reduce the $500 capital loss in the general limitation category to $214.29 ($500 x 15%/35%) pursuant to paragraph (d) of this section. Taking this adjustment into account, O's foreign source taxable income in all of O's separate categories in the aggregate is $1285.71 ($1000 - $214.29 + $500).

(iii) In computing O's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, O must reduce the $600 of net capital gain for the year to $257.14 ($600 x 15%/35%) pursuant to paragraph (c)(2) of this section. Taking this adjustment into account, O's entire taxable income for the year is $757.14 ($500 + $257.14).

(iv) Therefore, O's section 904(f)(5)(D) amount is $528.57 ($1285.71 - $757.14). This amount must be allocated *pro rata* to O's $500 of income in the passive category and O's $785.71 of adjusted income in the general limitation category in accordance with section 904(f)(5)(D).

(i) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. Taxpayers may choose to apply this section and §1.904(b)–2 to taxable years ending after July 20, 2004.

Par. 7. Section 1.904(b)–2 is revised to read as follows:

§1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) *Application of section 904(b)(2)(B) adjustments*. Section 904(b)(2)(B) shall apply for purposes of determining the alternative minimum tax foreign tax credit under section 59 (regardless of whether or not the taxpayer has made an election under section 59(a)(4)).

(b) *Use of alternative minimum tax rates*—(1) *Taxpayers other than corporations*. In the case of a taxpayer other than a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59—

(i) Section 904(b)(3)(D)(i) shall be applied by using the language "section 55(b)(3)" instead of "subsection (h) of section 1";

(ii) Section 904(b)(3)(E)(ii)(I) shall be applied by using the language "section 55(b)(1)(A)(i)" instead of "subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies)"; and

(iii) Section 904(b)(3)(E)(iii)(I) shall be applied by using the language "the alternative rate of tax determined under section 55(b)(3)" instead of "the alternative rate of tax determined under section 1(h)".

(2) *Corporate taxpayers*. In the case of a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59, section 904(b)(3)(E)(ii)(II) shall be applied by using the language "section 55(b)(1)(B)" instead of "section 11(b)".

(c) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. See §1.904(b)–1(i) for a rule permitting taxpayers to choose to apply §1.904(b)–1(i) and this §1.904(b)–2 to taxable years ending after July 20, 2004.

§§1.904(b)–3 and 1.904(b)–4 [Removed]

Par. 8. Sections 1.904(b)–3 and 1.904(b)–4 are removed.

Par. 9. Section 1.904(j)–1 is added to read as follows:

§1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) *Election available only if all foreign taxes are creditable foreign taxes*. A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

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

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

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

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

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

Example 2. (i) In 2009, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of $250 attributable to passive income. Under section 904(c), A may also carry forward to 2009 $100 of unused foreign taxes paid in 2005 with respect to passive income, $300 of unused foreign taxes paid in 2005 with respect to general limitation income, $400 of unused foreign taxes paid in 2006 with respect to passive income, and $200 of unused foreign taxes paid in 2006 with respect to general limitation income. In 2009, A's only foreign source income is passive income described in section 904(j)(3)(A)(i), and this income is reported to A on a payee statement (within the meaning of section 6724(d)(2)). If A elects to apply section 904(j) for the 2009 taxable year, the unused foreign taxes paid in 2005 and 2006 are not deemed paid in 2009, and A therefore cannot claim a foreign tax credit for those taxes in 2009.

(ii) In 2010, A again is eligible for and elects the application of section 904(j). The carryforwards from 2005 expire in 2010. The carryforward period established under section 904(c) is not extended by A's election under section 904(j). In 2011, A does not elect the application of section 904(j). The $600 of unused foreign taxes paid in 2006 on passive and general limitation income are deemed paid in 2011, under section 904(c), without any adjustment for any portion of those taxes that might have been used as a foreign tax credit in 2009 or 2010 if A had not elected to apply section 904(j) to those years.

(d) *Effective date*. Section 1.904(j)–1 applies to taxable years beginning after July 20, 2004.

Par. 10. Section 1.954–2 is amended by:

1. Revising paragraph (b)(2)(iv), *Example 2*.

2. Removing paragraph (b)(2)(iv), *Example 3*.

The revision reads as follows:

§1.954–2 Foreign personal holding company income.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

Example 2. (i) DS, a domestic corporation, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of §1.954–3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 is not manufactured in the United States under §1.927(a)–1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved June 16, 2004.

Gregory F. Jenner,
Acting Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on July 19, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 20, 2004, 69 F.R. 43304)