

## Notice of Proposed Rulemaking and Notice of Public Hearing

### Allocation of Loss on Disposition of Stock

#### INTL-4-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed Income Tax Regulations relating to the allocation of loss realized on the disposition of stock. These regulations will affect United States and foreign shareholders of stock in domestic and foreign corporations. The regulations are necessary to modify existing guidance with respect to stock losses. This document also contains a notice of public hearing on the regulations.

DATES: Written comments must be received by October 7, 1996. Outlines of topics to be discussed at the public hearing scheduled for November 6, 1996, at 10 a.m. must be received by October 16, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL-4-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (INTL-4-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington DC. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Seth B. Goldstein, (202) 622-3850; concerning submissions and the hearing, Evangelista Lee, (202) 622-7190 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### *Paperwork Reduction Act*

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by September 6, 1996.

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

The collection of information under section 865(j)(1) is in § 1.865-2(e)(2)-(ii). The proposed regulations provide that in order for taxpayers to elect retroactive application of the regulations, taxpayers must comply with the reporting requirements contained in § 1.865-2(e)(2)(ii). This information is required by the IRS as a condition for a taxpayer to elect to apply the rules of § 1.865-2 retroactively. This information will be used to determine whether a taxpayer properly applied the regulations. The respondents generally will be U.S. corporations or individuals that sell or otherwise dispose of stock in a foreign corporation of which the seller owns more than 10% of the vote or value.

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

Estimated total annual reporting burden: 4,000 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 2,000.

Estimated annual frequency of responses: Once.

##### *Background*

This document contains proposed regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 861, 865, and 904 of the Internal Revenue Code. These regulations are

also issued under authority contained in section 7805 of the Internal Revenue Code.

##### *Explanation of Provisions*

This notice of proposed rulemaking provides rules under section 865(j) relating to the treatment of losses from the sale or other disposition of stock.

Section 1.865-1 provides that the allocation of loss on the disposition of property not governed by § 1.865-2 continues to be governed by the generally applicable rules of § 1.861-8, except as provided in other administrative pronouncements. For example, Notice 89-58 (1989-1 C.B. 699) remains in effect with respect to losses described in that Notice. The treatment of portfolio stock, which is excluded from § 1.865-2, will be reviewed in the context of a broader project dealing with similar portfolio investments, including debt instruments and derivative financial products. Allocation of loss on the disposition of stock of a regulated investment company and stock of an S corporation also will continue to be governed by §§ 1.861-8(e)(7)(i) and (ii).

Section 1.865-2(a) provides the general rule that stock losses are allocated in the same manner as stock gains (determined without regard to sections 1248 and 865(f)). Thus, stock loss generally is allocated to the residence of the seller. Loss recognized by a United States resident on the disposition of stock attributable to a foreign branch is allocated to foreign source income if a gain would have been taxable by the foreign country and the highest marginal rate of tax imposed in that foreign country is at least 10 percent. Loss recognized by a nonresident alien individual or foreign corporation with respect to stock constituting a United States real property interest reduces United States source income, in accordance with section 897.

Section 1.865-2(b) provides exceptions to the general rule. Section 1.865-2(b)(1) provides a dividend recapture rule that applies to losses realized on a disposition of stock within 24 months following the inclusion of a dividend or similar amount. To the extent of the dividend recapture amount, the loss shall be allocated to the same class of income as the dividend. Under a *de minimis* rule, the recapture rule will not apply if

the sum of all dividend recapture amounts is less than 10 percent of the realized loss.

A dividend recapture amount includes an actual dividend, a subpart F or qualified electing fund inclusion attributable to a dividend received by a controlled foreign corporation in a separate limitation category other than that for passive income, and an inclusion attributable to section 956 or 956A. Dividends from foreign corporations, which often are sheltered from United States tax by foreign tax credits and do not reduce the shareholder's basis in the stock, may reduce the selling price of the stock, thereby creating or increasing a loss on sale. Similarly, the identified subpart F inclusions may increase the shareholder's stock basis without substantially affecting the value of the stock, offering similar opportunities to create a tax mismatch from an economic "wash" by pairing tax-sheltered foreign source inclusions and United States source loss.

Section 1.865-2(b)(2) provides a consistency rule requiring generally that loss recognized on the disposition of an 80%-owned foreign affiliate reduces foreign source passive income if, within the past five years, the seller or any member of its consolidated group recognized gain on the disposition of a foreign affiliate that was sourced under section 865(f). In order to provide relief for taxpayers that could have taken steps to avoid section 865(f) treatment on gain sales occurring prior to the publication of these proposed regulations, the five-year lookback period will be phased in so that losses will be tainted only by reason of gains recognized after September 6, 1996.

Section 1.865-2(b)(3) provides anti-abuse rules designed to prevent taxpayers from changing the allocation of a loss with respect to stock or other property by entering into certain transactions.

Section 1.865-2(c) provides rules of general application. Section 1.865-2(c)(1) provides that a partner's distributive share of loss resulting from a disposition of stock by a partnership is allocated as if the partner disposed of the stock. In an appropriate case the loss may be attributable to a fixed place of business of the partnership rather than to the partner's residence.

Section 1.865-2(c)(2) provides that worthlessness shall be treated as a disposition for purposes of the stock loss allocation rules.

Section 1.865-2(d) provides definitions.

Under § 1.865-2(e), the regulations are proposed to be effective for taxable years beginning after 60 days after the date final regulations are published in the **Federal Register**. However, a taxpayer may elect to apply the regulations retroactively to stock losses in all open post-1986 taxable years. A taxpayer generally may make the election by attaching a statement to an original or amended federal income tax return filed after final regulations are published in the **Federal Register**. However, the election will not be effective unless amended returns are filed within 120 days of the date final regulations are published in the **Federal Register**.

Section 1.904-4(c) is proposed to be amended to provide rules specifically addressing the treatment of loss allocated to the section 904(d) separate category for passive income. The proposed amendments provide that, for purposes of the grouping rules relating to the high-tax kick-out described in section 904(d)(2)(F), a passive loss is initially allocated to a group based on the foreign tax that was, or would have been, imposed on the transaction had the sale resulted in a gain under foreign law. If, after allocation and apportionment of all deductions, net income in a group is less than zero, any taxes imposed with respect to the group are considered related to general limitation income. The net loss is not considered related to general limitation income, but proportionately reduces income in the other passive income groups. The determination of whether income in the positive income groups is high-taxed is made after this allocation of loss groups. Any net loss in the section 904(d) separate category for passive income constitutes a separate limitation loss governed by section 904(f)(5).

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect U.S. owners of significant interests in foreign corporations, which owners generally are large multinational

corporations. This certification is also based upon the fact that, even in cases in which the regulation applies to small entities, the burden imposed by the collection of information in the regulation, which is merely an election to apply the regulation to prior taxable years, is not substantial and, therefore, the collection of information will not impose a significant economic impact on such entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 6, 1996, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by October 7, 1996 and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by October 16, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### *Drafting Information*

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

*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

**PART 1—INCOME TAXES**

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

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

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

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

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

\* \* \* \* \*

(e) \* \* \*

(7) \* \* \*

(iii) *Special rules for allocation of loss from disposition of stock.* See § 1.865-2 for special rules regarding the allocation of loss recognized on certain dispositions of stock in taxable years beginning after December 31, 1986.

Par. 3. Sections 1.865-1 and 1.865-2 are added under the undesignated center heading, DETERMINATION OF SOURCES OF INCOME, to read as follows:

*§ 1.865-1 Loss from the disposition of personal property.*

Allocation of loss on the sale or other disposition of portfolio stock, stock of a regulated investment company (as defined in section 851), stock of an S corporation (as defined in section 1361), and other personal property not governed by § 1.865-2 is governed by § 1.861-8 or other administrative pronouncements. Portfolio stock is, with respect to a taxpayer, stock in a corporation in which the taxpayer owns, or is considered to own under the rules of section 267(c), less than 10 percent of the total combined voting power of all classes of stock entitled to vote of such corporation and less than 10 percent of the total value of the stock of such corporation.

*§ 1.865-2 Loss from the disposition of certain stock.*

(a) *General rules for allocation of loss on disposition of stock—(1) Allocation against gain.* Except as otherwise

provided in § 1.865-1 and paragraph (b) of this section, loss recognized on the sale or other disposition of stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 1248) from the sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). For purposes of section 904, any such loss shall be allocated to the separate category to which such gain would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904-4(c)(2)(ii)(A), any loss allocated to passive income shall be allocated (prior to the application of § 1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on the sale would have been assigned if the sale of the stock had resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions. See section 904(f)(5) and the regulations under that section for rules regarding the treatment of separate limitation losses.

(2) *Stock attributable to foreign office.* Except as otherwise provided in § 1.865-1 and paragraph (b) of this section, in the case of loss on the sale or other disposition of stock (other than stock constituting inventory) by a United States resident that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain would have been taxable by the foreign country and the highest marginal rate of tax imposed in the foreign country is at least 10 percent.

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

(b) *Exceptions—(1) Dividend recapture exception—(i) In general.* Except as otherwise provided in § 1.865-1, if a taxpayer realizes a loss on a disposition of stock, and the taxpayer included in income a dividend recapture amount (or

amounts) with respect to such stock at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts.* Paragraph (b)(1)(i) of this section shall not apply to a loss realized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts included in income by the taxpayer with respect to such stock during the recapture period is less than 10 percent of the realized loss.

(2) *Consistency exception—(i) In general.* Except to the extent provided in paragraph (b)(1) of this section, loss recognized by a taxpayer with respect to the sale or other disposition of stock of a foreign affiliate (or of a corporation that was a foreign affiliate within the five-year period preceding the date of the sale) or a foreign affiliate holding company shall be allocated to reduce foreign source income if the taxpayer (or, in the case of a taxpayer that is a member of a consolidated group (within the meaning of § 1.1502-1(h)) at the time the loss is recognized, the consolidated group) recognized gain on the disposition of any stock that was sourced under section 865(f) within the five-year period ending on the last day of the taxable year in which the loss was recognized. See paragraph (a)(1) of this section for rules relating to the allocation of the loss to separate categories described in section 904(d).

(ii) *Phased-in lookback period.* The rule of paragraph (b)(2)(i) of this section shall apply only if gain sourced under section 865(f) was recognized after September 6, 1996.

(3) *Anti-abuse rules.* If one of the principal purposes of a reorganization within the meaning of section 368(a), liquidation under section 332, transfer to a corporation under section 351, transfer to a partnership under section 721, transfer to a trust, distribution by a partnership, distribution by a trust, or transfer to or from a qualified business unit (within the meaning of section 989(a)) is to change the allocation of a built-in loss on the disposition of stock (or other personal property), the loss shall be allocated as if it were recognized on the disposition of the stock (or other personal property) immediately

prior to the reorganization, liquidation, transfer, or distribution. In addition, if a loss recognized by a taxpayer with respect to the sale or other disposition of stock in a corporation is primarily attributable to loss with respect to one or more financial instruments held by the corporation, and one of the taxpayer's principal purposes for holding the financial instrument or instruments through the corporation is to allocate loss under § 1.865-2, the stock loss shall be allocated under § 1.865-1 as if it were recognized on the disposition of such financial instrument or instruments. Whether a taxpayer has a principal purpose to allocate loss under § 1.865-2 shall be determined by taking into account all the facts and circumstances, including whether the corporation engages in business activities (other than trading financial instruments) and whether the taxpayer or any related person or persons (within the meaning of section 267(b) or 954(d)(3)) hold positions that offset loss positions held by the corporation. For purposes of this paragraph (b)(3), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(4) *Example.* The application of this paragraph (b) may be illustrated by the following example:

*Example.* (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On August 5, 1997, *N* distributes a dividend to *P* in the amount of \$100. The dividend gives rise to a \$5 foreign withholding tax, and *P* is deemed to have paid an additional \$45 of foreign income tax with respect to the dividend under section 902. Under section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 1998, *P* sells its shares of *N* and recognizes a \$110 loss. In 1998, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) \$1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I), which is subject to foreign taxes of \$400;

(B) \$1,000 of foreign source capital gain that is passive income described in section 904(d)(1)(A) attributable to gain on the sale of stock in a foreign affiliate that is sourced under section 865(f), which is subject to foreign taxes of \$30.

(iii) The \$100 dividend paid in 1997 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The de minimis exception of paragraph (b)(1)(ii) of this section

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

(iv) Because *P* recognized gain on the sale of stock in a foreign affiliate that was sourced under section 865(f) within the period described in paragraph (b)(2)(i) of this section, *P*'s remaining \$10 loss on the disposition of the *N* stock is allocated to foreign source passive income under paragraph (b)(2)(i) of this section.

(v) After allocation of the stock loss, *P*'s taxable income in 1998 consists of \$900 of foreign source general limitation income and \$990 of foreign source passive income.

(c) *Rules of application*—(1) *Loss recognized by partnership.* A partner's distributive share of loss resulting from the sale or other disposition of stock by a partnership shall be allocated and apportioned in accordance with this section as if the partner had disposed of the stock. If a sale of stock is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(2) *Worthless stock.* For purposes of this section, worthlessness giving rise to a deduction under section 165(g) (including section 165(g)(3)) with respect to stock shall be treated as a disposition.

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

(2) *Dividend recapture amount.* A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend included in the earnings of a controlled foreign corporation that is included in foreign personal holding company income under section 954(c)-(1)(A) and that, pursuant to section 904(d)(3)(B), is treated as income in a separate category other than the separate category for passive income described in section 904(d)(2)(A)), an inclusion described in section 951(a)(1)(B) or (C), and an inclusion described in section 1293(a)(1) (but only to the extent attributable to a dividend that is included in the earnings of a qualified electing fund and that, pursuant to section 904(d)(3)-(I), is treated as income in a separate category other than the separate cat-

egory for passive income described in section 904(d)(2)(A)).

(3) *Foreign affiliate.* A foreign affiliate is a foreign corporation that is a member of the affiliated group (within the meaning of section 1504(a) without regard to section 1504(b)) that includes the taxpayer.

(4) *Foreign affiliate holding company.* A foreign affiliate holding company is any corporation, substantially all the assets of which consist of stock of one or more foreign affiliates, held directly or indirectly. For purposes of this paragraph, any assets acquired or held by a corporation with a principal purpose of avoiding foreign affiliate holding company status shall be disregarded.

(5) *Recapture period.* A recapture period is the 24-month period preceding the date on which a taxpayer realizes a loss on a disposition of stock, increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder.

(6) *Taxpayer.* A taxpayer shall include all predecessors or successors of the taxpayer.

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

(e) *Effective date*—(1) *In general.* This section is effective for taxable years beginning after the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register**.

(2) *Prior year election*—(i) *In general.* A taxpayer may elect to apply the rules of this section to all (but not less than all) of its taxable years that begin after December 31, 1986, and on or before the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register**, and with respect to which the statute of limitations expires after the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register**. The election shall be effective only if the taxpayer satisfies all the applicable requirements specified in paragraph (e)(2)(ii) of this section.

(ii) *Requirements for election*—(A) *Statement filed with original or amended return.* For each taxable year subject to the election, a taxpayer shall file an original or amended federal income tax return that reflects the rules of this section and includes the statement

described in paragraph (e)(2)(ii)(C) of this section. Amended returns filed pursuant to this section must be filed on or before the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register**.

(B) *Presentation of statement upon audit.* A taxpayer that is under examination with respect to any taxable year subject to the election on the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register** must furnish a copy of the statement described in paragraph (e)(2)(ii)(C) of this section for all years subject to the election to the revenue agent responsible for examining its federal income tax returns on or before the date that is 140 days after the date these regulations are published as final regulations in the **Federal Register**. For purposes of this paragraph (e)(2)(ii)(B), a taxpayer is under examination beginning on the date the taxpayer (or any member of the consolidated group of which the taxpayer is a member) has been contacted in any manner by a representative of the Internal Revenue Service for the purpose of scheduling any type of examination of any of its federal income tax returns and ending on the earliest of the date: the taxpayer (or consolidated group of which the taxpayer is a member) receives a “no change” letter; the taxpayer (or consolidated group of which the taxpayer is a member) pays the deficiency (or proposed deficiency); or on which a deficiency, jeopardy, termination, bankruptcy, or receivership assessment is made. An electing taxpayer that is not under examination with respect to any taxable year subject to the election on the date that is 120 days after the date these regulations are published as final regulations in the **Federal Register** and is contacted thereafter by a representative of the Internal Revenue Service for the purpose of scheduling any type of examination of any of its federal income tax returns for a year subject to the election must furnish a copy of the statement described in paragraph (e)(2)(ii)(C) of this section for all years subject to the election to the revenue agent responsible for examining its federal income tax returns within 20 days of being contacted.

(C) *Contents of statement.* The statement shall be entitled “ELECTION UNDER § 1.865–2(e)(2) TO APPLY RETROACTIVELY § 1.865–2 STOCK LOSS ALLOCATION RULES.” The statement shall identify, for the taxable

year subject to the election, each loss from the disposition of stock that is subject to this section and that was incurred by the taxpayer or by any controlled foreign corporation (within the meaning of section 953(c)(1)(B) or 957) with respect to which the taxpayer is a United States shareholder (within the meaning of section 951(b) or 953(c)(1)(A)). For each such loss, the statement shall provide the name and identifying number of the entity that incurred the loss, the amount of the loss, and the paragraph of this section under which the loss is allocated. Each loss subject to paragraph (b)(1) of this section shall be separately identified with a notation stating “Subject to dividend recapture under § 1.865–2(b)(1).” The statement shall also include the following declaration: “No losses, other than those so identified herein, are subject to § 1.865–2(b)(1).” The statement shall indicate whether the taxpayer or any controlled foreign corporation (within the meaning of section 953(c)(1)(B) or 957) with respect to which the taxpayer is a United States shareholder (within the meaning of section 951(b) or 953(c)(1)(A)) acquired the stock after July 8, 1996, as a result of a transaction described in paragraph (b)(3) of this section (regardless of the purpose or purposes of the transaction). An election shall not be effective unless each statement required by this paragraph (e)(2)(ii) contains all the information specified herein.

Par. 4. Section 1.904–0 is amended by revising the entry for § 1.904–4(c)(2)(ii) and adding entries for paragraphs (c)(2)(ii)(A) and (B) of that section to 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.*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(ii) Grouping rules.

(A) Initial allocation and apportionment of deductions.

(B) Reallocation of loss groups.

Par. 5. Section 1.904–4 is amended by revising paragraphs (c)(1) and (c)(2) and adding paragraph (c)(8) *Example 11* and *Example 12* to read as follows:

(c) *High-taxed income*—(1) *In general.* Income received or accrued by a

United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or section 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under § 1.904–6. If, after application of this paragraph (c), passive income is less than zero, the loss shall constitute a passive separate limitation loss (subject to the rules of section 904(f)(5) and the regulations under that section), but any taxes imposed on passive income shall be considered related to general limitation income under § 1.904–6. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* (10), (11) and (12) of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective date.* For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3), (c)(4), and (c)(5) of this

section apply to taxable years beginning after December 31, 1987. See notice 87-6 for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. Paragraph (2)(ii)(B) of this section is effective for taxable years beginning after the date that is 60 days after the date these regulations are published as final regulations in the **Federal Register**.

(ii) *Grouping rules*(A) *Initial allocation and apportionment of deductions.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§ 1.861-8 through 1.861-14T, 1.865-1, and 1.865-2. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. If loss from the disposition of property gives rise to foreign tax (e.g., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which the loss is allocated under this paragraph (c)(2)(ii)(A), without regard to paragraph (c)(2)(ii)(B) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero), and any taxes imposed with respect to such loss group or groups shall be considered related to general limitation income.

\*\_ \*\_ \*\_ \*\_ \*

(8) \*\*\*

*Example 11.* *P*, a domestic corporation, earns the following items of gross income: \$100 of foreign source, passive limitation interest income not subject to any foreign tax, \$200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is \$10), \$1300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is \$325), \$500 of foreign source, general limitation income that gives rise to a \$250 foreign tax, and \$2000 of

U.S. source capital gain that is not subject to any foreign tax. *P* has a \$700 deduction allocable to its passive rental income. *P*'s only other deduction is a \$500 capital loss on a sale of stock that is allocated to foreign source passive limitation income under § 1.865-2(b)(2). If *P* had recognized a gain on the stock sale under foreign law, the gain would not have been subject to foreign tax. The \$500 capital loss is initially allocated to the group of passive income not subject to any foreign tax, and the \$400 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The net royalty income is thus reduced by \$100 to \$100 ( $\$200 - (\$400 \times (200/800))$ ) and the net rental income is reduced by \$300 to \$300 ( $\$1300 - \$700 - (\$400 \times (600/800))$ ). The \$100 net royalty income is not high-taxed and remains passive income. The \$300 net rental income is high-taxed because the foreign taxes exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the \$300 of net rental income (the gross rental income and expenses allocated and apportioned thereto) and the \$325 of associated foreign tax are assigned to the general limitation category.

*Example 12.* The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under § 1.865-2(b)(2) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no foreign tax is \$1100. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of \$1000 must be reapportioned to the \$200 of net royalty income subject to a 5% withholding tax and the \$600 of net rental income subject to a 25% withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of (\$200) constitutes a separate limitation loss with respect to passive income.

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