Sentence	Remove	Add

§ 1.884–5 [Corrected]

2. On page 9343, column 1, § 1.884–5(e)(4)(ii), line 7, the language "country in its country of residence" is corrected to read "corporation in its country of residence".

§ 1.897–1 [Corrected]

3. On page 9343, column 1, amendatory instruction "Par. 10." is corrected by removing items 1. and 2. and correcting "Par. 10." to read as follows:

Par. 10. Paragraph (f)(2)(i) in § 1.897–1 is revised to read as follows:

Cynthia E. Grigsby,

Chief, Regulations Unit, Assistant Chief Counsel (Corporate).

[FR Doc. 96–7772 Filed 3–29–96; 8:45 am]

BILLING CODE 4830–01–U

Corrections

Federal Register
Vol. 61, No. 58
Monday, March 25, 1996

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8657]

Regulations on Effectively Connected Income and the Branch Profits Tax

Correction

In rule document 96–5261 beginning on page 9336 in the issue of Friday, March 8, 1996, make the following correction:

§ 1.884-4 [Corrected]

On page 9341, in the third column, in amendatory instruction 3. to § 1.884-4, "removed" should read "revised".

BILLING CODE 1505–01–D.

(f) *Effective date*—(1) *General rule.* This section is effective for taxable years beginning on or after June 6, 1996.

(2) *Special rules for financial products.* [Reserved]

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: February 28, 1996.

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 96-5262 Filed 3-5-96; 8:45 am]

BILLING CODE 4830-01-U

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26 CFR Parts 1 and 602

[TD 8657] INTL-934-86

RIN 1545-AQ58

Regulations on Effectively Connected Income and the Branch Profits Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the determination of effectively connected income under section 864 and final and temporary Income Tax Regulations relating to the branch profits tax and branch-level interest tax under section 884 of the Internal Revenue Code of 1986 (Code). Section 884 was added to the Code by section 1241 of the Tax Reform Act of 1986. This document also contains conforming changes to sections 861, 871 and 897.

EFFECTIVE DATE: June 6, 1996.

FOR FURTHER INFORMATION CONTACT: Gwendolyn A. Stanley, (202) 622- 3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1070.

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 estimated annual burden per respondent is .25 hours.

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

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

Background

On September 2, 1988, proposed and temporary regulations (TD 8223 and INTL-934-86 [1988-2 C.B. 825]) under section 884 were published in the Federal Register (53 FR 34045). Written comments were received on the proposed amendments. On September 11, 1992, temporary regulations under § 1.884-2T were amended and final regulations (1992 final regulations) (TD 8432 [1992-2 C.B. 157]) under section 884 of the Code were published in the Federal Register (57 FR 41644). Proposed amendments (1992 proposed regulations) (INTL-0003-92 [1992-2 C.B. 752]) to the Income Tax Regulations (26 CFR part 1) under sections 864 and 884 of the Internal Revenue Code were published in the Federal Register (57 FR 41707) on the same day. Written comments were received on the proposed amendments. After consideration of all the comments, § 1.884-2(a)(2)(ii) and § 1.884-2(c)(2)(iii) of the 1988 proposed regulations and the 1992 proposed regulations are adopted as final regulations as amended by this Treasury decision. The revisions and conforming changes are discussed below.

Explanation of the Provisions

I. Section 864 Stock Rule

The proposed regulations under section 864 provided that stock of a corporation shall not be treated as an asset used in, or held for use in, the conduct of a U.S. trade or business. Accordingly, the regulations proposed to delete the example of stock acquired and held to assure a constant source of supply as an asset that satisfies the asset-use test under § 1.864-4(c)(2). Commenters criticized this rule and cited to the legislative history to the Foreign Investors Tax Act of 1966 as contemplating that stock may satisfy the asset-use test. The IRS and Treasury continue to believe, however, that stock does not satisfy the asset-use test. Therefore § 1.864-4(c)(2)(iii) adopts the rule contained in the proposed regulations.

In response to our request for comments on whether insurance companies require an exception to the stock rule for their portfolio stock, one commenter suggested that foreign life insurance companies be permitted to refer to the National Association of Insurance Commissioners (NAIC) Annual Statement to determine whether their assets are used in, or held for use in, the conduct of a U.S. trade or business. The IRS and Treasury will continue to consider whether modifications to the regulations under section 864 are appropriate for foreign insurance companies and reserve on the treatment of stock held by a foreign insurance company.

Conforming changes have been made to regulations under section 864, as well as regulations under sections 871 and 897 to reflect the clarification of § 1.864-4(c)(2). The effective date of the changes to sections 871 and 897 corresponds to the effective date of the changes to section 864.

II. Branch Profits Tax

A. *Interest in a partnership.* Currently, a foreign corporation engaged in a U.S. trade or business through a partnership applies different rules to determine its U.S. assets depending on whether the determination is for purposes of section 884 or § 1.882-5. For purposes of computing its interest expense under § 1.882-5, the rules of § 1.861-9T(e)(7) apply. Therefore a foreign corporation takes into account either its pro rata share of partnership assets and liabilities or applies the rules of § 1.882-5 as if the partnership were a foreign corporation, depending on the nature of its interest in the partnership. In contrast, for purposes of section 884, a foreign corporation generally takes into account its adjusted basis in its partnership interest as a starting point for determining its U.S. assets.

Final regulations under section 882 published elsewhere in this issue of the Federal Register remove the temporary regulations under § 1.861-9T(e)(7)(i). These final regulations provide a new U.S. asset rule for partnership interests for purposes of determining the U.S. assets of a foreign corporate partner under sections 882 and 884. The final regulations under § 1.882-5 contain a corresponding rule to determine the value of a partnership interest held by a foreign corporation for purposes of computing its worldwide assets.

In the event that a partnership derives any income that is not effectively connected with a U.S. trade or business, or otherwise holds non-U.S. assets, the rules in § 1.884-1(d)(3) continue to provide a rule that allocates the basis in

the partnership interest between U.S. and non-U.S. assets. However, the allocation rule is more flexible than the rule contained in either the 1992 final regulations or the proposed regulations under section 884. The rule allows a foreign corporation to use either an income method or an asset method to determine the proportionate share of its partnership interest that is a U.S. asset, regardless of its ownership interest in the partnership. This is a change from the previous 1992 final regulations, which required all foreign corporate partners to use an income method, and from the 1992 proposed regulations, which required more than 10% partners to use the asset method.

Based on commenters' suggestions, other clarifying changes have been made to the asset method. For example, the final regulations clarify that the adjusted bases of partnership assets reflect any adjustment under section 754 with respect to a foreign corporate partner.

B. *Interest in a trust or estate.* The rules applicable to interests in a trust or estate in § 1.884–1(d)(4) are finalized as proposed.

C. *Nonrecourse indebtedness and integrated financial transactions.* Because the final regulations under § 1.882–5 incorporate the special allocation rules of § 1.861–10T, certain changes to the final regulations under § 1.884–1(e) are needed to maintain the proper U.S. net equity of a foreign corporation that elects to directly allocate any portion of its interest expense. These regulations include a conforming change that provides that liabilities giving rise to such interest will be considered U.S. liabilities for purposes of section 884, notwithstanding that such liabilities are not taken into account in Step 2 of § 1.882–5.

In addition, a new provision has been added in § 1.884–4(b) so that branch interest continues to include interest paid with respect to liabilities that are subject to the special allocation rules, notwithstanding that such liabilities are not considered U.S. booked liabilities for purposes of Step 3 of the § 1.882–5 calculation.

D. *Structural changes to conform branch interest rules to final regulations under § 1.882–5.* These regulations adopt the changes made by the 1992 proposed regulations under § 1.884–4(b), and thus incorporate the rules in § 1.882–5(d)(2) (relating to U.S. booked liabilities) in defining the term branch interest of a foreign corporation. Although certain changes were made to the definition of U.S. booked liabilities in the final regulations under § 1.882– 5, the manner in which a foreign corporation computes its branch interest and excess interest remains substantially unchanged.

E. *Excess interest—definition of a foreign bank.* A foreign corporation that is a foreign bank may treat a minimum of 85% of its excess interest as interest on deposits, regardless of its actual ratio of deposits to interest bearing liabilities. The IRS and Treasury believe this rule should be applicable only to a foreign bank engaging in substantial deposit-taking activities, taking into account its activities in the United States as well as other countries in which it operates. The definition used in the 1992 final regulations did not clearly convey this limitation. Thus, § 1.884–4(a)(2)(iii) now defines a foreign bank by reference to section 585(a)(2)(B) of the Code, but also requires that a substantial part of its business consists of receiving deposits and making loans and discounts.

III. Complete termination rules

The rules in § 1.884–2T(a)(5), applicable to a foreign corporation whose beneficial interest in a trust terminates, are finalized as proposed by the 1992 regulations. In addition the waiver provisions contained in § 1.884–2 of the 1988 proposed regulations are finalized as amended by this Treasury decision.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue 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 its impact on small business.

Drafting Information

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

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805.

Section 1.884–2 also issued under 26 U.S.C. 884(g).

Par. 2. Section 1.864–4 is amended as follows:

1. The third sentence in paragraph (c)(2)(i) is revised.
2. Paragraph (c)(2)(ii) is revised.
3. Paragraphs (c)(2)(iii) and (c)(2)(iv) are redesignated as (c)(2)(iv) and (c)(2)(v) respectively.
4. New paragraph (c)(2)(iii) is added.
5. Newly designated paragraph (c)(2)(v) is amended by:
   a. Revising the introductory text.
   b. Removing *Example (2)* through *Example (4)*.
   c. Redesignating "*Example (5)*" as "*Example (2)*".
   d. Amending newly designated *Example (2)* by:
   i. Revising the fifth and sixth sentences.
   ii. Removing the date "1968" and adding the date "1997" where it appears in the second, third, and eighth sentences.
6. The last sentence of paragraph (c)(6)(i) is removed.
7. Paragraph (c)(7) is added.

The additions and revisions read as follows:

§ 1.864–4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(i) * * * The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States. * * *

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct

of a trade or business in the United States if the asset is—

(*a*) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(*b*) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(*c*) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock*—(*a*) *In general.* Except as provided in paragraph (c)(2)(iii)(*b*) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States.

(*b*) *Stock held by foreign insurance companies.* [Reserved]

* * * * *

(v) *Illustration.* The application of paragraph (iv) may be illustrated by the following examples:

* * * * *

Example (2). * * * During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(*b*) of this section to be held in a direct relationship to that business. * * *

* * * * *

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

* * * * *

Par. 3. In § 1.871–12, paragraph (d) is amended by:

1. Revising the paragraph heading and introductory text.

2. Removing *Example 1.*

3. Removing the designation "*(2)*" in *Example (2).*

The revision reads as follows:

§ 1.871–12 Determination of tax on treaty income.

* * * * *

(d) *Illustration.* The application of this section may be illustrated by the following example:

* * * * *

Par. 4. Section 1.884–0(b) is amended by revising the entries for §§ 1.884–1(d)(4), 1.884–2T(a)(5), 1.884–4(b)(1), and 1.884–4(b)(2) and adding entries for §§ 1.884–1(i)(4), 1.884–2T(a)(6), 1.884–4(e)(1) and 1.884–4(e)(2) to read as follows:

§ 1.884–0 Overview of regulation provisions for section 884.

* * * * *

(b) * * *

§ 1.884–1 Branch profits tax.

* * * * *

(d) * * *

(4) Interest in a trust or estate.

* * * * *

(i) * * *

(4) Special rule for certain U.S. assets and liabilities.

§ 1.884–2T Special Rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) * * *

(5) Special rule if a foreign corporation terminates an interest in a trust. [Reserved]

(6) Coordination with second-level withholding tax.

* * * * *

§ 1.884–4 Branch-level interest tax.

* * * * *

(b) * * *

(1) Definition of branch interest.

(2) [Reserved]

(3) * * *

(4) [Reserved]

* * * * *

(e) * * *

(1) General rule.

(2) Special rule.

* * * * *

Par. 5. Section 1.884–1 is amended as follows:

1. Paragraph (c)(2) is amended as follows:

a. The text of paragraph (c)(2) is redesignated as paragraph (c)(2)(i) and a paragraph heading for (c)(2)(i) is added.

b. New paragraph (c)(2)(ii) is added.

2. In paragraph (d)(2)(xi), *Example 2* through *Example 4* are redesignated *Example 3* through *Example 5*, respectively, and new *Example 2* is added.

3. Paragraph (d)(3) is revised.

4. The text of paragraph (d)(4) is added.

5. Paragraph (d)(5)(iii) is revised.

6. In Paragraph (d)(6)(iii) the reference to "(d)(3)(iv)" is removed and "(d)(3)(vi)" is added in its place.

7. Paragraph (d)(6)(v) is redesignated as paragraph (d)(6)(vi).

8. New paragraph (d)(6)(v) is added and reserved.

9. Paragraph (e)(2) is amended as follows:

a. The paragraph heading and text of paragraph (e)(2) are redesignated as paragraph (e)(2)(i).

b. In newly designated paragraph (e)(2)(i) the language "(e)(2)" is removed and "(e)(2)(i)" is added in its place.

c. A new paragraph heading for paragraph (e)(2) is added.

d. Paragraph (e)(2)(ii) is added.

10. Paragraph (e)(3)(ii) is revised.

11. Paragraph (e)(5) is amended as follows:

a. The second sentence in *Example 1* is revised.

b. In the list below, for each sentence in *Example 1* indicated in the left column, remove the language in the middle column and add the language in the right column:

Sentence	Remove	Add
First and third sentence.	1993	1997.
First sentence.	§ 1.882–5(b) .	§ 1.882–5(c).
Fourth and fifth sentence.	§ 1.882–5(b)(2).	§ 1.882–5(c)(2)
Seventh sentence.	Amount	Value.
Seventh sentence.	§ 1.882–5(b)(1).	§ 1.882–5(b)(2).

c. The second sentence in paragraph (i) of *Example 2* is revised.

d. In the list below, for each paragraph in *Example 2* indicated in the left column, remove the language in the middle column and add the language in the right column:

Paragraph	Remove	Add
(i) First sentence	1993	1997
(i) Third and fifth sentence	1994	1998
(ii) First, second, and third sentence	1995	1999
(ii) Second sentence	1994	1998
(iii) First sentence	1995	1999
(iii) Last sentence	1994	1998

12. Paragraph (l)(4) is added.

The additions and revisions read as follows:

§ 1.884–1 Branch profits tax.

* * * * *

(c) * * *

(2) * * * (i) *In general.* * * *

(ii) *Bad debt reserves.* A bank described in section 585(a)(2)(B) (without regard to the second sentence thereof) that uses the reserve method of accounting for bad debts for U.S. federal income tax purposes shall decrease the amount of loans that qualify as U.S. assets by any reserve that is permitted under section 585.

(d) * * *

(2) * * *
(xi) * * *

Example 2. U.S. real property interest connected to a U.S. business. FC is a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof), and is engaged in the business of taking deposits and making loans through its branch in the United States. In 1996, FC makes a loan in the ordinary course of its lending business in the United States, securing the loan with a mortgage on the U.S. real property being financed by the borrower. In 1997, after the borrower has defaulted on the loan, FC takes title to the real property that secures the loan. On December 31, 1997, FC continues to hold the property, classifying it on its financial statement as *Other Real Estate Owned.* Because all income and gain from the property would be ECI to FC under the principles of section 864(c)(2), the U.S. real property constitutes a U.S. asset within the meaning of paragraph (d) of this section.

* * * * *

(3) *Interest in a partnership*—(i) *In general.* A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method described in paragraph (d)(3)(ii) of this section or the income method described in paragraph (d)(3)(iii) of this section.

(ii) *Asset method*—(A) *In general.* A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, to the extent that the assets would be treated as U.S. assets if the partnership were a foreign corporation, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

(B) *Non-uniform proportionate shares.* If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the period that includes the taxable year of the partner is not uniform, then, for purposes of determining the partner's proportionate share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following presumptions. These presumptions may, however, be rebutted if the partner or the Internal Revenue Service shows that the presumption is inconsistent with the partner's true economic interest in the asset during the corporation's taxable year.

(*1*) If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*2*) If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*3*) For other partnership assets not described in paragraph (d)(3)(ii)(B) (*1*) or (*2*) of this section, a partner's economic interest in the asset is determined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

(C) *Partnership election under section 754.* If a partnership files an election in accordance with section 754, then for purposes of this paragraph (d)(3)(ii), the basis of partnership property shall reflect adjustments made pursuant to sections 734 (relating to distributions of property to a partner) and 743 (relating to the transfer of an interest in a partnership). However, adjustments made pursuant to section 743 may be made with respect to a transferee partner only.

(iii) *Income method.* Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

(iv) *Manner of election*—(A) *In general.* In determining the proportion of a foreign corporation's interest in a partnership that is a U.S. asset, a foreign corporation must elect one of the methods described in paragraph (d)(3) of this section on a timely filed return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100–1 of this chapter and any guidance promulgated thereunder apply. An election shall be made by the foreign corporation calculating its U.S. assets in accordance with the method elected. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a foreign corporation's request to change its election only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest.

(B) *Elections with tiered partnerships.* If a foreign corporation elects to use the asset method with respect to an interest in a partnership, and that partnership is a partner in a lower-tier partnership, the foreign corporation may apply either the asset method or the income method to determine the proportion of the upper-tier partnership's interest in the lower-tier partnership that is a U.S. asset.

(v) *Failure to make proper election.* If a foreign corporation, for any reason, fails to make an election to use one of the methods required by paragraph (d)(3) of this section in a timely fashion, the district director or the Assistant Commissioner (International) may make the election on behalf of the foreign corporation and such election shall be binding as if made by that corporation.

(vi) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of paragraphs (d)(3) and (6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (determined under section 705) reduced by the partner's share of the liabilities of the partnership determined under section 752 and increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share of the expense, for income tax purposes, attributable to such liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the

calculation of a foreign corporation's E&P basis in a partnership interest.

(viii) The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. General rule—(i) *Facts.* Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of $50. ABC also owns a non-U.S. asset with an adjusted basis of $100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is $100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method described in paragraph (d)(3)(ii) of this section.

(ii) *Analysis.* FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50% of $100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50% of $200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is $50 ($100 × $50/$100).

Example 2. Special allocation of gain with respect to real property—(i) *Facts.* The facts are the same as in *Example 1*, except that under the partnership agreement, FC is allocated 20 percent of the income from the partnership property but 80 percent of the gain on disposition of the partnership property.

(ii) *Analysis.* Assuming that the buildings ordinarily generate directly identifiable income, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*1*) of this section that FC's proportionate share of the adjusted basis of the buildings is FC's proportionate share of the income generated by the buildings (20%) rather than the total gain that it would be entitled to under the partnership agreement (80%) if the buildings were sold at a gain on the determination date. Thus, the sum of FC's proportionate share of the adjusted bases in ABC's U.S. assets (the buildings) is presumed to be $20 [(20% of $50) + (20% of $50)]. Assuming that the non-U.S. asset is not income-producing and does not generate current deductions, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*3*) of this section that FC's proportionate share of the adjusted basis of that asset is FC's interest in the gain on the disposition of the asset (80%) rather than its proportionate share of the income that may be generated by the asset (20%). Thus, FC's proportionate share of the adjusted basis of ABC's non-U.S. asset is presumed to be $80 (80% of $100). FC's proportionate share of the adjusted bases of all of the assets of ABC is $100 ($20 + $80). The amount of FC's interest in ABC that is a U.S. asset is $20 ($100 × $20/$100).

Example 3. Tiered partnerships (asset method)—(i) *Facts.* The facts are the same as in *Example 1*, except that FC's adjusted basis in ABC is $175 and ABC also has a 50 percent interest in the capital of partnership DEF. DEF owns and operates a commercial shopping center in the United States with an adjusted basis of $200 and also owns non-U.S. assets with an adjusted basis of $100. DEF has no liabilities. ABC's adjusted basis in its interest in DEF is $150 and ABC has a 50 percent interest in all the items of income, gain, loss and deduction that may be generated by the assets of DEF.

(ii) *Analysis.* Because FC has elected to use the asset method described in paragraph (d)(3)(ii) of this section, it must determine what proportion of ABC's partnership interest in DEF is a U.S. asset. As permitted by paragraph (d)(3)(iv)(B) of this section, FC also elects to use the asset method with respect to ABC's interest in DEF. ABC's interest in DEF is treated as a U.S. asset in the same proportion that the sum of ABC's proportionate share of the adjusted bases of all DEF's U.S. assets (50% of $200), bears to the sum of ABC's proportionate share of the adjusted bases of all of DEF's assets (50% of $300). Thus, the amount of ABC's interest in DEF that is a U.S. asset is $100 ($150 x $100/$150). FC must then apply the rules of paragraph (d)(3)(ii) of this section to all the assets of ABC, including ABC's interest in DEF that is treated in part as a U.S. asset ($100) and in part as a non-U.S. asset ($50). FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of the U.S. assets of ABC (including ABC's interest in DEF), bears to the sum of FC's proportionate share of the adjusted bases of all ABC's assets (including ABC's interest in DEF). Thus, the amount of FC's interest in ABC that is a U.S. asset is $100 (FC's adjusted basis in ABC ($175) multiplied by FC's proportionate share of the sum of the adjusted bases of ABC's U.S. assets ($100)) over FC's proportionate share of the sum of the adjusted bases of ABC's assets ($175)).

Example 4. Tiered partnerships (income method)—(i) *Facts.* The facts are the same as in *Example 3*, except that FC has elected to use the income method described in paragraph (d)(3)(iii) of this section to determine the proportion of its interest in ABC that is a U.S. asset. The two office buildings located in the United States generate $60 of income that is ECI for the taxable year. The non-U.S. asset is not-income producing. In addition ABC's distributive share of income from DEF consists of $40 of income that is ECI and $140 of income that is not ECI.

(ii) *Analysis.* Because FC has elected to use the income method it does need to determine what proportion of ABC's partnership interest in DEF is a U.S. asset. FC's interest in ABC is treated as a U.S. asset in the same proportion that its distributive share of ABC's income for the taxable year that is ECI ($50) ($30 earned directly by ABC + $20 distributive share from DEF) bears to its distributive share of all ABC's income for the taxable year ($55) ($30 earned directly by ABC + $25 distributive share from DEF). Thus, FC's interest in ABC that is a U.S. asset is $159 ($175 x $50/$55).

(4) *Interest in a trust or estate*—(i) *Estates and non-grantor trusts.* A foreign corporation that is a beneficiary of a trust or estate shall not be treated as having a U.S. asset by virtue of its interest in the trust or estate.

(ii) *Grantor trusts.* If, under sections 671 through 678, a foreign corporation is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion of a trust asset), the foreign corporation will be treated as owning the trust asset (or pro rata portion thereof) for purposes of determining its U.S. assets under this section.

(5) * * *

(iii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(6) * * *

(v) *Computation of E&P basis of financial instruments.* [Reserved]

* * * * *

(e) * * *

(2) *Additional liabilities*—(i) * * *

(ii) *Liabilities described in § 1.882-5(a)(1)(ii).* The amount of liabilities determined under this paragraph (e)(2)(ii) is the amount (as of the determination date) of liabilities described in § 1.882-5(a)(1)(ii) (relating to liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset).

(3) * * *

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the excess, if any, of the amount of liabilities in paragraph (e)(1) of this section over the amount, as of the determination date, of U.S. booked liabilities (determined under § 1.882-5(d)(2)) and liabilities described in paragraph (e)(2) of this section.

* * * * *

(5) * * *

Example 1. * * * For purposes of computing its U.S.- connected liabilities under § 1.882-5(c), A must determine the average total value of its assets that are U.S. assets. * * *

Example 2. * * * *A has $800 of liabilities under paragraph (e)(1) of this section and $300 of liabilities properly reflected on the books of its U.S. trade or business under § 1.882-5(d)(2).* * * *

* * * * *

(i) * * *

(4) *Special rules for certain U.S. assets and liabilities.* Paragraphs (c)(2)(i) and (ii), (d)(3), (d)(4), (d)(5)(iii), (d)(6)(iii), (d)(6)(vi), (e)(2), and (e)(3)(ii),

of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 6. § 1.884–2 is added to read as follows:

§ 1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(a) through (a)(2)(i) [Reserved] For further information, see § 1.884–2T(a) through (a)(2)(ii).

(a)(2)(ii) *Waiver of period of limitations.* The waiver referred to in § 1.884–2T(a)(2)(i)(D) shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that taxable year. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by applying § 1.884–2T(a)(2)(ii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (a)(2)(ii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(a)(3) through (a)(4) [Reserved] For further information, see § 1.884–2T(a)(3) through (a)(4).

(a)(5) *Special rule if a foreign corporation terminates an interest in a trust.* A foreign corporation whose beneficial interest in a trust terminates (by disposition or otherwise) in any taxable year shall be subject to the branch profits tax on ECEP attributable to amounts (including distributions of accumulated income or gain) treated as ECI to such beneficiary in such taxable year notwithstanding any other provision of § 1.884–2T(a).

(b) through (c)(2)(ii) [Reserved] For further information, see § 1.884–2T (b) through (c)(2)(ii).

(c)(2)(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of § 1.884–2T(c)(2)(i) shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign Form 2045. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by applying § 1.884–2T(c)(2)(iii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (c)(2)(iii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(c)(3) through (f) [Reserved] For further information, see § 1.884–2T (c)(3) through (f).

(g) *Effective dates.* Paragraphs (a)(2)(ii) and (c)(2)(iii) of this section are effective for taxable years beginning after December 31, 1986. Paragraph (a)(5) of this section is effective for taxable years beginning on or after June 6, 1996.

Par. 7. Section 1.884–2T is amended as follows:

1. Paragraph (a)(2)(ii) is revised.

2. Paragraph (a)(5) is redesignated as (a)(6).

3. New paragraph (a)(5) is added.

4. Paragraph (c)(2)(iii) is revised.

The additions and revisions read as follows:

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).

(a) * * *

(2) * * *

(ii) *Waiver of period of limitations.* [Reserved] See § 1.884–2(a)(2)(ii) for rules relating to this paragraph.

* * * * *

(5) *Special rule if a foreign corporation terminates an interest in a trust.* [Reserved] See § 1.884–2(a)(5) for rules relating to this paragraph.

* * * * *

(c) * * *

(2) * * *

(iii) *Waiver of period of limitations and transferee agreement.* [Reserved] See § 1.884–2(c)(2)(iii) for rules relating to this paragraph.

Par. 8. Section 1.884–4 is amended as follows:

1. In paragraph (a)(1), the fifth sentence is revised.

2. Paragraph (a)(2)(iii) is revised.

3. Paragraph (b)(1) is removed and paragraph (b)(2) is revised and reserved.

4. Paragraph (b)(3) is amended by:

a. Removing the reference "(b)(1)(v)" and adding the language "(b)(1)(ii)" in the following:

i. Paragraph (b)(3)(i), first sentence.

ii. Paragraph (b)(3)(ii), introductory text.

iii. Paragraph (b)(3)(iii), heading and introductory text.

b. Adding a sentence at the end of paragraph (b)(3)(i).

5. Paragraph (b)(4) is removed and reserved.

6. In the list below, for each paragraph indicated in the left column, remove the language in the middle column and add the language in the right column:

Paragraph	Remove	Add
(a)(2)(i)(A)	Apportioned	Allocated or apportioned.
(a)(4) *Example 1* first sentence	(b)(2)	(a)(2)(iii).
(a)(4) *Example 1* first and seventh sentence	Apportioned	Allocated or apportioned.
(a)(4) *Example 1* first, second, and eighth sentence	1993	1997.
(a)(4) *Example 2* first sentence	(b)(2)	(a)(2)(iii).

Paragraph	Remove	Add
(a)(4) Example 2 second and third sentence	1993	1997.
(b)(5)(i) last sentence	Apportioned	Allocated or apportioned.
(b)(5)(ii) *Example* first, fifth, and last sentence	Apportioned	Allocated or apportioned.
(b)(6) paragraph heading	Apportioned	Allocated or apportioned.
(b)(6)(i) first and last sentence	Apportioned	Allocated or apportioned.
(b)(6)(i) second sentence	(b)(1)(v)	(b)(1)(ii).
(b)(6)(ii) first and second sentence	(b)(1)(v)	(b)(1)(ii).
(b)(6)(ii) first and second sentence	Paragraphs (b)(1)(i) through (b)(i)(iv).	Paragraph (b)(1)(i).
(b)(6)(iv) *Example 1* introductory text, paragraphs (i), (iii), and (iv), flush language first, fourth, and seventh sentence.	1993	1997.
(b)(6)(iv) *Example 1* paragraph (ii)	1992	1996.
(b)(6)(iv) *Example 1* flush language second, and sixth sentence	(b)(1)(v)	(b)(1)(ii).
(c)(1)(iv) *Example 1* first sentence	Apportioned	Allocated or apportioned.
(c)(1)(iv) *Example 1* first, second, third, fifth, sixth, and seventh sentence	1993	1997.
(c)(1)(iv) *Example 1* third, fourth, and seventh sentence	1994	1998.
(c)(1)(iv) *Example 2* second sentence	Apportioned	Allocated or apportioned.
(c)(1)(iv) *Example 2* first, second, third, and last sentence	1993	1997.
(c)(1)(iv) *Example 2* second and last sentence	1994	1998.
(c)(2)(i) first sentence	Apportioned	Allocated or apportioned.
(c)(4) *Example* third, fourth, fifth, sixth, and eighth sentence	1993	1997.
(c)(4) *Example* fifth sentence	Allocated	Allocated or apportioned.

7. Paragraph (e) is amended as follows:

a. The text of paragraph (e) is redesignated as paragraph (e)(1) and a paragraph heading for (e)(1) is added.

b. The first sentence of newly designated paragraph (e)(1) is revised.

8. Paragraph (e)(2) is added.

The revisions and additions read as follows:

§ 1.884–4 Branch-level interest tax.

(a) * * * (1) * * * For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under § 1.882–5(a)(1)(ii) or (b)(1) for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to ECI. * * *

(2) * * *

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits.* A portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) without regard to the second sentence thereof) provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts, shall be treated as interest on deposits (as described in section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

* * * * *

(b) *Branch interest*—(1) *Definition of branch interest.* For purposes of this section, the term "branch interest" means interest that is—

(i) Paid by a foreign corporation with respect to a liability that is—

(A) A U.S. booked liability within the meaning of § 1.882–5(d)(2) (other than a U.S. booked liability of a partner within the meaning of § 1.882–5(d)(2)(vii)); or

(B) Described in § 1.884–1(e)(2) (relating to insurance liabilities on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset); or

(ii) In the case of a foreign corporation other than a corporation described in paragraph (a)(2)(iii) of this section, a liability specifically identified (as provided in paragraph (b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of such interest does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(ii);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or paragraph (b)(1)(i) of this section.

(2) [Reserved]

(3)(i) * * * A foreign corporation that is subject to this section may identify a liability under paragraph (b)(1)(ii) of this section whether or not it is actually

engaged in the conduct of a trade or business in the United States. * * *

* * * * *

(4) [Reserved]

* * * * *

(e) *Effective dates*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884(f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. * * *

(2) *Special rule.* Paragraphs (a)(1), (a)(2)(i)(A), (a)(2)(iii), (b)(1), (b)(3), (b)(5)(i), (b)(6)(i), (b)(6)(ii), and (c)(2)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 9. In § 1.884–5, paragraphs (e)(4)(ii) and (g) are revised to read as follows:

§ 1.884–5 Qualified resident.

* * * * *

(e) * * *

(4) * * *

(ii) *Presumption for banks.* A U.S. trade or business of a foreign corporation that is described in § 1.884–4(a)(2)(iii) shall be presumed to be an integral part of an active banking business conducted by the foreign country in its country of residence provided that a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. This paragraph shall be effective for taxable years beginning on or after June 6, 1996.

* * * * *

(g) * * * Except as provided in paragraph (e)(4)(ii) of this section, this section is effective for taxable years beginning on or after October 13, 1992.

* * *

* * * * *

Par. 10. Section 1.897–1 is amended as follows:

1. In paragraph (f)(1)(iii) the language "stock," is removed.

2. Paragraph (f)(2)(i) is revised to read as follows:

§ 1.897–1 Taxation of foreign investments in United States real property interests, definition of terms.

* * * * *

(f) * * *

(2) * * *

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 12. In § 602.101, the table in paragraph (c) is amended by adding in numerical order "§ 1.884–2 * * * 1545–1070".

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: February 28, 1996.

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 96–5261 Filed 3–5–96; 8:45 am]

BILLING CODE 4830–01–U

Office of Foreign Assets Control

31 CFR Part 500

Foreign Assets Control Regulations; Humanitarian Donations to North Korea

AGENCY: Office of Foreign Assets Control, Treasury.

ACTION: Final rule; amendments.

SUMMARY: This rule amends the Foreign Assets Control Regulations to authorize by general license all transactions with respect to the donation of funds to the United Nations and the American and International Red Cross for humanitarian assistance in the Democratic People's Republic of Korea, as well as all transactions incident to the donation of goods to meet basic human needs to the Democratic People's Republic of Korea from third countries by persons subject to U.S. jurisdiction.

EFFECTIVE DATE: March 5, 1996.

FOR FURTHER INFORMATION CONTACT: Steven I. Pinter, Chief of Licensing, tel.: 202/622–2480, or William B. Hoffman, Chief Counsel, tel.: 202/622–2410, Office of Foreign Assets Control, Department of the Treasury, Washington, DC 20220.

SUPPLEMENTARY INFORMATION:

Electronic Availability

This document is available as an electronic file on *The Federal Bulletin Board* the day of publication in the Federal Register. By modem, dial 202/512–1387 and type "/GO FAC," or call 202/512–1530 for disks or paper copies. This file is available for downloading without charge in WordPerfect, ASCII, and Adobe Acrobat™ readable (*.PDF) formats. The document is also accessible for downloading without charge in ASCII format from Treasury's Electronic Library ("TEL") in the "Business, Trade and Labor Mall" of the FedWorld bulletin board. By modem dial 703/321–3339, and select the appropriate self–expanding file in TEL. For Internet access, use one of the following protocols: Telnet = fedworld.gov (192.239.93.3); World Wide Web (Home Page) = http://www.fedworld.gov; FTP = ftp.fedworld.gov (192.239.92.205).

Background

As part of the October 21, 1994 United States–Democratic People's Republic of Korea ("DPRK") Agreed Framework, the United States undertook to ease economic sanctions against the DPRK. Since that time, the DPRK has experienced severe flooding and is in need of emergency disaster assistance. As a separate measure, to facilitate the provision of humanitarian aid to the DPRK by private and nongovernmental persons, the Treasury Department is amending the Foreign Assets Control Regulations, 31 CFR part 500 (the "Regulations"), by amending § 500.573 to authorize, by general license, the donation of funds for humanitarian assistance to the United Nations, related UN programs and specialized agencies, the American Red Cross and the International Committee of the Red Cross. Amended § 500.573 also authorizes by general license transactions incident to the donation to the DPRK from third countries of goods to meet basic human needs by persons subject to U.S. jurisdiction. Goods meeting basic human needs are defined by reference to § 773.5 and supplement no. 7 to part 773 of the Commerce Department's Export Administration Regulations, 15 CFR parts 768–799.

Because the Regulations involve a foreign affairs function, Executive Order 12866 and the provisions of the Administrative Procedure Act, 5 U.S.C. 553, requiring notice of proposed rulemaking, opportunity for public participation, and delay in effective date, are inapplicable. Because no notice of proposed rulemaking is required for this rule, the Regulatory Flexibility Act, 5 U.S.C. 601–612, does not apply.

List of Subjects in 31 CFR Part 500

Administrative practice and procedure, Banks, banking, Cambodia, Exports, Fines and penalties, Finance, Foreign investment in the United States, Foreign trade, Imports, Information and informational materials, International organizations, North Korea, Reporting and recordkeeping requirements,

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8432]

RIN 1545-AP18

Branch Profits Tax; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to the correc ion to final regulations.

SUMMARY: This document contains a correction to the correction to final regulations (T.D. 8432), which was published in the Federal Register for Friday, December 18, 1992 (57 FR 60126). The final regulations relate to the branch profits tax, branch-level interest tax and qualified resident rules issued under section 884 of the Internal Revenue Code of 1986.

EFFECTIVE DATE: October 13, 1992.

FOR FURTHER INFORMATION CONTACT: Elizabeth U. Karzon (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The correction to the final regulations that is the subject of this document corrects the final rules that provide guidance to comply with section 884 and generally affect foreign corporations engaged in trade or business in the United States. These regulations also provide guidance relating to the application of section 884 to foreign governments in light of the changes made by the Technical and Miscellaneous Revenue Act of 1988 under section 892(a)(3) of the Internal Revenue Code.

Need for Correction

As published, one of the corrections to T.D. 8432 contains an error which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of the correction to final regulations (T.D. 8432), which was the subject of FR Doc. 92-30310 is corrected as follows:

§ 1.884-1 [Corrected]

On page 60126, column 2, § 1.884-1 [Corrected], regulatory text of § 1.884-1(d)(2)(vii) following amendatory instruction 3, line 6, the language "the United States during the taxable" is corrected to read "the active conduct of a banking, financing, or similar business in the United States during the taxable".

Dale D. Goode,

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

[FR Doc. 93-7607 Filed 3-31-93; 8:45 am]

BILLING CODE 4830-01-U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8432]

RIN 1545-AP18

Branch Profits Tax; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to Treasury Decision 8432, which was published in the Federal Register for Friday, September 11, 1992 (57 FR 41644). The final regulations relate to the branch profits tax, branch-level interest tax and qualified resident rules issued under section 884 of the Internal Revenue Code of 1986.

EFFECTIVE DATE: October 13, 1992.

FOR FURTHER INFORMATION CONTACT: Elizabeth U. Karzon, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections provide guidance needed to comply with this section and generally affect foreign corporations engaged in trade or business in the United States. These regulations also provide guidance relating to the application of section 884 to foreign governments in light of the changes made by the Technical and Miscellaneous Revenue Act of 1988 under section 892(a)(3) of the Internal Revenue Code.

Need for Correction

As published, T.D. 8432 contains errors which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8432), which was the subject of FR Doc. 92-21297, is corrected as follows:

§ 1.884-0 [Corrected]

1. On page 41650, column 2, § 1.884-0(b), the entry for § 1.884-2T(c)(3), first line, the language, "Transferor's dividend equivalent among" is corrected to read "Transferor's dividend equivalent amount".

§ 1.884-1 [Corrected]

2. On page 41651, column 3, § 1.884-1(b)(4), *Example 5*, third line from the bottom of the paragraph, the language "A has $50 of accumulated ECEP (i.e. 110" is corrected to read "A has $50 of accumulated ECEP (i.e. $110".

3. On page 41653, column 1, § 1.844-1(d)(2)(vii) is corrected to read:

(d) * * *

(2) * * *

(vii) *Securities held by a foreign corporation engaged in a banking, financing or similar business.* Securities described in § 1.864-4(c)(5)(ii)(*b*)(3) held by a foreign corporation engaged in the United States during the taxable year shall be treated as U.S. assets in the same proportion that income, gain, or loss from such securities is ECI for the taxable year under § 1.864-4(c)(5)(ii).

4. On page 41654, column 1, § 1.884-1(d)(3)(iii), in the *Example*, line fifteen, the language, "The real estate securities each have an" is corrected to read "The real estate and the securities each have an".

§ 1.884-2T [Corrected]

5. On page 41659, column 3, § 1.884-2T(b), second line from the bottom of the paragraph, the language "substitution is not less than their" is corrected to read "substitution not less than their".

§ 1.884-4 [Corrected]

6. On page 41663, column 2, § 1.884-4(b)(6)(ii), line ten, the language, "next latest payment until the amount of" is corrected to read "next-latest payment until the amount of".

§ 1.884-5 [Corrected]

7. On page 41667, column 2, § 1.884-5(b)(1)(iv)(B), line three, the language "its not-for-profit status;" is corrected to read "its not-for-profit status; and".

8. On page 41669, column 1, § 1.884-5(b)(3)(iii), second line from the bottom of the concluding text, the language, "conditions set forth in this paragraph are" is corrected to read "conditions set forth in this paragraph (b)(3)(iii) are".

9. On page 41669, column 1, § 1.884-5(b)(3)(v), line twelve, the language, "specified in paragraph (b)(3) or (b)(8) of" is corrected to read "specified in this paragraph (b)(3) or (b)(8) of".

10. On page 41669, column 1, § 1.884-5(b)(3)(v), line twenty-one, the language, "in a timely manner and a describing the" is corrected to read "in a timely manner and describing the".

11. On page 41675, column 3, § 1.884-5(e)(4)(iii), the last line of the paragraph, the language, "consistent manner from year-to-year" is corrected to read "consistent manner from year to year".

Dale D. Goode,

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

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Corrections

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8432]
RIN 1545-AJ73

Branch Profits Tax

Correction

In rule document 92-21297 beginning on page 41644 in the issue of Friday, September 11, 1992, make the following corrections:

1. On page 41645:

a. In the first column, under **Paperwork**, in the first paragraph, in the sixth line, "(44 U.S.C. 35049(h))" should read "(44 U.S.C. 3504 (h))".

b. In the second column, in the first full paragraph, in the second, third and eighth lines, the sections should read "§§ 1.884–0T, 1.884–1T, 1.884–4T, and 1.884–5T" and "§ 1.884–2T".

c. In the same column, in the second paragraph, in the seventh line, the section number should read "§ 1.884–0".

d. In the third column, in the second and last lines from the top of the page, the section numbers should read "§ 1.884–1" and "§ 1.884–4".

2. On page 41648, in the first column, under number 4., in the third line from the end of the paragraph, "payment" should read "payments".

§ 1.884–0 [Corrected]

3. On page 41650, in the third column, in § 1.884–0(b), in the heading for *§ 1.884–3T*, "*secondtier*" should read "*second-tier*"; and in *§ 1.884–4*(f)(2), in the second line, "nonbanks" should read "non-banks".

§ 1.884–1 [Corrected]

4. On page 41654, in the third column, in § 1.884–1(d)(6)(iv), in the seventh line, "substained" should read "sustained".

5. On page 41656, in the first column, in § 1.884–1(e)(5), in *Example 2*(ii), insert ")" after "books".

6. On the same page, in the second column, in § 1.884–1(f)(2)(iv), in the second line, "953(3)(c)(C)" should read "953(c)(3)(C)".

§ 1.884–2T [Corrected]

7. On page 41659, in the second column, under paragraph 4, in the amendments to § 1.884–2T, in amendment 4., in the second line, "§ 1.884—1T" should read "§ 1.884–1T"; and in amendment 10., in the first line, "introduction" should read "introductory".

8. On page 41660, in the first column, in § 1.884–2T(b)(3), in the second line, "Section" should read "election".

§ 1.884–4 [Corrected]

9. On page 41662, in the 3rd column, in § 1.884–4(b)(5)(i), in the 13th line from the bottom, "interests" should read "interest".

10. On page 41665, in the second column, in § 1.884–4(c)(1)(iv), in *Example 1*, in the fourth line from the bottom, "interested" should read "interest"; and in paragraph (c)(2), in the first line, remove the ")" after "*partnership*".

11. On the same page, in the 3rd column, in § 1.884–4(c)(3)(i), in the 12th line, "limitations" should read "limitation".

§ 1.884–5 [Corrected]

12. On page 41666, in the third column, in § 1.884–5(b)(1)(i)(D), in the seventh line, "of" should read "or".

13. On page 41668, in the second column, in § 1.884–5(b)(3)(i), in the sixth line, "paragraphs" should read "paragraph".

14. On page 41670, in the first column, in § 1.884–5(b)(6)(iv), in the sixth line, "of" should read "or".

15. On page 41675, in the 2d column, in § 1.884–5(e)(3)(iii), in the 14th line, "(e)(i)(B)" should read "(e)(3)(i)(B)".

16. On the same page, in the third column, in § 1.884–5(e)(4)(ii), in the last line, remove "making loans and".

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8432] INTL-934-86

RIN 1545-AJ73

Branch Profits Tax

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the branch profits tax, branch-level interest tax and qualified resident rules issued under section 884 of the Internal Revenue Code of 1986 (the "Code"). Section 884 was added to the Code by section 1241 of the Tax Reform Act of 1986. These regulations provide guidance needed to comply with this section and generally affect foreign corporations engaged in trade or business in the United States. These regulations also provide guidance relating to the application of section 884 to foreign governments in light of the changes made by the Technical and

Miscellaneous Revenue Act of 1988 under section 892(a)(3) of the Code.

EFFECTIVE DATES: Except as otherwise provided, both the final and temporary regulations are effective for taxable years beginning on or after October 13, 1992. The fourth sentence of § 1.884–0(a) is effective for taxable years ending on or after September 11, 1992, subject to the conditions provided in § 1.884–0. The amendments to § § 1.884–2T(a)(2)(ii) and 1.884–2T(c)(2)(iii) are effective with respect to taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: Elizabeth U. Karzon of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (202–622–3860, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545–1070. The estimated average annual burden per respondent recordkeeper varies from .1 hours to 8.0 hours depending on individual circumstances, with an estimated average of .3 hours.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending on their particular circumstances.

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

Background

On September 2, 1988, proposed and temporary regulations § § 1.884–0T, 1.884–1T, 1.884–2T, 1.884–4T and 1.884–5T were adopted (as part of T.D. 8223) and published in the Federal Register at 53 FR 34045 (September 2, 1988). Written comments were received and a public hearing was held on February 19, 1989. Subsequently, several notices were issued by the Internal Revenue Service that set forth changes that would be made to the temporary regulations. Notice 88–133 (1988–2 C.B. 558) provided for transitional relief with respect to certain procedural requirements relating to the qualified resident rules; Notice 89–14 (1989–1 C.B. 633) provided for transitional relief with respect to compliance with the branch-level interest tax rules; Notice 89–73 (1989–1 C.B. 739) announced the branch profits tax rate for foreign corporations that are qualified residents of France; and Notice 89–80 (1989–2 C.B. 394) clarified the branch-level interest tax rules, announced certain changes to those rules for taxable years beginning on or after January 1, 1990, and modified certain of the qualified resident rules.

After consideration of all the comments relating to § § 1.884–0T, 1.884–1T, 1.884–4T, and 1.884–5T, these sections of the temporary regulations are adopted by this Treasury Decision as final regulations. The comments and revisions relating to these sections are discussed below. Section 1.884–2T is also amended by these regulations.

Explanation of the Provisions

I. Branch Profits Tax

A. Foreign Governments

Under section 892(a)(3) (added to the Code by the Technical and Miscellaneous Revenue Act of 1988), a foreign government is treated as a corporate resident of its country for all purposes of the Internal Revenue Code. The final regulations under § 1.884–0 provide that a foreign government is treated as a foreign corporation for purposes of section 884 and is subject to the branch profits tax and the branch-level interest tax. This amendment to the regulations will be effective for taxable years of a foreign government ending on or after September 11, 1992. However, for the first taxable year ending on or after September 11, 1992, no branch profits tax shall be imposed with respect to effectively connected earnings and profits ("ECEP") of a foreign government earned prior to such date or with respect to decreases in U.S. net equity of a foreign government attributable to the portion of the taxable year prior to such date. Nor shall the tax on branch interest or excess interest apply to interest apportioned to the effectively connected income of the foreign government that has been paid or accrued by its U.S. trade or business prior to such date. Pending issuance of final regulations under § 1.882–5, a foreign government may apply the rules in the proposed regulations under § 1.882–5, issued at 57 FR 15038 (April 24, 1992), to determine the amount of its U.S. liabilities for purposes of § 1.884–1 and for purposes of determining its interest expense apportioned to its income that is (or is treated as) effectively connected with its U.S. trade or business for purposes of applying § 1.884–4 of the regulations.

B. U.S. Assets

The rules regarding the definition of U.S. assets have been reorganized for purposes of clarity and revised as discussed below.

1. United States Real Property Interests

A United States real property interest that does not meet the general definition of a U.S. asset under § 1.884–1(d)(1) is no longer treated as a U.S. asset under the special rules of § 1.884–1(d)(2). For example, if a foreign corporation owns non-income producing real property in the United States, such as raw land or a condominium not used in the foreign corporation's trade or business, the property shall not be treated as a U.S. asset of the foreign corporation. The elimination of real property not used in a trade or business as a U.S. asset allows a foreign corporation to make a passive investment in real property in the United States without incurring a branch profits tax on the amount of its initial investment in the United States. Only subsequent appreciation recognized on a disposition of the investment will be subject to the tax. The rule is also consistent generally with the proposed regulations under § 1.882–5 that excludes United States real property interests not used in a trade or business from the definition of U.S. assets for purposes of computing a foreign corporation's interest expense, other than in the year of disposition.

2. Installment Obligations

Taxpayers commented that the rule in § 1.884–1T(d)(7) (relating to the amount of an installment obligation treated as a U.S. asset) inappropriately treats installment obligations arising in taxable years beginning prior to the effective date of the branch profits tax in the same manner as those arising after such date. The final regulations in § 1.884–1(d)(6)(ii)(B) provide that an installment obligation arising from a sale of a U.S. asset occurring in a taxable year prior to January 1, 1987, will have a zero basis (for purposes of computing earnings and profits) ("E&P basis").

The final regulations in § 1.884–1(d)(2)(iii) provide also that if interest or original issue discount received by a foreign corporation on an installment

obligation is not effectively connected with the conduct of a U.S. trade or business, the obligation will not be treated as a U.S. asset. Thus, a decrease in U.S. assets, and a dividend equivalent amount could arise in the year of an installment sale if the interest on the obligation does not give rise to effectively connected income. However, a foreign corporation may elect to treat the interest or original issue discount as effectively connected with the conduct of a trade or business in the United States if the interest or original issue discount would not otherwise be so considered. The U.S. asset rule for installment obligations now conforms more closely to the treatment of U.S. assets generally: An asset is a U.S. asset only if all the income and gain from the asset is (or is treated as) income effectively connected with the conduct of a trade or business in the United States. The rule also parallels the treatment of interest received on installment obligations held by domestic subsidiaries of foreign corporations. Since an installment obligation is generally no longer treated as a U.S. asset, a foreign corporation may completely terminate its U.S. trade or business, within the meaning of § 1.884–2T(a), while holding an installment obligation provided all other requirements of that section have been met.

3. Marketable Securities

The rules of § 1.884–1T(d)(8) describing when marketable securities will be treated as U.S. assets have been replaced by three separate rules in § 1.884–1(d)(2) (v) through (vii): One for bank deposits and credit balances, whether or not interest-bearing; a second for debt instruments; and a third for certain stock or securities owned by foreign corporations engaged in the active conduct of a banking, financing, or similar business in the United States, to the extent that such stock or securities do not otherwise qualify as U.S. assets under the general rule. The rules of § 1.884–1T(d)(8) that are relevant for an election by a foreign corporation to remain engaged in a U.S. trade or business under § 1.884–2T(a) have been moved to that section.

4. Expansion Capital

The expansion capital election provided in § 1.884–1T(d)(11) was intended to permit a foreign corporation to treat cash in excess of working capital as a U.S. asset so that it could accumulate earnings for later capital investment. The election was also intended to provide relief to a foreign corporation that sold a major U.S. asset shortly before the close of the year and was unable to purchase a substitute U.S. asset before the end of the year. Taxpayers commented that the election as drafted in the temporary regulations does not provide the intended relief because an expansion capital asset is treated as a U.S. asset for all purposes of section 884. Thus, a foreign corporation's U.S. liabilities increase proportionately with the amount of expansion capital elected and the foreign corporation cannot in fact increase its U.S. net equity on a dollar-for-dollar basis. Taxpayers also criticized the rule because it does not permit a foreign corporation to convert expansion capital into "real" U.S. assets during the course of the taxable year.

In response to the comments, the expansion capital election has been replaced with an election to reduce liabilities (discussed below). The election to reduce liabilities will accomplish many of the same objectives of the expansion capital election, but without the complexity of a properly drafted expansion capital rule.

5. Interest in a Trust or Estate

Section 1.884–1(d)(4) of the final regulations (relating to an interest in a trust or estate) has been reserved. Proposed regulations relating to this paragraph are being issued simultaneously with these final regulations.

6. U.S. Assets of Insurance Companies

Section 1.884–1T(g) provides a special rule for the computation of U.S. assets of an insurance company that includes in taxable income effectively connected net investment income computed under section 842(b). Taxpayers have commented that the rule produces significant fluctuations in the amount of U.S. assets of an insurance company from year to year, because an insurance company may or may not be subject to the special rule in a given year, and the amount of U.S. assets produced by the formula each year will vary depending on the profitability of the U.S. branch of the insurance company vis-a-vis the profitability of the company worldwide.

A number of alternative rules were considered that would have imputed an amount of U.S. assets to correspond to the additional net investment income computed under section 842(b). Because of the complexity of the other options and the problems inherent in § 1.884–1T(g), the special rule was deleted and the final regulations provide that foreign insurance companies will be subject to the same U.S. asset rules as all other foreign corporations.

C. U.S. Liabilities

1. U.S. Liabilities of an Insurance Company

The final regulations add a rule to clarify that an insurance company's U.S. liabilities include the amount of its total insurance liabilities on United States business within the meaning of section 842(b)(2)(B), as well as any other U.S.-connected liabilities determined under § 1.882–5.

2. Election to Reduce U.S. Liabilities

Under § 1.884–1T(e), a foreign corporation is required to compute its U.S. liabilities by multiplying its U.S. assets by the ratio of its worldwide liabilities to worldwide assets, or, if the foreign corporation computes the amount of its interest expense under § 1.882–5 using a fixed ratio of liabilities to assets, then by such fixed ratio. The use of this formulary approach to determine U.S. liabilities is retained in § 1.884–1(e) of the final regulations, with some minor adjustments. Taxpayers commented, however, that the formulary approach creates a hardship in certain circumstances, because a foreign corporation may reinvest all of its effectively connected earnings and profits in its U.S. trade or business and still have a dividend equivalent amount.

In response to this concern and as a replacement for expansion capital, the final regulations under § 1.884–1(e)(3) allow a foreign corporation to elect annually to reduce the amount of its U.S. liabilities for purposes of both §§ 1.884–1 and 1.884–4 down to the amount of liabilities actually shown on the books of the U.S. trade or business for purposes of § 1.882–5(b)(3) as of the last day of the taxable year. In return, a taxpayer must permanently forego the interest deduction attributable to the reduction in liabilities.

The election to reduce liabilities is similar to the expansion capital election because it would permit a foreign corporation to accumulate earnings to expand its U.S. trade or business. For example, if a foreign corporation has $50 of ECEP, it can retain $50 for expansion of its U.S. trade or business without triggering a $50 dividend equivalent amount if it elects to reduce its U.S. liabilities by $50, thereby increasing its U.S. net equity by $50.

If, however, a foreign corporation does not ultimately reinvest the retained earnings created by the election in additional U.S. assets, it will be required to recapture that amount in a year of complete termination, notwithstanding the complete termination rules in § 1.884–2T(a).

The election was also suggested by foreign corporations whose U.S. trades or businesses produce effectively connected losses. Although a foreign corporation with an effectively connected loss for a taxable year would generally not have a branch tax liability in that year, the interest apportioned to its effectively connected income would still be treated as U.S. source interest under section 884. Such a corporation may prefer to forego the interest deduction rather than be treated as paying U.S. source interest.

D. Treaty-Related Issues

The final regulations under § 1.884-1(g)(4)(iii) clarify the branch profits tax consequences for a foreign corporation with ECEP attributable to both a permanent establishment and a non-permanent establishment. The regulations in § 1.684-1(g)(1) also clarify that if a foreign corporation has more than one trade or business in the United States, and meets the requirements of the active trade or business test described in § 1.884-5(e) with respect to only one of the trades or businesses, the branch profits tax treaty benefits only apply to the ECEP related to the one trade or business. See, however, the new de minimis rule described in the active trade or business test (below).

II. Branch-Level Interest Tax

The final regulations under § 1.884-4 were revised to incorporate the rules announced in Notices 88-14 and 89-80. In response to taxpayers' comments, other technical changes were made in this section relating to the special rules for interest paid and excess interest. For purposes of the final regulations, interest paid by a U.S. trade or business is referred to as "branch interest".

A. Branch Interest of Banks

Notice 89-80 sets forth a new definition of branch interest of banks for taxable years beginning after January 1, 1990. Under this definition, branch interest of a bank includes interest paid with respect to certain liabilities of offshore "shell" branches of foreign banks. A liability of a shell branch does not give rise to branch interest, however, unless the bank notifies its depositors within two months following the close of the calendar year that the interest they have received from the shell branch is U.S. source.

Taxpayers criticized the notification requirement, however, because they believed it placed foreign banks in a competitive disadvantage vis-a-vis domestic banks that were not required to notify their shell branch depositors of the source of their interest payments. In response, the final regulations delete the notification requirements for banks. No inference should be drawn from this regulation regarding the source of interest received or paid with respect to shell branch liabilities. The Service is studying the circumstances under which a foreign branch of a domestic bank should be treated as a shell branch and not engaged in commercial banking business for purposes of section 861(a)(1)(B)(i). Comments are invited on this issue.

B. Nondeductible Interest

Section 1.884-4T(a)(2) of the temporary regulations defines excess interest as the excess of the amount of interest allowable as a deduction to the foreign corporation in computing its effectively connected taxable income under § 1.882-5 over the amount of interest paid by the U.S. trade or business, not including nondeductible amounts of branch interest. The final regulations define excess interest generally as the excess of the amount of interest apportioned to the effectively connected income of a foreign corporation under § 1.882-5, after application of § 1.884-1(e)(3) (relating to the election to reduce liabilities), over the foreign corporation's branch interest. The reference to nondeductible interest was deleted because the amount of interest expense apportioned to effectively connected income under § 1.882-5 includes both deductible and nondeductible interest. Provisions that permanently disallow or defer a deduction or result in the capitalization of interest expense apply after interest expense is apportioned to effectively connected income under § 1.882-5.

C. Excess Interest

The Treasury Department has concluded that the tax on excess interest is not prohibited by the nondiscrimination provision or any other provision in any income tax treaty to which the United States is a party.

III. Qualified Resident Rules

A majority of the comments with respect to this section related to clarifying and liberalizing the three "qualified resident" tests: The stock ownership and base erosion test, the publicly-traded test, and the active trade or business test.

A. Stock Ownership and Base Erosion Test

In the final regulations under § 1.884-5(b), a foreign corporation will satisfy the stock ownership test if more than 50 percent of its stock is beneficially owned by qualifying shareholders (individuals, governments, publicly-traded corporations, not-for-profit organizations and beneficiaries of certain pension trusts resident in the United States or the country of residence of the foreign corporation). As under the temporary regulations, a foreign corporation is required to obtain ownership statements from its qualifying shareholders showing the ownership of its stock by the due date of the corporation's return (including extensions). In addition, each individual shareholder (other than a U.S. citizen or resident) must obtain a certificate of residency from his or her Competent Authority or other relevant authority annually and submit it with the stock ownership statement. If a qualifying shareholder does not directly own stock in the foreign corporation seeking qualified resident status, both the qualifying shareholder and the intermediary in which it does have an interest must submit the appropriate documentation to the foreign corporation. Each intermediary must also submit sufficient information for the foreign corporation to determine the amount of stock (by value) that the qualifying shareholder (or other intermediary) beneficially owns in that intermediary for the requisite time period. The amount of information required has been streamlined where possible. The rules permitting intermediary verification statements as substitutes for certain documentation have been retained.

1. Form of Documentation

Commentators criticized as burdensome the documentation requirements, suggesting that documentation be required only once every three years, or that a resident tax return be provided in lieu of a certificate of residency. In response to these comments, the final regulations under § 1.884-5(b)(3)(iii) ease the documentation requirements for certain widely-held corporations, including mutual savings banks and insurance companies. If such a foreign corporation has at least 250 individual owners, it need not obtain ownership statements and certificates of residency from those of its owners that own less than one percent of the equity of the corporation and may generally rely instead on such individual owners' addresses of record.

2. Special Attribution Rules

Special attribution rules for stock owned by pension trusts were issued in Notice 89-80. Those rules have been incorporated into the regulations in § 1.884-5(b)(8) and expanded to cover

pension funds and other entities that provide pension benefits. The regulations under § 1.884–5(b)(2) also provide attribution rules for determining the ownership of mutual insurance companies, savings banks, and other similar non-stock entities, and revise the attribution rules for corporations and partnerships generally.

3. Documentation Received After Filing of Return

The final regulations will continue to require that the documentation be received by the due date of the return (including extensions). However, § 1.884–5(b)(3)(v) provides that, on a showing of good cause in a petition (prior to examination) to the District Director or Assistant Commissioner (International), as appropriate, a foreign corporation may be granted the right to perfect its documentation after the due date of the return (including extensions).

4. Base Erosion

Taxpayers commented that the base erosion test in § 1.884–5T(c) is too broad because the test treats as base eroding payments all deductible payments, including bona fide payments at arms' length to unrelated persons. The test has been retained in large part, however, because of the difficulty in administering a rule that would exclude such payments. It should be noted that payments by a foreign corporation included in its cost of goods sold are not considered base eroding payment since such payments are excluded from gross income.

B. Publicly-Traded Test

A foreign corporation can be a qualified resident of its country of residence if its stock is both primarily and regularly traded on an established securities market in its country of residence. With respect to the regularly traded portion of the test, taxpayers commented that the minimum turnover requirement for a class of stock in the temporary regulations was too high for many corporations listed on established securities exchanges. Consistent with Notice 89–80, the final regulations lower the turnover requirement for all corporations from 30 percent to 10 percent and the 10 percent rate is adopted in the final regulations in § 1.884–5(d)(4)(i)(B)(*2*).

The final regulations also liberalize the closely-held exception to the regularly traded test. Under § 1.884–5T(d)(4)(ii), a class of stock that is otherwise regularly traded will not meet the test if 100 or fewer persons own 50 percent or more of the stock. The final regulations under § 1.884–5(d)(4)(iii) treat a class of stock as closely held if 50 percent or more of the stock is beneficially owned by one or more five percent shareholders who are not qualifying shareholders. The test applies to both domestic and foreign corporations. The regulations under § 1.884–5(d)(5) clarify that corporations with registered shareholders can sustain the burden of proof with respect to the closely-held test if they maintain a list of their registered shareholders and have no knowledge and no reason to know that their stock is closely held. Corporations with bearer shares can meet the burden of proof with respect to this test as long as they have no knowledge and no reason to know that their stock is closely held. No inference should be drawn from this regulation regarding the definition of "property where there is public trading" for purposes of section 1273(b)(3).

C. Active Trade or Business Test

The active trade or business test generally requires that a foreign corporation have both an active and substantial business in its home country and that the trade or business that gives rise to the income for which a treaty benefit is claimed is an integral part of the home country business. The temporary regulations generally require that a minimum percentage of the foreign corporation's assets, income, and payroll be in the treaty country to meet the substantial presence portion of the test.

Commentators raised a number of issues regarding the regulation's standards for determining whether a foreign corporation has a substantial presence in its home country. In particular, it was argued that certain types of businesses, particularly trading companies, will frequently be unable to meet the minimum percentage of assets and income in the treaty country, although they may meet the payroll test. The suggestions made by commentators would have placed excessive weight on the payroll test, however, and thus were not adopted. While the final regulations retain the minimum asset and income ratios, they do provide an alternative to the income ratio for certain corporations. A foreign corporation engaged in selling tangible property or in manufacturing, producing, growing or extracting tangible property may use the ratio of its direct material costs attributable to tangible property manufactured, produced, grown or extracted in its country of residence to its total cost of goods sold rather than the ratio of its income derived from its country of residence to total income in computing whether it has a substantial presence in the treaty country.

Through the private letter ruling process, it was determined that the active trade or business test should also be available to foreign groups that form a wholly-owned subsidiary in their country of residence to conduct the U.S. operations of the group. In such a case, the subsidiary corporation could not have a substantial presence in its country of residence, nor could its U.S. business be integrated with a foreign trade or business, although its affiliated group as a whole might have a substantial presence in the subsidiary's country of residence and the U.S. business might be an integral part of the business conducted by one or more of the other corporations included in that group. In response to this situation, a rule has been added to the active trade or business test that would allow a foreign corporation to apply the active trade or business test to its entire affiliated group within the meaning of section 1504(a), but without regard to the exclusions under section 1504(b) (2) and (3), rather than just to the foreign corporation alone.

With respect to the integral part requirement of the active trade or business test, the temporary regulations provide that the U.S. and foreign business must be "complementary and mutually interdependent steps * * * in the production and sale or lease of goods or in the provision of services". The temporary regulations also provide a presumption that a U.S. branch of a foreign bank will be treated as an integral part of the foreign bank's activities if more than 50 percent of its loans to the public are to residents in the home country. The final regulations modify the presumption with regard to a bank so that a bank can meet the integral part test provided a substantial part of its business in its country of residence consists of receiving deposits and making loans and discounts. The final regulations also provide a rule that allows a foreign corporation with more than one trade or business in the United States to meet the integral part test with respect to all such trades or businesses provided that at least 80 percent of the foreign corporation's ECEP for a three-year period is attributable to one or more of such trades or businesses that would meet the test.

D. Ruling Process

The ruling process was designed to assist the Service in determining the extent to which the stock ownership test, publicly-traded test and active trade or business test did not adequately

deal with the range of corporations seeking qualified resident status. Many of the issues raised by the rulings have been addressed by changes in the final regulations. The Service recognizes that there are still cases that have to be handled individually, and the regulations retain a ruling request procedure for situations in which corporations do not meet any of the other tests, provided that the ruling request is filed by the due date (including extensions) of the return for the taxable year. The final regulations also indicate with greater specificity some of the factors that will be considered in issuing a ruling.

IV. Complete Termination, Liquidation or Reorganization of a Foreign Corporation

Section 1.884-2T(a)(2)(ii) provides that a foreign corporation must extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the sixth taxable year following that taxable year. Section 1.884-2T(c)(2)(iii) provides that a foreign corporation must also extend the period for assessment of the branch profits tax if it liquidates or reorganizes as part of a section 381(a) transaction and the transferee is a domestic corporation. These regulations provide guidance concerning compliance with this waiver requirement until such time as forms are published.

V. Effective Dates

Except as otherwise provided, the final regulations are effective for taxable years beginning on or after October 13, 1992. Taxpayers may elect, however, to apply § 1.884-1 together with § 1.884-4 to taxable years beginning after December 31, 1986 and before the effective date of these regulations, provided certain conditions are met. Taxpayers may also separately elect to apply § 1.884-5 retroactively to such date, provided certain conditions are met.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the 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 authors of these regulations are Elizabeth U. Karzon, of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service and Richard M. Elliott, formerly of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from that office and other offices of the Internal Revenue Service and the Treasury Department participated in developing the regulations on matters of both substance and style.

List of Subjects in 26 CFR 1.881-1 Through 1.884-5

Foreign investments in United States, Income taxes.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 "Sections 1.884-0T through 1.884-5T", "Section 1.884-1T (d)", "Section 1.884-1T (e)" and "Section 1.884-5T (e) and (f)" and adding the following citations to read as follows:

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

Section 1.884-0 also issued under 26 U.S.C. 884 (g).

Section 1.884-1 also issued under 26 U.S.C. 884 (g).

Section 1.884-1 (d) also issued under 26 U.S.C. 884 (c) (2) (A).

Section 1.884-1 (d) (13) (i) also issued under 26 U.S.C. 884 (c) (2).

Section 1.884-1 (e) also issued under 26 U.S.C. 884 (c) (2) (B).

Section 1.884-2T also issued under 26 U.S.C. 884 (g).

Section 1.884-4 also issued under 26 U.S.C. 884 (g).

Section 1.884-5 also issued under 26 U.S.C. 884 (g).

Section 1.884-5 (e) and (f) also issued under 26 U.S.C. 884 (e) (4) (C). * * *

§§ 1.884-0T, 1.884-1T, 1.884-4T, and 1.884-5T [Removed]

Par. 2. Sections 1.884-0T, 1.884-1T, 1.884-4T and 1.884-5T are removed.

§§ 1.884-0 and 1.884-1 [Added]

Par. 3. Sections 1.884-0 and 1.884-1 are added to read as follows:

§ 1.884-0 Overview of regulation provisions for section 884.

(a) *Introduction.* Section 884 consists of three main parts: a branch profits tax on certain earnings of a foreign corporation's U.S. trade or business; a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business; and an anti-treaty shopping rule. A foreign corporation is subject to section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States. An international organization (as defined in section 7701(a)(18)) is not subject to the branch profits tax by reason of section 884(e)(5). A foreign government treated as a corporate resident of its country of residence under section 892(a)(3) shall be treated as a corporation for purposes of section 884. The preceding sentence shall be effective for taxable years ending on or after September 11, 1992, except that, for the first taxable year ending on or after that date, the branch profits tax shall not apply to effectively connected earnings and profits of the foreign government earned prior to that date nor to decreases in the U.S. net equity of a foreign government occurring after the close of the preceding taxable year and before that date. Similarly, § 1.884-4 shall apply, in the case of branch interest, only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in § 1.884-1(d)(1)(iii). Except as otherwise provided, for purposes of the regulations under section 884, the term "U.S. trade or business" includes all the U.S. trades or businesses of a foreign corporation.

(1) *The branch profits tax.* Section 1.884-1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, section 884(a) imposes a 30-percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings have been reinvested in, or disinvested from, a U.S. trade or business. An increase in the equity during the taxable year is

generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax. The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. Section 1.884–2T contains special rules relating to the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(2) *The branch-level interest tax.* Section 1.884–4 provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business of a foreign corporation ["branch interest", as defined in § 1.884–4(b)] is treated as if it were paid by a domestic corporation and may be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442. In addition, if the interest apportioned to ECI exceeds branch interest, the excess is treated as interest paid to the foreign corporation by a wholly-owned domestic corporation and is subject to tax under section 881(a).

(3) *Qualified resident.* Section 1.884–5 provides rules for determining whether a foreign corporation is a qualified resident of a foreign country. In general, a foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

(b) *Outline of major topics in §§ 1.884–1 through 1.884–5.*

§ 1.884–1 Branch profits tax.

(a) General rule.
(b) Dividend equivalent amount.
  (1) Definition.
  (2) Adjustment for increase in U.S. net equity.
  (3) Adjustment for decrease in U.S. net equity.
  (4) Examples.
(c) U.S. net equity.
  (1) Definition.
  (2) Definition of amount of a U.S. asset.
  (3) Definition of determination date.
(d) U.S. assets.
  (1) Definition of a U.S. asset.
  (2) Special rules for certain assets.
  (3) Interest in a partnership.
  (4) Interest in a trust or estate. [Reserved]
  (5) Property that is not a U.S. asset.
  (6) E&P basis of a U.S. asset.
(e) U.S. liabilities.
  (1) Liabilities based on § 1.882–5.
  (2) Insurance reserves.
  (3) Election to reduce liabilities.
  (4) Artificial decrease in U.S. liabilities.
  (5) EExamples.
(f) Effectively connected earnings and profits.
  (1) In general.
  (2) Income that does not produce ECEP.
  (3) Allocation of deductions attributable to income that does not produce ECEP.
  (4) Examples.
(g) Corporations resident in countries with which the United States has an income tax treaty.
  (1) General rule.
  (2) Special rules for foreign corporations that are qualified residents on the basis of their ownership.
  (3) Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.
  (4) Modifications with respect to other income tax treaties.
  (5) Benefits under treaties other than income tax treaties.
(h) Stapled entities.
(i) Effective date.
  (1) General rule.
  (2) Election to reduce liabilities.
  (3) Separate election for installment obligations.
(j) Transition rules.
  (1) General rule.
  (2) Installment obligations.

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) Complete termination of a U.S. trade or business.
  (1) General rule.
  (2) Operating rules.
  (3) Complete termination in the case of a section 338 election.
  (4) Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).
  (5) Coordination with second-level withholding tax.
(b) Election to remain engaged in a U.S. trade or business.
  (1) General rule.
  (2) Marketable security.
  (3) Identification requirements.
  (4) Treatment of income from deemed U.S. assets.
  (5) Method of election.
  (6) Effective date.
(c) Liquidation, reorganization, etc. of a foreign corporation.
  (1) Inapplicability of paragraph (a) (1) to section 381 (a) transactions.
  (2) Transferor's dividend equivalent amount for the taxable year in which a section 381 (a) transaction occurs.
  (3) Transferor's dividend equivalent among for any taxable year succeeding the taxable year in which the section 381 (a) transaction occurs.
  (4) Earnings and profits of the transferor carried over to the transferee pursuant to the section 381 (a) transaction.
  (5) Determination of U.S. net equity of a transferee that is a foreign corporation.
  (6) Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor.
(d) Incorporation under section 351.
  (1) In general.
  (2) Inapplicability of paragraph (a)(1) of this section to section 351 transactions.
  (3) Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.
  (4) Election to increase earnings and profits.
  (5) Dispositions of stock or securities of the transferee by the transferor.
  (6) Example.
(e) Certain transactions with respect to a domestic subsidiary.
(f) Effective date.

§ 1.884–3T Coordination of branch profits tax with secondtier withholding (temporary).

[Reserved]

§ 1.884–4 Branch-level interest tax.

(a) General rule.
  (1) Tax on branch interest.
  (2) Tax on excess interest.
  (3) Original issue discount.
  (4) Examples.
(b) Branch interest.
  (1) Definition of branch interest of a foreign corporation that is not a bank.
  (2) Definition of branch interest of a bank.
  (3) Requirements relating to specifically identified liabilities.
  (4) Interbranch interest disregarded.
  (5) Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets.
  (6) Special rule where branch interest exceeds interest apportioned to ECI of a foreign corporation.
  (7) Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.
  (8) Effect of treaties.
(c) Rules relating to excess interest.
  (1) Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual.
  (2) Interest paid by a partnership.
  (3) Effect of treaties.
  (4) Examples.
(d) Stapled entities.
(e) Effective dates.
(f) Transition rules.
  (1) Election under paragraph (c)(1) of this section.
  (2) Waiver of notification requirement for nonbanks under Notice 89–80.
  (3) Waiver of legending requirement for certain debt issued prior to January 3, 1989.

§ 1.884–5 Qualified resident.

(a) Definition of qualified resident.
(b) Stock ownership requirement.
  (1) General rule.
  (2) Rules for determining constructive ownership.
  (3) Required documentation.
  (4) Ownership statements from qualifying shareholders.
  (5) Certificate of residency.
  (6) Intermediary ownership statement.
  (7) Intermediary verification statement.
  (8) Special rules for pension funds.

§ 1.884–1 Branch profits tax.

(a) *General rule.* A foreign corporation shall be liable for a branch profits tax in an amount equal to 30 percent of the foreign corporation's dividend equivalent amount for the taxable year. The branch profits tax shall be in addition to the tax imposed by section 882 and shall be reported on a foreign corporation's income tax return for the taxable year. The tax shall be due and payable as provided in section 6151 and such other provisions of Subtitle F of the Internal Revenue Code as apply to the income tax liability of corporations. However, no estimated tax payments shall be due with respect to a foreign corporation's liability for the branch profits tax. See paragraph (g) of this section for the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty, and § 1.884–2T for the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(b) *Dividend equivalent amount*—(1) *Definition.* The term "dividend equivalent amount" means a foreign corporation's effectively connected earnings and profits ("ECEP", as defined in paragraph (f)(1) of this section) for the taxable year, adjusted pursuant to paragraph (b) (2) or (3) of this section, as applicable. The dividend equivalent amount cannot be less than zero.

(2) *Adjustment for increase in U.S. net equity.* If a foreign corporation's U.S. net equity (as defined in paragraph (c) of this section) as of the close of the taxable year exceeds the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be reduced (but not below zero) by the amount of such excess.

(3) *Adjustment for decrease in U.S. net equity*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, if a foreign corporation's U.S. net equity as of the close of the taxable year is less than the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be increased by the amount of such difference.

(ii) *Limitation based on accumulated ECEP.* The increase of a foreign corporation's ECEP under paragraph (b)(3)(i) of this section shall not exceed the accumulated ECEP of the foreign corporation as of the beginning of the taxable year. The term "accumulated ECEP" means the aggregate amount of ECEP of a foreign corporation for preceding taxable years beginning after December 31, 1986, minus the aggregate dividend equivalent amounts for such preceding taxable years. Accumulated ECEP may be less than zero.

(4) *Examples.* The principles of paragraph (b) (2) and (3) of this section are illustrated by the following examples.

Example 1. Reinvestment of all ECEP. Foreign corporation A, a calender year taxpayer, had $1,000 U.S. net equity as of the close of 1986 and $100 of ECEP for 1987. A acquires $100 of additional U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,100. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paragraph (b)(2) of this section by the $100 increase in U.S. net equity between the close of 1986 and the close of 1987. A has no dividend equivalent amount for 1987.

Example 2. Partial reinvestment of ECEP. Assume the same facts as in *Example 1* except that A acquires $40 (rather than $100) of U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,040. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paregraph (b)(2) of this section by the $40 increase in U.S. net equity between the close of 1986 and the close of 1987. A has a dividend equivalent amount of $60 for 1987.

Example 3. Disinvestment of prior year's ECEP. Assume the same facts as in *Example 1* for 1987. A has no ECEP for 1988. A's U.S. net equity decreases by $40 (to $1,060) as of the close of 1988. A has a dividend equivalent amount of $40 for 1988, even though it has no ECEP for 1988. A's ECEP of $0 for 1988 is increased under paragraph (b)(3)(i) of this section by the $40 reduction in U.S. net equity (subject to the limitation in paragraph (b)(3)(ii) of this section of $100 of accumulated ECEP).

Example 4. Accumulated ECEP limitation. Assume the same facts as in *Example 2* for 1987. For 1988, A has $125 of ECEP and its U.S. net equity decreases by $50. A's U.S. net equity as of the close of 1988 is $990 ($1,040–$50). In computing A's dividend equivalent amount for 1988, the $125 of ECEP for 1988 is not increased under paragraph (b)(3)(i) of this section by the full amount of the $50 decrease in U.S. net equity during 1988. Rather, the increase in ECEP resulting from the decrease in U.S. net equity is limited to A's accumulated ECEP as of the beginning of 1988. A had $100 of ECEP for 1987 and a dividend equivalent amount of $60 for that year, so A had $40 of accumulated ECEP as of the beginning of 1988. The increase in ECEP resulting from a decrease in U.S. net equity is thus limited to $40, and the dividend equivalent amount for 1988 is $165 ($125 ECEP + $40 decrease in U.S. net equity).

Example 5. Effect of deficits in ECEP. Foreign corporation A, a calendar year taxpayer, has $150 of accumulated ECEP as of the beginning of 1991 ($200 aggregate ECEP less $50 aggregate dividend equivalent amounts for years preceding 1991). A has U.S. net equity of $450 as of the close of 1990, U.S. net equity of $350 as of the close of 1991 (i.e., a $100 decrease in U.S. net equity) and a $90 deficit in ECEP for 1991. A's dividend equivalent amount is $10 for 1991, i.e., A's deficit of $90 in ECEP for 1991 increased by $100, the decrease in A's U.S. net equity during 1991. A portion of the reduction in U.S. net equity in 1991 ($90) is attributable to A's deficit in ECEP for that year. The reduction in U.S. net equity in 1991 ($100) triggers a dividend equivalent amount only to the extent it exceeds the $90 current year deficit in ECEP for 1991. As of the beginning of 1992, A has $50 of accumulated ECEP (i.e., 110 aggregate ECEP less $60 aggregate dividend equivalent amounts for years preceding 1992).

Example 6. Nimble dividend equivalent amount. Foreign corporation A, a calendar year taxpayer, had a deficit in ECEP of $100 for 1987 and $100 for 1988, and has $90 of ECEP for 1989. A had $2,000 U.S. net equity as of the close of 1988 and has $2,000 U.S. net equity as of the close of 1989. A has a dividend equivalent amount of $90 for 1989, its ECEP for the year, even though it has a net deficit of $110 in ECEP for the period 1987–1989.

(c) *U.S. net equity*—(1) *Definition.* The term "U.S. net equity" means the aggregate amount of the U.S. assets (as defined in paragraphs (c)(2) and (d)(1) of this section) of a foreign corporation as of the determination date (as defined in paragraph (c)(3) of this section), reduced (including below zero) by the U.S. liabilities (as defined in paragraph (e) of this section) of the foreign corporation as of the determination date.

(2) *Definition of the amount of a U.S. asset.* For purposes of this section, the term "amount of a U.S. asset" means the

U.S. asset's adjusted basis for purposes of computing earnings and profits ("E&P basis") multiplied by the proportion of the asset that is treated as a U.S. asset under paragraphs (d) (1) through (4) of this section. The amount of a U.S. asset that is money shall be its face value. See paragraph (d)(8) of this section for rules concerning the computation of the E&P basis of a U.S. asset.

(5) *Definition of determination date.* For purposes of this section, the term "determination date" means the close of the day on which the amount of U.S. net equity is required to be determined. Unless otherwise provided, the U.S. net equity of a foreign corporation is required to be determined as of the close of the foreign corporation's taxable year.

(d) *U.S. assets*—(1) *Definition of a U.S. asset*—(i) *General rule.* Except as provided in paragraph (d)(5) of this section, the term "U.S. asset" means an asset of a foreign corporation (other than an interest in a partnership, trust, or estate) that is held by the corporation as of the determination date if—

(A) All income produced by the asset on the determination date is ECI (as defined in paragraph (d)(1)(iii) of this section) (or would be ECI if the asset produced income on that date); and

(B) All gain from the disposition of the asset would be ECI if the asset were disposed of on that date and the disposition produced gain.

For purposes of determining whether income or gain from an asset would be ECI under this paragraph (d)(1)(i), it is immaterial whether the asset is of a type that is unlikely to, or cannot, produce income or gain. For example, money may be a U.S. asset although it does not produce income or gain. In the case of an asset that does not produce income, however, the determination of whether income from the asset would be ECI shall be made under the principles of section 864 and the regulations thereunder, but without regard to § 1.864-4(c)(2)(iii)(*b*). For purposes of determining whether an asset is a U.S. asset under this paragraph (d)(1), a foreign corporation may presume, unless it has reason to know otherwise, that gain from the sale of personal property (including inventory property) would be U.S. source if gain from the sale of that type of property would ordinarily be attributable to an office or other fixed place of business of the foreign corporation within the United States (within the meaning of section 865(e)(2)).

(ii) *Special rules for assets not described in paragraph (d)(1)(i) of this section.* An asset of a foreign corporation that is held by the corporation as of the determination date and is not described in paragraph (d)(1)(i) of this section shall be treated as a U.S. asset to the extent provided in paragraph (d)(2) of this section (relating to special rules for certain assets, including assets that produce income or gain at least a portion of which is ECI), and in paragraphs (d) (3) and (4) of this section (relating to special rules for interests in a partnership, trust, and estate).

(iii) *Definition of ECI.* For purposes of the regulations under section 864, the term "ECI" means income that is effectively connected with the conduct of a trade or business in the United States and income that is treated as effectively connected with the conduct of a trade or business in the United States under any provision of the Code. The term "ECI" also includes all income that is or is treated as effectively connected with the conduct of a U.S. trade or business whether or not the income is included in gross income (for example, interest income earned with respect to tax-exempt bonds).

(2) *Special rules for certain assets*—(i) *Depreciable and amortizable property.* An item of depreciable personal property or an item of amortizable intangible property shall be treated as a U.S. asset of a foreign corporation in the same proportion that the amount of the depreciation or amortization with respect to the item of property that is allowable as a deduction, or is includible in cost of goods sold, for the taxable year in computing the effectively connected taxable income of the foreign corporation bears to the total amount of depreciation or amortization computed for the taxable year with respect to the item of property.

(ii) *Inventory.* An item or pool of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the same proportion as the amount of gross receipts from the sale or exchange of such property for the three preceding taxable years (or for such part of the three-year period as the corporation has been in existence) that is effectively connected with the conduct of a U.S. trade or business bears to the total amount of gross receipts from the sale or exchange of such property during such period (or part thereof). If a foreign corporation has not sold or exchanged such property during such three-year period (or part thereof), then the property shall be treated as a U.S. asset in the same proportion that the anticipated amount of gross receipts from the sale or exchange of the property that is reasonably anticipated to be ECI bears to the anticipated total amount of gross receipts from the sale or exchange of the property.

(iii) *Installment obligations.* An installment obligation received in connection with an installment sale (as defined in section 453(b)) for which an election under section 453(d) has not been made shall be treated as a U.S. asset to the extent that it is received in connection with the sale of a U.S. asset. If an obligation is received in connection with the sale of an asset that is wholly a U.S. asset, it shall be treated as a U.S. asset in its entirety. If a single obligation is received in connection with the sale of an asset that is in part a U.S. asset under the rules of paragraphs (d) (2) through (4) of this section, or in connection with the sale of several assets including one or more non-U.S. assets, the obligation shall be treated as a U.S. asset in the same proportion as—

(A) The sum of the amount of gain from the installment sale that would be ECI if the obligation were satisfied in full on the determination date and the adjusted basis of the obligation on such date (as determined under section 453B) attributable to the amount of gain that would be ECI bears to

(B) The sum of the total amount of gain from the sale if the obligation were satisfied in full and the adjusted basis of the obligation on such date (as determined under section 453B). However, the obligation will only be treated as a U.S. asset if the interest income or original issue discount with respect to the obligation is ECI or the foreign corporation elects to treat the interest or original issue discount as ECI in the same proportion that the obligation is treated as a U.S. asset. A foreign corporation may elect to treat interest income or original issue discount as ECI by reporting such interest income or original issue discount as ECI on its income tax return or an amended return for the taxable year. See paragraph (d)(8)(ii) of this section to determine the E&P basis of an installment obligation for purposes of this paragraph (d)(2)(iii).

(iv) *Receivables*—(A) *Receivables arising from the sale or exchange of inventory property.* An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the sale or exchange of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the proportion determined under paragraph (d)(2)(iii) of this section as if the receivable were an installment obligation.

(B) *Receivables arising from the performance of services or leasing of property.* An account or note receivable (whether or not bearing stated interest)

with a maturity not exceeding six months that arises from the performance of services or the leasing of property in the ordinary course of a foreign corporation's trade or business shall be treated as a U.S. asset in the same proportion that the amount of gross income represented by the receivable that is ECI bears to the total amount of gross income represented by the receivable. For purposes of this paragraph (d)(2)(iv)(B), the amount of income represented by a receivable shall not include interest income or original issue discount.

(v) *Bank and other deposits.* A deposit or credit balance with a person described in section 871(i)(3) or a Federal Reserve Bank that is interest-bearing shall be treated as a U.S. asset if all income derived by the foreign corporation with respect to the deposit or credit balance during the taxable year is ECI. Any other deposit or credit balance shall only be treated as a U.S. asset if the deposit or credit balance is needed in a U.S. trade or business within the meaning of § 1.864–4(c)(2)(iii)(*a*).

(vi) *Debt instruments.* A debt instrument, as defined in section 1275(a)(1) (other than an asset treated as a U.S. asset under any other subdivision of this paragraph (d)) shall be treated as a U.S. asset, notwithstanding the fact that gain from the sale or exchange of the obligation on the determination date would not be ECI, if—

(A) All income derived by the foreign corporation from such obligation during the taxable year is ECI; and

(B) The yield for the period that the instrument was held during the taxable year equals or exceeds the Applicable Federal Rate for instruments of similar type and maturity.

Shares in a regulated investment company that purchases solely instruments that, under this paragraph (d)(2)(vi), would be U.S. assets if held directly by the foreign corporation shall also be treated as a U.S. asset.

(vii) *Stocks or securities held by a foreign corporation engaged in a banking, financing or similar business.* Stocks or securities described in § 1.864–4(c)(5)(ii)(*b*)(*3*) held by a foreign corporation engaged in the active conduct of a banking, financing, or similar business in the United States during the taxable year shall be treated as U.S. assets in the same proportion that income, gain, or loss from such stocks or securities is ECI for the taxable year under § 1.864–4(c)(5)(ii).

(viii) *Federal income taxes.* An overpayment of Federal income taxes shall be treated as a U.S. asset to the extent that the tax would reduce a foreign corporation's ECEP for the taxable year but for the fact that the tax does not accrue during the taxable year.

(ix) *Losses involving U.S. assets.* A foreign corporation that sustains, with respect to a U.S. asset, a loss for which a deduction is not allowed under section 165 (in whole or in part) because there exists a reasonable prospect of recovering compensation for the loss shall be treated as having a U.S. asset ("loss property") from the date of the loss in the same proportion that the asset was treated as a U.S. asset immediately before the loss. See paragraph (d)(6)(iv) of this section to determine the E&P basis of the loss property.

(x) *Ruling for involuntary conversion.* If property that is a U.S. asset of a foreign corporation is compulsorily or involuntarily converted into property not similar or related in service or use (within the meaning of section 1033), the foreign corporation may apply to the Commissioner for a ruling to determine its U.S. assets for the taxable year of the involuntary conversion.

(xi) *Examples.* The principles of paragraphs (c) and (d) (1) and (2) of this section are illustrated by the following examples.

Example 1. Depreciable property. Foreign corporation A, a calendar year taxpayer, is engaged in a trade or business in the United States. A owns equipment that is used in its manufacturing business in country X and in the United States. Under § 1.861–8, A's depreciation deduction with respect to the equipment is allocated to sales income and is apportioned 70 percent to ECI and 30 percent to income that is not ECI. Under paragraph (d)(2)(ii) of this section, the equipment is 70 percent a U.S. asset. The equipment has an E&P basis of $100 at the beginning of 1993. A's depreciation deduction (for purposes of computing earnings and profits) with respect to the equipment is $10 for 1993. To determine the amount of A's U.S. asset at the close of 1993, the equipment's $90 E&P basis at the close of 1993 is multiplied by 70 percent (the proportion of the asset that is a U.S. asset). The amount of the U.S. asset as of the close of 1993 is $63.

Example 2. U.S. real property interest not connected to a U.S. business. Foreign corporation A owns a condominium apartment in the United States. Assume that holding the apartment does not constitute a U.S. trade or business and the foreign corporation has not made an election under section 682(d) to treat income with respect to the property as ECI. The condominium apartment is not a U.S. asset of A because the income, if any, from the asset would not be ECI. However, the disposition by A of the condominium apartment at a gain will give rise to ECEP.

Example 3. Stock in a domestically-controlled REIT. As an investment, foreign corporation A owns stock in a domestically-controlled REIT, within the meaning of section 897(h)(4)(B). Under section 897(h)(2), gain on disposition of stock in the REIT is not treated as ECI. For this reason the stock does not qualify as a U.S. asset under paragraph (d)(1) of this section even if dividend distributions from the REIT are treated as ECI. Thus, A will have a dividend equivalent amount based on the ECEP attributable to a distribution of ECI from the REIT, even if A invests the proceeds from the dividend in additional stock of the REIT. (Stock in a REIT that is not a domestically-controlled REIT is also not a U.S. asset. See § 1.864–1(d)(5)).

Example 4. Section 864(c)(7) property. Foreign corporation A is engaged in the equipment leasing business in the United States and Canada. A transfers the equipment leased by its U.S. trade or business to its Canadian business after the equipment is fully depreciated in the United States. The Canadian business sells the equipment two years later. Section 864(c)(7) would treat the gain on the disposition of the equipment by A as taxable under section 882 as if the sale occurred immediately before the equipment was transferred to the Canadian business. The equipment would not be treated as a U.S. asset even if the gain was ECI because the income from the equipment in the year of the sale in Canada would not be ECI.

(3) *Interest in a partnership*—(i) *General rule.* Except as provided in paragraph (d)(3)(ii) of this section, a foreign corporation's interest in a partnership shall be treated as a U.S. asset in the same proportion as its distributive share of partnership gross income for the partnership's taxable year that ends with or within its taxable year that is ECI bears to its distributive share of all partnership gross income for that taxable year.

(ii) *Partnership operated to increase a foreign corporation's U.S. assets artificially.* If the District Director determines that one of the principal purposes of the acquisition of a partnership interest or the acquisition or ownership of certain properties by a partnership is to increase the U.S. assets of a foreign corporation artificially, the District Director may compute the portion of the foreign corporation's interest in the partnership that is a U.S. asset using a method that more accurately reflects the foreign corporation's interest in the partnership property that would be U.S. assets if held directly by the foreign corporation. Whether a partnership interest is acquired, or partnership property is acquired or owned, for such purpose will depend on all the facts and circumstances of each case. Factors to be considered include whether the partnership conducts unrelated businesses or whether the partnership accumulates investment property unrelated to its trade or business or

liquid assets in excess of the reasonable needs of its business. For purposes of this paragraph (d)(3)(ii), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(iii) *Example.* The application of paragraph (d)(3)(ii) of this section is illustrated by the following example.

Example. Foreign corporation A is a partner in partnership X and is entitled to 50 percent of the income of X and 50 percent of the value of all property of X upon X's liquidation. X is engaged in an active U.S. real estate business which, during the taxable year, produces $100 of gross income that is ECI. In the same taxable year, X acquires securities (from funds that are either generated by its business, borrowed or contributed) that produce $50 of gross income that is not ECI. The securities are unrelated to the real estate business and substantially exceed the reasonable needs of the business. The real estate securities each have an adjusted basis of $1000. Under paragraph (d)(3)(i) of this section, two-thirds (50/75) of A's distributive share of partnership gross income is ECI, and two-thirds of A's basis in its partnership interest is therefore treated as a U.S. asset. However, because the securities acquired by X are unrelated to X's real estate business and exceed the reasonable needs of the business, the District Director may determine that a principle purpose of X's acquisition of the securities is to increase artificially the U.S. assets of A. The District Director may, therefore, compute the portion of A's interest in X that is treated as a U.S. asset by, for example, using the ratio of A's pro rata share of the adjusted basis of the property of X that produces income that is ECI ($500) to A's pro rata share of all property of X ($1000). As a result, 50 percent of A's partnership interest would be treated as a U.S. asset rather than 75 percent.

(iv) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of this paragraph (d)(3) and paragraph (d)(6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (as determined under section 705)—

(A) Reduced by the partner's share of the liabilities of the partnership (as determined under section 752); and

(B) Increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share, for income tax purposes, of the interest expense attributable to such liability for the taxable year.

(v) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the calculation of a foreign corporation's E&P basis in a partnership interest.

(4) *Interest in a trust or estate.* [Reserved]

(5) *Property that is not a U.S. asset*—(i) *Property that does not give rise to ECEP.* Property described in paragraphs (d)(1) through (4) of this section shall not be treated as a U.S. asset of a foreign corporation if, on the determination date, income from the use of the property, or gain or loss from the disposition of the property, would be described in paragraph (f)(2) of this section (relating to certain income that does not produce ECEP).

(ii) *Assets acquired to increase U.S. net equity artificially.* U.S. assets shall not include assets acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether assets are acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from, or disposed of to, a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on the determination date. For purposes of this paragraph (d)(5)(ii), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(iii) *Interbranch transactions disregarded.* All assets that arise from interbranch transactions will be disregarded.

(6) *E&P basis of a U.S. asset*—(i) *General rule.* The E&P basis of a U.S. asset for purposes of this section is its adjusted basis for purposes of computing the foreign corporation's earnings and profits. In determining the E&P basis of a U.S. asset, the adjusted basis of the asset (for purposes of computing taxable income) must be increased or decreased to take into account inclusions of income or gain, and deductions or similar charges, that affect the basis of the asset where such items are taken into account in a different manner for purposes of computing earnings and profits than for purposes of computing taxable income. For example, if section 312 (k) requires that depreciation with respect to a U.S. asset be determined using the straight line method for purposes of computing earnings and profits, but depreciation with respect to the asset is determined using a different method for purposes of computing taxable income, the E&P basis of the property for purposes of this section must be computed using the straight line method of depreciation.

(ii) *Installment obligations*—(A) *Sales in taxable year beginning on or after January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning on or after January 1, 1987, shall equal the sum of the total amount of gain from the sale if the obligation were satisfied in full and the adjusted basis of the property sold as of the date of sale, reduced by payments received with respect to the obligation that are not interest or original issue discount. See paragraph (j)(2)(ii) of this section, however, for a special E&P basis rule for an installment obligation arising in connection with a sale of a U.S. asset by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987.

(B) *Sales in taxable year prior to January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning before January 1, 1987, shall equal zero.

(iii) *Computation of E&P basis in a partnership.* For purposes of this section, a foreign corporation's E&P basis in a partnership interest shall be the foreign corporation's adjusted basis in such interest (as determined under paragraph (d)(3)(iv) of this section), further adjusted to take into account any differences between the foreign corporation's distributive share of items of partnership income, gain, loss, and deduction for purposes of computing the taxable income of the foreign corporation and the foreign corporation's distributive share of items of partnership income, gain, loss, and deductions for purposes of computing the earnings and profits of the foreign corporation.

(iv) *Computation of E&P basis of a loss property.* The E&P basis of a loss property (as defined in paragraph (d)(2)(ix) of this section) shall equal the E&P basis, immediately before the loss, of the U.S. asset with respect to which the loss was substained, reduced (but not below zero) by—

(A) The amount of any deduction claimed under section 165 by the foreign corporation with respect to the loss for earnings and profits purposes; and

(B) Any compensation received with respect to the loss.

(v) *Example.* The application of paragraph (d)(6)(ii) of this section is illustrated by the following example.

Example. Sale in taxable year beginning on or after January 1, 1987. Foreign corporation A, a calendar year taxpayer, sells a U.S. asset on the installment method in 1993. Under the terms of the sale, A is to receive $100, payable in ten annual installments of $10 beginning in 1994, plus an arm's-length rate of interest on the unpaid balance of the sales price. A's adjusted basis in the property sold is $70. The obligation received in connection with the installment sale is treated as a U.S. asset with an E&P basis of $100 ($30 (the amount of gain from the sale if the obligation were satisfied in full) + $70 (the adjusted basis of the property sold)). If A receives a payment of $10 (not including interest) in 1994 with respect to the obligation, the obligation is treated as a U.S. asset with an E&P basis of $90 ($100−$10) as of the close of 1994.

(e) *U.S. liabilities.* The term "U.S. liabilities" means the amount of liabilities determined under paragraph (e)(1) of this section decreased by the amount of liabilities determined under paragraph (e)(3) of this section, and increased by the amount of liabilities determined under paragraph (e)(2) of this section.

(1) *Liabilities based on § 1.882–5.* The amount of liabilities determined under this paragraph (e)(1) is the amount of U.S.-connected liabilities of a foreign corporation under § 1.882–5 if the U.S.-connected liabilities were computed using the assets and liabilities of the foreign corporation as of the determination date (rather than the average of such assets and liabilities for the taxable year) and without regard to paragraph (e)(3) of this section.

(2) *Insurance reserves.* The amount of liabilities determined under this paragraph (e)(2) is the amount (as of the determination date) of the total insurance liabilities on United States business (within the meaning of section 842(b)(2)(B)) of a foreign corporation described in section 842(a) (relating to foreign corporations carrying on an insurance business in the United States) to the extent that such liabilities are not otherwise treated as U.S. liabilities by reason of paragraph (e)(1) of this section.

(3) *Election to reduce liabilities*—(i) *General rule.* The amount of liabilities determined under this paragraph (e)(3) is the amount by which a foreign corporation elects to reduce its liabilities under paragraph (e)(1) of this section.

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the excess, if any, of the amount of liabilities in paragraph (e)(1) of this section over the amount of liabilities shown on the books of the U.S. trade or business (determined under either § 1.882–5(b)(3) (i) or (ii)) as of the determination date.

(iii) *Effect of election on interest deduction and branch-level interest tax.* A foreign corporation that elects to reduce its liabilities under this paragraph (e)(3) must, for purposes of computing the amount of its interest apportioned to ECI under § 1.882–5, reduce its U.S.-connected liabilities for the taxable year of the election by the amount of the reduction in liabilities under this paragraph (e)(3). The reduction of its U.S.-connected liabilities will also require a corresponding decrease in the amount of its interest apportioned to ECI under § 1.882–5 for purposes of § 1.884–4(a) and for all other Code sections for which the amount of interest apportioned under § 1.882–5 is relevant.

(iv) *Method of election.* A foreign corporation that elects the benefits of this paragraph (e)(3) for a taxable year shall state on its return for the taxable year (or on a statement attached to the return) that it has elected to reduce its liabilities for the taxable year under this paragraph (e)(3) and that it has reduced the amount of its U.S.-connected liabilities as provided in paragraph (e)(3)(iii) of this section, and shall indicate the amount of such reductions on the return or attachment. An election under this paragraph (e)(3) must be made before the due date (including extensions) for the foreign corporation's income tax return for the taxable year.

(v) *Effect of election on complete termination.* If a foreign corporation completely terminates its U.S. trade or business (within the meaning of § 1.884–2T (a)(2)), notwithstanding § 1.884–2T(a), the foreign corporation will be subject to tax on a dividend equivalent amount that equals the lesser of—

(A) The foreign corporation's accumulated ECEP that is attributable to an election to reduce liabilities; or

(B) The amount by which the corporation elected to reduce liabilities at the end of the taxable year preceding the year of complete termination.

For purposes of the preceding sentence, accumulated ECEP is attributable to an election to reduce liabilities to the extent that the ECEP was accumulated because of such an election rather than because of an increase in U.S. assets. For example, if a foreign corporation did not have positive ECEP in any year for which an election was made, it would not be required to include an amount as a dividend equivalent amount under this paragraph (e)(3)(v) because any accumulated ECEP that it may have is not attributable to an election to reduce liabilities.

(4) *Artificial decrease in U.S. liabilities.* If a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to decrease artificially its U.S. liabilities on the determination date, then such decrease shall not be taken into account for purposes of computing the foreign corporation's U.S. net equity. Whether the U.S. liabilities of a foreign corporation are artificially decreased will depend on all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for the repayment or decrease of the liabilities is to decrease artificially the U.S. liabilities of a foreign corporation shall include whether the aggregate liabilities are temporarily decreased on or before the determination date by, for example, the repayment of liabilities, or U.S. liabilities are temporarily decreased on or before the determination date by the acquisition with contributed funds of passive-type assets that are not U.S. assets. For purposes of this paragraph (e)(4), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(5) *Examples.* The application of this paragraph (e) is illustrated by the following examples.

Example 1. General rule for computation of U.S. liabilities. As of the close of 1993, foreign corporation A, a calendar year taxpayer computes its U.S.-connected liabilities under § 1.882–5(b) using its actual ratio of liabilities to assets. For purposes of computing its U.S.-connected liabilities under § 1.882–5(b), A must determine the average total value of its assets that generate, have generated, or could reasonably have been or be expected to generate ECI. Assume that the average value of such assets is $100, while the amount of such assets as of the close of 1993 is $125. For purposes of § 1.882–5(b)(2), A must determine the ratio of the average of its worldwide liabilities for the year to the average total value of worldwide assets for the taxable year. Assume that A's average liabilities-to-assets ratio under § 1.882–5(b)(2) is 55 percent, while its liabilities-to-assets ratio at the close of 1993 is only 50 percent. Thus, assuming no further adjustments under paragraph (e)(3) of this section, A's U.S.-connected liabilities for purposes of § 1.882–5 are $55 ($100×55%). However, A's U.S. liabilities are $62.50 for purposes of this section, the amount of its assets determined under § 1.882–5(b)(1) as of the close of December ($125) multiplied by the liabilities-to-assets ratio of (50%) as of such date.

Example 2. Election made to reduce liabilities. (i) As of the close of 1993, foreign

corporation A, a real estate company, owns U.S. assets with an E&P basis of $1000. A has $800 of liabilities under paragraph (e)(1) of this section and $300 of liabilities shown on the books and records of its U.S. trade or business under § 1.882–5(b)(3). A has accumulated ECEP of $500 and in 1994, A has $60 of ECEP that it intends to retain for future expansion of its U.S. trade or business. A elects under paragraph (e)(3) of this section to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 1994 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its ECEP will be reduced to zero. Under paragraph (e)(3)(iii) of this section, A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and ECEP are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election under paragraph (e)(3) of this section to further reduce its liabilities, thus increasing its U.S. net equity and reducing the amount of additional ECEP created for the election.

(ii) In 1995, assuming A again has $60 of ECEP, A may again make the election under paragraph (e)(3) to reduce its liabilities. However, assuming A's U.S. assets and liabilities under paragraph (e)(1) of this section remain constant, A will need to make an election to reduce its liabilities by $120 to reduce to zero its ECEP in 1995 and to continue to retain for expansion (without the payment of the branch profits tax) the $60 of ECEP earned in 1994. Without an election to reduce liabilities, A's dividend equivalent amount for 1995 would be $120 ($60 of ECEP plus the $60 reduction in U.S. net equity from $260 to $200). If A makes the election to reduce liabilities by $120 (from $800 to $680), A's U.S. net equity will increase by $60 (from $260 at the end of the previous year to $320), the amount necessary to reduce its ECEP to $0. However, the reduction of liabilities will itself create additional ECEP subject to section 884 because of the reduction in interest expense attributable to the $120 of liabilities. A can make the election to reduce liabilities by $120 without exceeding the limitation on the election provided in paragraph (e)(3)(ii) of this section because $120 does not exceed the excess of $800 (the amount of A's liabilities under paragraph (e)(1) of this section) over $300 (the amount of liabilities on A's books.

(iii) If A terminates its U.S. trade or business in 1995 in accordance with the rules in § 1.884–2T(a), A would not be subject to the branch profits tax on the $60 of ECEP earned in that year. Under paragraph (e)(3)(v) of this section, however, it would be subject to the branch profits tax on the portion of the $60 of ECEP that it earned in 1994 that became accumulated ECEP because of an election to reduce liabilities.

(f) *Effectively connected earnings and profits*—(1) *In general.* Except as provided in paragraph (f)(2) of this section and as modified by § 1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation or its domestic subsidiary), the term "effectively connected earnings and profits" ("ECEP") means the earnings and profits (or deficits therein) determined under section 312 and this paragraph (f) that are attributable to ECI (within the meaning of paragraph (d)(1)(iii) of this section). Because the term "ECI" includes income treated as effectively connected, income that is ECI under section 842(b) (relating to minimum net investment income of an insurance business) or 864(c)(7) (relating to gain from property formerly held for use in a U.S. trade or business) gives rise to ECEP. ECEP also includes earnings and profits attributable to ECI of a foreign corporation earned through a partnership, and through a trust or estate. For purposes of section 884, gain on the sale of a U.S. real property interest by a foreign corporation that has made an election to be treated as a domestic corporation under section 897(i) will also give rise to ECEP. ECEP is not reduced by distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest (as defined in § 1.884–4(a)(2)) paid by the foreign corporation. Earnings and profits are treated as attributable to ECI even if the earnings and profits are taken into account under section 312 in an earlier or later taxable year than the taxable year in which the ECI is taken into account.

(2) *Income that does not produce ECEP.* The term "ECEP" does not include any earnings and profits attributable to—

(i) Income excluded from gross income under section 883(a)(1) or 883(a)(2) (relating to certain income derived from the operation of ships or aircraft);

(ii) Income that is ECI by reason of section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation or nonresident alien) that is not otherwise ECI;

(iii) Gain on the disposition of a U.S. real property interest described in section 897(c)(1)(A)(ii) (relating to certain interests in a domestic corporation);

(iv) Income that is ECI by reason of section 953(3)(c)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI;

(v) Income that is exempt from tax under section 892 (relating to certain income of foreign governments); and

(vi) Income that is ECI by reason of section 882(e) (relating to certain interest income of banks organized under the laws of a possession of the United States) that is not otherwise ECI.

(3) *Allocation of deductions attributable to income that does not produce ECEP.* In determining the amount of a foreign corporation's ECEP for the taxable year, deductions and other adjustments shall be allocated and apportioned under the principles of § 1.861–8 between ECI that gives rise to ECEP and income described in paragraph (f)(2) of this section (relating to income that is ECI but does not give rise to ECEP).

(4) *Examples.* The principles of paragraph (f) of this section are illustrated by the following examples.

Example 1. Tax-exempt income. Foreign corporation A owns a tax-exempt municipal bond that is a U.S. asset as of the close of its 1989 taxable year. The municipal bond gives rise in 1989 to ECI (even though the income is excluded from gross income under section 103(a) and is not gross income of a foreign corporation by reason of section 882(b)), and therefore gives rise to ECEP in 1989.

Example 2. Income exempt under a treaty. Foreign corporation A derives ECI that constitutes business profits that are not attributable to a permanent establishment maintained by A in the United States. The ECI is exempt from taxation under section 882(a) by reason of an income tax treaty and section 894(a). The income nevertheless gives rise to ECEP under this paragraph (f). However, a dividend equivalent amount attributable to such ECEP may be exempt from the branch profits tax by reason of paragraph (g) of this section (relating to the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty).

(g) *Corporations resident in countries with which the United States has an income tax treaty*—(1) *General rule.* Except as provided in paragraph (g)(2) of this section, a foreign corporation that is a resident of a country with which the United States has an income tax treaty in effect for a taxable year in which it has a dividend equivalent amount and that meets the requirements, if any, of the limitation on benefits provisions of such treaty with respect to the dividend equivalent amount shall not be subject to the branch profits tax on such amount (or will qualify for a reduction in the amount of tax with respect to such amount) only if—

(i) The foreign corporation is a qualified resident of such country for the taxable year, within the meaning of § 1.884–5(a); or

(ii) The limitation on benefits provision, or an amendment to that

provision, entered into force after December 31, 1986.

If, after application of § 1.884–5(e)(4)(iv), a foreign corporation is a qualified resident under § 1.884–5(e) (relating to the active trade or business test) only with respect to one of its trades or businesses in the United States, i.e., the trade or business that is an integral part of its business conducted in its country of residence, and not with respect to another, the rules of this paragraph shall apply only to that portion of its dividend equivalent amount attributable to the trade or business for which the foreign corporation is a qualified resident.

(2) *Special rules for foreign corporations that are qualified residents on the basis of their ownership*—(i) *General rule.* A foreign corporation that, in any taxable year, is a qualified resident of a country with which the United States has an income tax treaty in effect solely by reason of meeting the requirements of § 1.884–5 (b) and (c) (relating, respectively, to stock ownership and base erosion) shall be exempt from the branch profits tax or subject to a reduced rate of branch profits tax under paragraph (g)(1) of this section with respect to the portion of its dividend equivalent amount for the taxable year attributable to accumulated ECEP only if the foreign corporation is a qualified resident of such country within the meaning of § 1.884–5(a) for the taxable years includable, in whole or in part, in a consecutive 36-month period that includes the taxable year of the dividend equivalent amount. A foreign corporation that fails the 36-month test described in the preceding sentence shall be exempt from the branch profits tax or subject to the branch profits tax at a reduced rate under paragraph (g)(1) of this section with respect to accumulated ECEP (determiend on a last-in-first-out basis) accumulated only during prior years in which the foreign corporation was a qualified resident of such country within the meaning of § 1.884–5(a).

(ii) *Rules of application.* A foreign corporation that has not satisfied the 36-month test as of the close of the taxable year of the dividend equivalent amount but satisfies the test with respect to such dividend equivalent amount by meeting the 36-month test by the close of the second taxable year succeeding the taxable year of the dividend equivalent amount shall be subject to the branch profits tax for the year of the dividend equivalent amount without regard to paragraph (g)(1) of this section on the portion of the dividend equivalent amount attributable to accumulated ECEP derived in a taxable year in which the foreign corporation was not a qualified resident within the meaning of § 1.884–5(a). Upon meeting the 36-month test, the foreign corporation shall be entitled to claim by amended return a refund of the tax paid with respect to the dividend equivalent amount in excess of the branch profits tax calculated by taking into account paragraph (g)(2)(i) of this section, provided the foreign corporation establishes in the amended return for the taxable year that it has met the requirements of such paragraph. For purposes of section 6611 (dealing with interest on overpayments), any overpayment of branch profits tax by reason of this paragraph (g)(2)(ii) shall be deemed not to have been made before the filing date for the taxable year in which the foreign corporation establishes that it has met the 36-month test.

(iii) *Example.* The application of this paragraph (g)(2) is illustrated by the following example.

Example. (i) Foreign corporation A, a calendar year taxpayer, is a resident of the United Kingdom. A has a dividend equivalent amount for its taxable year 1991 of $300, of which $100 is attributable to 1991 ECEP and $200 to accumulated ECEP. A is a qualified resident for its taxable year 1991 because for that year it meets the requirements of § 1.884–5 (b) and (c), relating, respectively, to stock ownership and base erosion. For 1991 A does not meet the requirements of § 1.884–5 (d), (e), or (f) for qualified residence. A is not a qualified resident of the United Kingdom for any taxable year prior to 1990 but is a qualified resident for its taxable years 1990 and 1992.

(ii) Because A is a qualified resident for the 3-year period (1990, 1991, and 1992) that includes the taxable year of the dividend equivalent amount (1991), A satisfies the 36-month test of this paragraph (g)(2) and no branch profits tax is imposed on the total $300 dividend equivalent amount. However, since A was not a qualified resident for any taxable year prior to 1990 and therefore cannot establish that it has satisfied the 36-month test until the taxable year following the year of the dividend equivalent amount, A must pay the branch profits tax for its taxable year 1991 with respect to the portion of the dividend equivalent amount attributable to accumulated ECEP relating to years prior to 1990 without regard to paragraph (g)(1) of this section. A may file for a refund of the branch profits tax paid with respect to its 1991 taxable year at any time after it establishes that it is a qualified resident for its 1992 taxable year.

(3) *Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.* The branch profits tax shall not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect, except to the extent the treaty is modified on or after January 1, 1987, to expressly provide for the imposition of the branch profits tax:

Aruba	Jamaica
Austria	Japan
Belgium	Korea
People's Republic of China	Luxembourg
Cyprus	Malta
Denmark	Morocco
Egypt	Netherlands
Finland	Netherlands Antilles
Germany	Norway
Greece	Pakistan
Hungary	Philippines
Iceland	Sweden
Ireland	Switzerland
Italy	United Kingdom

(4) *Modifications with respect to other income tax treaties*—(i) *Limitation on rate of tax*—(A) *General rule.* If, under paragraphs (g) (1) and (2) of this section, a corporation qualifies for a reduction in the amount of the branch profits tax and paragraph (g)(3) of this section does not apply, the rate of tax shall be the rate of tax on branch profits specified in the treaty between the United States and the corporation's country of residence or, if no rate of tax on branch profits is specified, the rate of tax that would apply under such treaty to dividends paid to the foreign corporation by a wholly-owned domestic corporation.

(B) *Certain treaties in effect on January 1, 1987.* The branch profits tax shall generally be imposed at the following rates on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, for as long as the relevant provisions of those income tax treaties remain in effect and are not modified or superseded by subsequent agreement:

Australia (15%)	Poland (5%)
Barbados (5%)	Romania (10%)
Canada (10%)	South Africa (30%)
France (5%)	Trinidad & Tobago (10%)
New Zealand (5%)	U.S.S.R. (30%)

However, for special rates imposed on corporations resident in France and Trinidad & Tobago that have certain amounts of dividend and interest income, see the dividend articles of the income tax treaties with those countries.

(ii) *Limitations other than rate of tax.* If, under paragraphs (g) (1) and (2) of this section, a foreign corporation qualifies for a reduction in the amount of branch profits tax and paragraph (g) (3) of this section does not apply, then—

(A) The foreign corporation shall be entitled to the benefit of any limitations on imposition of a tax on branch profits (in addition to any limitations on the rate of tax) contained in the treaty; and

(B) No branch profits tax shall be imposed with respect to a dividend equivalent amount out of ECEP or accumulated ECEP of the foreign corporation unless the ECEP or accumulated ECEP is attributable to a permanent establishment in the United States or, if not otherwise prohibited under the treaty, to gain from the disposition of a U.S. real property interest described in section 897(c)(1)(A)(i), except to the extent the treaty specifically permits the imposition of the branch profits tax on such earnings and profits.

No article in such treaty shall be construed to provide any limitations on imposition of the branch profits tax other than as provided in this paragraph (g)(4).

(iii) *Computation of the dividend equivalent amount if a foreign corporation has both ECEP attributable to a permanent establishment and not attributable to a permanent establishment.* To determine the dividend equivalent amount of a foreign corporation out of ECEP that is attributable to a permanent establishment, the foreign corporation may only take into account its U.S. assets, U.S. liabilities, U.S. net equity and ECEP attributable to its permanent establishment. Thus, a foreign corporation may not reduce the amount of its ECEP attributable to its permanent establishment by reinvesting all or a portion of that amount in U.S. assets not attributable to the permanent establishment.

(iv) *Limitations under the Canadian treaty.* The limitations on the imposition of the branch profits tax under the Canadian treaty include, but are not limited to, those described in paragraphs (g)(4)(iv) (A) and (B).

(A) *Effect of deficits in earnings and profits.* In the case of a foreign corporation that is a qualified resident of Canada, the dividend equivalent amount for any taxable year shall not exceed the foreign corporation's accumulated ECEP as of the beginning of the taxable year plus the corporation's ECEP for the taxable year. Thus, for example, if a foreign corporation that is a qualified resident of Canada has a deficit in accumulated ECEP of $200 as of the beginning of the taxable year and ECEP of $100 for the taxable year, it will have no dividend equivalent amount for the taxable year because it would have a cumulative deficit in ECEP of $100 as of the close of the taxable year. For purposes of this paragraph (g)(4)(iii)(A), any net deficit in accumulated earnings and profits attributable to taxable years beginning before January 1, 1987, shall be includible in determining accumulated ECEP.

(B) *One-time exemption of Canadian $500,000—(1) General rule.* In the case of a foreign corporation that is a qualified resident of Canada, the branch profits tax shall be imposed only with respect to that portion of the dividend equivalent amount for the taxable year that, when translated into Canadian dollars and added to the dividend equivalent amounts for preceding taxable years translated into Canadian dollars, exceeds Canadian $500,000. The value of the dividend equivalent amount in Canadian currency shall be determined by translating the ECEP for each taxable year that is includible in the dividend equivalent amount (as determined in U.S. dollars under the currency translation method used in determining the foreign corporation's taxable income for U.S. tax purposes) by the weighted average exchange rate for the taxable year (determined under the rules of section 989(b)(3)) during which the earnings and profits were derived.

(2) *Reduction in amount of exemption in the case of related corporations.* The amount of a foreign corporation's exemption under this paragraph (g)(4)(iii)(B) shall be reduced by the amount of any exemption that reduced the dividend equivalent amount of an associated foreign corporation with respect to the same or a similar business. For purposes of this paragraph (g)(4)(iii)(B), a foreign corporation is an associated foreign corporation if it is related to the foreign corporation for purposes of sectional 267(b) or it and the foreign corporation are stapled entities (within the meaning of section 269B(c)(2)) or are effectively stapled entities. A business is the same as or similar to another business if it involves the sale, lease, or manufacture of the same or a similar type of property or the provision of the same or a similar type of services. A U.S. real property interest described in section 897(c)(1)(A)(i) shall be treated as a business and all such U.S. real property interests shall be treated as businesses that are the same or similar.

(3) *Coordination with second-tier withholding tax.* The value of the dividend equivalent amount that is exempt from the branch profits tax by reason of paragraph (g)(4)(iii)(B)(1) of this section shall not be subject to tax under section 871(a) or 881, or to withholding under section 1441 or 1442, when distributed by the foreign corporation.

(5) *Benefits under treaties other than income tax treaties.* A treaty that is not an income tax treaty does not exempt a foreign corporation from the branch profits tax or reduce the amount of the tax.

(h) *Stapled entities.* Any foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 and the regulations thereunder, notwithstanding section 269B or the regulations thereunder. Dividends paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871(a) or 881(a), and to withholding under section 1441 or 1442, as applicable, to the extent paid out of earnings and profits that are not subject to tax under section 884(a). Dividends paid by such foreign corporation out of earnings and profits subject to tax under section 884(a) shall be exempt from the tax imposed by sections 871(a) and 881(a) and shall not be subject to withholding under section 1441 or 1442. Whether dividends are paid out of earnings and profits that are subject to tax under section 884(a) shall be determined under section 884(e)(3)(A) and the regulations thereunder. The limitation on the application of treaty benefits in section 884(e)(3)(B) (relating to qualified residents) shall apply to a foreign corporation described in this paragraph (h).

(i) *Effective date—(1) General rule.* This section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992 and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of § 1.884–1T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992), but only if the foreign corporation also makes an election under § 1.884–4(e) to apply § 1.884-4 in lieu of § 1.884–1T (as contained in the CFR edition revised as of April 1, 1992) for that taxable year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years. However, paragraph (f)(2)(vi) of this section (relating to certain interest income of Possessions banks) shall not apply for taxable years beginning before January 1, 1990.

(2) *Election to reduce liabilities.* A foreign corporation may make an election to reduce its liabilities under paragraph (e)(3) of this section with respect to a taxable year for which an election under paragraph (i)(1) of this section is in effect by filing an amended return for the taxable year and recomputing its interest deduction and any other item affected by the election on an amended Form 1120F to take into account the reduction in liabilities for such year.

(3) *Separate election for installment obligations.* A foreign corporation may make a separate election to apply paragraphs (d)(2)(iii) and (d)(6)(ii) of this section (relating to installment obligations treated as U.S. assets) to any prior taxable year without making an election under paragraph (i)(1) of this section, provided the statute of limitations for assessment of a deficiency has not expired for that taxable year and each succeeding taxable year. Once an election under this paragraph (i)(3) has been made, it shall apply to all subsequent taxable years.

(j) *Transition rules*—(1) *General rule.* Except as provided in paragraph (j)(2) of this section, in order to compute its dividend equivalent amount in the first taxable year to which this section applies (whether or not such year begins before October 13, 1992, a foreign corporation must recompute its U.S. net equity as of close of the preceding taxable year using the rules of this section and use such recomputed amount, rather than the amount computed under § 1.884–1T (as contained in the CFR edition revised as of April 1, 1992), to determine the amount of any increase or decrease in the U.S. net equity as of the close of that taxable year.

(2) *Installment obligations*—(i) *Interest election.* In recomputing its U.S. net equity as of the close of the preceding taxable year, a foreign corporation that holds an installment obligation treated as a U.S. asset under § 1.884–1T(d)(7) (as contained in the CFR edition revised as of April 1, 1992) as of such date may apply the rules of paragraph (d)(2)(iii) of this section without regard to the rule in that paragraph that requires interest or original issue discount on the obligation to be treated as ECI in order for such obligation to be treated as a U.S. asset.

(ii) *1987 sales by certain foreign corporations.* The E&P basis of an installment obligation arising in connection with a sale of property by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987, shall equal the E&P basis of the property sold as of the determination date reduced by payments received with respect to the obligation that do not represent gain for earnings and profits purposes, interest or original issue discount.

Par. 4. Section 1.884–2T is amended as follows:

1. In paragraph (a)(2)(i), the first sentence of the concluding text, the reference to "§ 1.884–1T" is removed and the language "§ 1.884–1" is added in its place.

2. Paragraph (a)(2)(ii) is amended by adding three new sentences following the last sentence in that paragraph, which read as set forth below.

3. Paragraph (b) is revised to read as set forth below.

4. In paragraph (c)(2) introductory text, the reference to "§ 1.884—1T" is removed and the language "§ 1.884–1" is added in its place.

5. Paragraph (c)(2)(iii) is amended by adding three new sentences following the last sentence in that paragraph, which read as set forth below.

6. In paragraph (c)(3), the reference to "§ 1.884–1T (b)(3)(ii)" is removed and the language "§ 1.884–1(b)(3)(ii)" is added in its place.

7. In paragraph (c)(4)(iii), the reference to "§ 1.884–1T(h)(1) and (2)(i)" is removed and the language "§ 1.884–1(g)(1) and (2)(i)" is added in its place.

8. In paragraph (c)(5), the reference to "§ 1.884–1T" is removed and the language "§ 1.884–1" is added in its place.

9. In paragraph (c)(6), the concluding text, the reference to "§ 1.884–1T" is removed and the language "§ 1.884–1" is added in its place.

10. In paragraph (d)(3) introduction text, the reference to "§ 1.884–1T" is removed and the language "§ 1.884–1" is added in its place.

11. In paragraph (d)(3)(ii) the reference to "§ 1.884–1T(b)(3)(ii)" is removed and the language "§ 1.884–1(b)(3)(ii)" is added in its place.

12. In paragraph (d)(6), paragraph (iv) of the *Example*, the reference to "§ 1.884–1T" is removed and the language "§ 1.884–1" is added in its place.

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) * * *

(2) * * *

(ii) * * *. Until such time as forms are published, a foreign corporation may file Form 872 to extend the period for assessment of the branch profits tax for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to September 11, 1992, a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by attaching a statement to its income tax return that the foreign corporation agrees to extend the period for assessment of the branch profits tax for the year of complete termination in accordance with the terms of this paragraph (a)(2)(ii). A properly executed Form 872 or a statement authorized under the preceding sentence shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d).

(b) Election to remain engaged in a U.S. trade or business—(1) *General rule.* A foreign corporation that would be considered to have completely terminated all of its U.S. trade or business for the taxable year under the provisions of paragraph (a)(2)(i) of this section, but for the provisions of paragraph (a)(2)(i)(B) of this section that prohibit reinvestment within a three-year period, may make an election under this paragraph (b) for the taxable year in which it completely terminates all its U.S. trade or business (as determined without regard to paragraph (a)(2)(i)(B) of this section) and, if it so chooses, for the following taxable year (but not for any succeeding taxable year). The election under this paragraph (b) is an election by the foreign corporation to designate an amount of marketable securities as U.S. assets for purposes of § 1.884–1. The marketable securities identified pursuant to the election under paragraph (b)(3) of this section shall be treated as being U.S. assets in an amount equal, in the aggregate, to the lesser of the adjusted basis of the U.S. assets that ceased to be U.S. assets during the taxable year in which the election is made (determined on the date or dates the U.S. assets ceased to be U.S. assets) or the adjusted basis of the marketable securities as of the end of the taxable year. The securities must be held from the date that they are identified until the end of the taxable year for which the election is made, or if disposed of during the taxable year, must be replaced on the date of disposition with other marketable securities that are acquired on or before that date and that have a fair market value as of the date of substitution is not less than their adjusted basis.

(2) *Marketable security.* For purposes of this paragraph (b), the term "marketable security" means a security (including stock) that is part of an issue

any portion of which is regularly traded on an established securities market (within the meaning of § 1.884–5(d)(2) and (4)) and a deposit described in section 871(i)(3) (A) or (B).

(3) *Identification requirements.* In order to qualify for this Section—

(i) The marketable securities must be identified on the books and records of the U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets; and

(ii) On the date a marketable security is identified, its adjusted basis must not exceed its fair market value.

(4) *Treatment of income from deemed U.S. assets.* The income or gain from the marketable securities (or replacement securities) subject to an election under this paragraph (b) that arises in a taxable year for which an election is made shall be treated as ECI (other than for purposes of section 864(c)(7)), and losses from the disposition of such marketable securities shall be allocated entirely to income that is ECI. In addition, all such securities shall be treated as if they had been sold for their fair market value on the earlier of the last business day of a taxable year for which an election is in effect or the day immediately prior to the date of substitution by the foreign corporation of a U.S. asset for the marketable security, and any gain (but not loss) and accrued interest on the securities shall also be treated as ECI. The adjusted basis of such property shall be increased by the amount of any gain recognized by reason of this paragraph (b).

(5) *Method of election.* A foreign corporation may make an election under this paragraph (b) by attaching to its income tax return for the taxable year a statement—

(i) Identifying the marketable securities treated as U.S. assets under this paragraph (b);

(ii) Setting forth the S&P bases of such securities; and

(iii) Agreeing to treat any income, gain or loss as provided in paragraph (b)(4) of this section.

Such statement must be filed on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year. A foreign corporation shall not be permitted to make an election under this paragraph (b) more than once.

(6) *Effective date.* This paragraph (b) is effective for taxable years beginning on or after October 13, 1992. However, if a foreign corporation has made a valid election under § 1.884–1(i) to apply that section with respect to a taxable year beginning before October 13, 1992 and after December 31 1966, this paragraph (b) shall be effective beginning with such taxable year.

(c) * * *

(2) * * *

(iii) * * * Until such time as forms are published, a foreign corporation may file Form 872 to extend the period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs. With respect to a section 381(a) transaction occurring in a taxable year ending prior to September 11, 1992, a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by attaching a statement to its income tax return that the foreign corporation agrees to extend the period for assessment of the branch profits tax in accordance with the terms of this paragraph (c)(2)(iii). A properly executed Form 872 or a statement authorized under the preceding sentence shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d).

* * * * *

§§ 1.884–4 and 1.884–5 [Added]

Par. 5. Sections 1.884–4 and 1.884–5 are added to read as follows:

§ 1.884–4 Branch-level interest tax.

(a) *General rule*—(1) *Tax on branch interest.* In the case of a foreign corporation that, during the taxable year, is engaged in trade or business in the United States or has gross income that is ECI (as defined in § 1.884–1(d)(1)(iii)), any interest paid by such trade or business (hereinafter "branch interest," as defined in paragraph (b) of this section) shall, for purposes of subtitle A (Income Taxes), be treated as if it were paid by a domestic corporation (other than a corporation described in section 861(c)(1), relating to a domestic corporation that meets the 80 percent foreign business requirement). Thus, for example, whether such interest is treated as income from sources within the United States by the person who receives the interest shall be determined in the same manner as if such interest were paid by a domestic corporation (other than a corporation described in section 861(c)(1)). Such interest shall be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, in the same manner as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) if received by a foreign person and not effectively connected with the conduct by the foreign person of a trade or business in the United States, unless the interest, if paid by a domestic corporation, would be exempt under section 871(h) or 881(c) (relating to exemption for certain portfolio interest received by a foreign person), section 871(i) or 881(d) (relating, in part, to exemption for certain bank deposit interest received by a foreign person), or another provision of the Code. Such interest shall also be treated as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) for purposes of sections 864(c), 871(b) and 882(a) (relating to income that is effectively connected with the conduct of a trade or business within the United States) and section 904 (relating to the limitation on the foreign tax credit). For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under § 1.882–5(b)(1) (referring to assets that generate, or may generate, effectively connected income) for purposes of determining the amount of the foreign corporation's interest expense apportioned to ECI and the interest apportioned by reference to the value of such asset provides in any taxable year a tax benefit for U.S. tax purposes. See paragraph (b)(8) of this section for the effect of income tax treaties on branch interest.

(2) *Tax on excess interest*—(i) Definition of excess interest. For purposes of this section, the term "excess interest" means—

(A) The amount of interest apportioned to ECI of the foreign corporation under § 1.882–5 for the taxable year, after application of § 1.884–1(e)(3); minus

(B) The foreign corporation's branch interest (as defined in paragraph (b) of this section) for the taxable year, but not including interest accruing in a taxable year beginning before January 1, 1987; minus

(C) The amount of interest determined under paragraph (c)(2) of this section (relating to interest paid by a partnership).

(ii) *Imposition of tax.* A foreign corporation shall be liable for tax on excess interest under section 881(a) in the same manner as if such excess interest were interest paid to the foreign corporation by a wholly-owned domestic corporation (other than a corporation described in section 861(c)(1)) on the last day of the foreign corporation's taxable year. Excess interest shall be exempt from tax under section 881(a) only as provided in

paragraph (a)(2)(iii) of this section (relating to treatment of certain excess interest of banks as interest on deposits) or paragraph (c)(3) of this section (relating to income tax treaties).

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits.* A portion of the excess interest of a foreign corporation described in paragraph (b)(2) of this section (relating to foreign banks) shall be treated as interest on deposits (as described in section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest-bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest-bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

(iv) *Reporting and payment of tax on excess interest.* The amount of tax due under section 884(f) and this section with respect to excess interest of a foreign corporation shall be reported on the foreign corporation's income tax return for the taxable year in which the excess interest is treated as paid to the foreign corporation under section 884(f)(1)(B) and paragraph(a)(2) of this section, and shall not be subject to withholding under section 1441 or 1442. The tax shall be due and payable as provided in section 6151 and such other sections of Subtitle F of the Internal Revenue Code as apply, and estimated tax payments shall be due with respect to a foreign corporation's liability for the tax on excess interest as provided in section 6655.

(3) *Original issue discount.* For purposes of this section, the term "interest" includes original issue discount, as defined in section 1273(a)(1).

(4) *Examples.* The application of this paragraph (a) is illustrated by the following examples.

Example 1. Taxation of branch interest and excess interest. Foreign corporation A, a calendar year taxpayer that is not a corporation described in paragraph (b)(2) of this section (relating to banks), has $120 of interest apportioned to ECI under § 1.882-5 for 1993. A's branch interest (as defined in paragraph (b) of this section) for 1993 is as follows: $55 of portfolio interest (as defined in section 871(h)(2)) to B, a nonresident alien; $25 of interest to foreign corporation C, which owns 15 percent of the combined voting power of A's stock, with respect to bonds issued by A; and $20 to D, a domestic corporation. B and C are not engaged in the conduct of a trade or business in the United States. A, B and C are residents of countries with which the United States does not have an income tax treaty. The interest payments made to B and D are not subject to tax under section 871(a) or 881 and are not subject to withholding under section 1441 or 1442. The payment to C, which does not qualify as portfolio interest because C owns at least 10 percent of the combined voting power of A's stock, is subject to withholding of $7.50 ($25 × 30%). In addition, because A's interest apportioned to ECI under § 1.882-5 ($120) exceeds its branch interest ($100), A has excess interest of $20, which is subject to a tax of $6 ($20 × 30%) under section 881. The tax on A's excess interest must be reported on A's income tax return for 1993.

Example 2. Taxation of excess interest of a bank. Foreign corporation A, a calendar year taxpayer, is a corporation described in paragraph (b)(2) of this section (relating to banks) and is a resident of a country with which the United States does not have an income tax treaty. A has excess interest of $100 for 1993. At the close of 1993, A has $10,000 of interest-bearing liabilities (including liabilities that give rise to branch interest), of which $8,700 are interest-bearing deposits. For purposes of computing the tax on A's excess interest, $87 of the excess interest ($100 excess interest x ($8,700 interest-bearing deposits/$10,000 interest-bearing liabilities)) is treated as interest on deposits. Thus, $87 of A's excess interest is exempt from tax under section 881(a) and the remaining $13 of excess interest is subject to a tax of $3.90 ($13 × 30%) under section 881(a).

(b) *Branch interest*—(1) *Definition of branch interest of a foreign corporation that is not a bank.* For purposes of this section, the term "branch interest" means interest paid by a foreign corporation (other than a corporation described in paragraph (b)(2) of this section) with respect to a liability—

(i) Shown on the books of a U.S. trade or business of the foreign corporation for purposes of computing its interest apportioned to ECI under the branch book/dollar pool method of § 1.882-5(b)(3)(i) or the separate currency pool method of § 1.882-5(b)(3)(ii);

(ii) Secured (during at least half the days during the portion of the taxable year in which the interest accrues) predominantly by a U.S. asset (as defined in § 1.884-1(d)) of the foreign corporation unless such liability is secured by substantially all the property of the foreign corporation;

(iii) Taken into account by an insurance company described in section 842(a) on an annual statement approved by the National Association of Insurance Commissioners that is furnished to an insurance regulatory authority of a State or the District of Columbia;

(iv) Giving rise to interest for which no deduction is allowed and either—

(A) The liability is incurred or continued to purchase a U.S. asset (as defined in § 1.884-1(d)); or

(B) The basis of a U.S. asset is increased by the amount of the interest for which no deduction is allowed; or

(v) Specifically identified (as provided in paragraph(b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made (or deemed made under paragraph (c)(1) of this section) with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of interest attributable to specifically identified liabilities does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(v);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or in paragraph (b)(1) (i) through (iv) of this section.

A foreign corporation may identify a liability under paragraph (b)(1)(v) of this section whether or not the foreign corporation is engaged in the conduct of a trade or business in the United States. See paragraph (b)(5) of this section for special rules relating to branch interest of a foreign corporation whose U.S. assets equal 80 percent or more of its worldwide assets. See paragraph (b)(6) of this section for a limitation on the amount of branch interest in certain situations in which branch interest exceeds the amount of interest apportioned to ECI under § 1.882-5 and paragraph (b)(7) of this section for the

treatment of interest that is paid and accrued in different taxable years.

(2) *Definition of branch interest of a bank.* In the case of a foreign corporation that maintains and operates a Federal branch, Federal agency, State branch or State agency (as these terms are defined in section 1(b) of the International Banking Act of 1978) (hereinafter "U.S. branch or agency"), the term "branch interest" means, for purposes of this section—

(i) Interest paid by the foreign corporation with respect to a liability described in paragraph (b)(1) (ii) or (iv) of this section (concerning liabilities related to U.S. assets);

(ii) Interest paid with respect to a liability that is treated as a liability of a U.S. branch or agency of the foreign corporation for purposes of regulatory requirements of the Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, or an equivalent bank regulatory authority of a State or the District of Columbia (including a deposit with an international banking facility (as defined in 12 CFR 204.8(a)(1)) of the foreign corporation that is treated as a liability of such U.S. branch or agency for purposes of such regulatory requirements); and

(iii) Interest paid with respect to a liability properly reflected on the books of a foreign branch, agency, or office of the foreign corporation if personnel of the U.S. branch or agency perform substantially all of the material activities required to incur the liability. However, with respect to the interest described in paragraph (b)(2)(iii) of this section, if less than 80 percent of the gross income of such foreign branch, agency, or office for the taxable year is ECI, the total amount of interest paid or accrued with respect to liabilities of the branch, agency, or office that is treated as branch interest of the foreign corporation for the taxable year shall not exceed the amount of gross income of the branch, agency, or office that is ECI for the taxable year.

(3) *Requirements relating to specifically identified liabilities*—(i) *Method of identification.* A liability described in paragraph (b)(1)(v) of this section is identified as a liability of a U.S. trade or business only if the liability is shown on the records of the U.S. trade or business, or is identified as a liability of the U.S. trade or business on other records of the foreign corporation or on a schedule established for the purpose of identifying the liabilities of the U.S. trade or business. Each such liability must be identified with sufficient specificity so that the amount of branch interest attributable to the liability, and the name and address of the recipient, can be readily identified from such records or schedule. However, with respect to liabilities that give rise to portfolio interest (as defined in sections 871(h) and 881(c)) or that are payable 183 days or less from the date of original issue, and form part of a larger debt issue, such liabilities may be identified by reference to the issue and maturity date, principal amount and interest payable with respect to the entire debt issue. Records or schedules described in this paragraph that identify liabilities that give rise to branch interest must be maintained in the United States by the foreign corporation or an agent of the foreign corporation for the entire period commencing with the due date (including extensions) of the income tax return for the taxable year to which the records or schedules relate and ending with the expiration of the period of limitations for assessment of tax for such taxable year.

(ii) *Notification to recipient.* Interest with respect to a liability described in paragraph (b)(1)(v) of this section shall not be treated as branch interest unless the foreign corporation paying the interest either—

(A) Makes a return, pursuant to section 6049, with respect to the interest payment; or

(B) Sends a notice to the person who receives such interest in a confirmation of the transaction, a statement of account, or a separate notice, within two months of the end of the calendar year in which the interest was paid, stating that the interest paid with respect to the liability is from sources within the United States.

(iii) *Liabilities that do not give rise to branch interest under paragraph (b)(1)(v) of this section.* A liability is described in this paragraph (b)(3)(iii) (and interest with respect to the liability may not be treated as branch interest of a foreign corporation by reason of paragraph (b)(1)(v) of this section) if—

(A) The liability is directly incurred in the ordinary course of the profit-making activities of a trade or business of the foreign corporation conducted outside the United States, as, for example, an account or note payable arising from the purchase of inventory or receipt of services by such trade or business; or

(B) The liability is secured (during more than half the days during the portion of the taxable year in which the interest accrues) predominantly by property that is not a U.S. asset (as defined in § 1.884–1(d)) unless such liability is secured by substantially all the property of the foreign corporation.

(4) *Interbranch interest disregarded.* Interest with respect to liabilities to another office or branch of the same foreign corporation shall be disregarded for purposes of computing branch interest.

(5) *Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets—(i) General rule.* If a foreign corporation would have excess interest before application of this paragraph (b) (5) and the amount of the foreign corporation's U.S. assets as of the close of the taxable year equals or exceeds 80 percent of all money and the aggregate E&P basis of all property of the foreign corporation on such date, then all interest paid and accrued by the foreign corporation during the taxable year that was not treated as branch interest before application of this paragraph (b)(5) and that is not paid with respect to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by non-U.S. assets) shall be treated as branch interests. However, if application of the preceding sentence would cause the amount of the foreign corporation's branch interest to exceed the amount permitted by paragraph (b)(6)(i) of this section (relating to branch interest in excess of a foreign corporation's interest apportioned to ECI under § 1.882–5) the amount of branch interest arising by reason of this paragraph shall be reduced as provided in paragraphs (b)(6) (ii) and (iii) of this section, as applicable.

(ii) *Example.* The application of this paragraph (b)(5) is illustrated by the following example.

Example. Application of 80 percent test. Foreign corporation A, a calendar year taxpayer, has $90 of interest apportioned to ECI under § 1.882–5 for 1993. Before application of this paragraph (b)(5), A has $40 of branch interest in 1993. A pays $60 of other interest during 1993, none of which is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business and liabilities predominantly secured by foreign assets). As of the close of 1993, A has an amount of U.S. assets that exceeds 80 percent of the money and E&P bases of all A's property. Before application of this paragraph (b)(5), A would have $50 of excess interest (i.e., the $90 interest apportioned to its ECI under § 1.882–5 less $40 of branch interest). Under this paragraph (b)(5), the $60 of additional interest paid by A is also treated as branch interest. However, to the extent that treating the $60 of additional interest as branch interest would create an amount of branch interest that would exceed the amount of branch interest permitted under paragraph (b)(6) of this section (relating to branch interest that

exceeds a foreign corporation's interest apportioned to ECI under § 1.882–5) the amount of the additional branch interest is reduced under paragraph (b)(6)(iii) of this section, which generally allows a foreign corporation to specify certain liabilities that do not give rise to branch interest or paragraph (b) (6) (ii) of this section, which generally specifies liabilities that do not give rise to branch interest beginning with the most-recently incurred liability.

(8) *Special rule where branch interest exceeds interest apportioned to ECI of a foreign corporation*—(i) *General rule.* If the amount of branch interest that is both paid and accrued by a foreign corporation during the taxable year (including interest that the foreign corporation elects under paragraph (c)(1) of this section to treat as paid during the taxable year) exceeds the amount of interest apportioned to ECI of a foreign corporation under § 1.882–5 for the taxable year, then the amount of the foreign corporation's branch interest shall be reduced by the amount of such excess as provided in paragraphs (b)(6)(ii) and (iii) of this section, as applicable. The rules of paragraphs (b)(8) (ii) and (iii) of this section shall also apply where the amount of branch interest with respect to liabilities identified under paragraph (b)(1)(v) of this section exceeds the maximum amount that may be treated as branch interest under that paragraph. This paragraph (b)(6) shall apply whether or not a reduction in the amount of branch interest occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, such as a reduction in the amount of interest apportioned to ECI of the foreign corporation under § 1.882–5.

(ii) *Reduction of branch interest beginning with most-recently incurred liability.* Except as provided in paragraph (b)(6)(iii) of this section (relating to an election to specify liabilities that do not give rise to branch interest), the amount of the excess in paragraph (b)(6)(i) of this section shall first reduce branch interest attributable to liabilities described in paragraph (b)(1)(v) of this section (relating to liabilities identified as giving rise to branch interest) and then, if such excess has not been reduced to zero, branch interest attributable to the group of liabilities described in paragraphs (b)(1)(i) through (iv) of this section. The reduction of branch interest attributable to each group of liabilities (i.e., liabilities described in paragraph (b)(1)(v) of this section and liabilities described in paragraphs (b)(1)(i) through (iv) of this section) shall be made beginning with interest attributable to the latest-incurred liability and continuing, in reverse chronological order, with branch interest attributable to the next-latest incurred liability. The branch interest attributable to a liability must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-latest incurred liability. Where only a portion of the branch interest attributable to a liability is reduced by reason of this paragraph (b)(6)(ii), the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next latest payment until the amount of branch interest has been reduced by the amount specified in paragraph (b)(6)(i) of this section. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(ii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871(a) or 881(a).

(iii) *Election to specify liabilities that do not give rise to branch interest.* For purposes of reducing the amount of branch interest under paragraph (b)(6)(i) of this section, a foreign corporation may, instead of using the method described in paragraph (b)(6)(ii) of this section, elect for any taxable year to specify which liabilities will not be treated as giving rise to branch interest or will be treated as giving rise only in part to branch interest. Branch interest paid during the taxable year with respect to a liability specified under this paragraph (b)(6)(iii) must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-specified liability. If all interest payments with respect to a specified liability, when added to all interest payments with respect to other liabilities specified under this paragraph (b)(6)(iii), would exceed the amount of the reduction under paragraph (b)(6)(i) of this section, then only a portion of the branch interest attributable to that specified liability shall be reduced under this paragraph (b)(6)(iii), and the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next-latest payment until the amount of branch interest has been reduced by the amount of the reduction under paragraph (b)(6)(i) of this section. A foreign corporation that elects to have this paragraph (b)(6)(iii) apply shall note on its books and records maintained in the United States that the liability is not to be treated as giving rise to branch interest, or is to be treated as giving rise to branch interest only in part. Such notation must be made after the close of the taxable year in which the foreign corporation pays the interest and prior to the due date (with extensions) of the foreign corporation's income tax return for the taxable year. However, if the excess interest in paragraph (b)(8)(i) of this section occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, the election and notation may be made at the time of examination. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(iii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871 (a) or 881 (a).

(iv) *Examples.* The application of this paragraph (b)(6) is illustrated by the following examples.

Example 1. Branch interest exceeds interest apportioned to ECI with no election in effect. Foreign corporation A, a calendar year, accrual method taxpayer, has interest expense apportioned to ECI under § 1.882–5 of $230 for 1993. A's branch interest for 1993 is as follows:

(i) $130 paid to B, a domestic corporation, with respect to a note issued on March 10, 1993, and secured by real property located in the United States;

(ii) $60 paid to C, an individual resident of country X who is entitled to a 10 percent rate of withholding on interest payments under the income tax treaty between the United States and X, with respect to a note issued on October 15, 1992, which gives rise to interest subject to tax under section 871(a);

(iii) $80 paid to D, an individual resident of country Y who is entitled to a 15 percent rate of withholding on interest payments under the income tax treaty between the United States and Y, with respect to a note issued on February 15, 1993, which gives rise to interest subject to tax under section 871(a); and

(iv) $70 of portfolio interest (as defined in section 871(h) (2)) paid to E, a nonresident alien, with respect to a bond issued on March 1, 1993.

A's branch interest accrues during 1993 for purposes of calculating the amount of A's interest apportioned to ECI under § 1.882–5. A has identified under paragraph (b)(1)(v) of this section the liabilities described in paragraphs (ii), (iii) and (iv) of this example. A has not made an election under paragraph (b)(6)(iii) of this section to specify liabilities that do not give rise to branch interest. The amount of A's branch interest in 1993 is limited under paragraph (b)(6)(i) of this section to $230, the amount of the interest apportioned to A's ECI for 1993. The amount of A's branch interest must thus be reduced by $110 ($340–$230) under paragraph (b)(6)(ii) of this section. The reduction is first made with respect to interest attributable to liabilities described in paragraph (b)(1)(v) of this section (i.e., liabilities identified as giving rise to branch interest) and, within the group of liabilities described in paragraph (b)(1)(v) of this section, is first made with respect to the latest-incurred liability. Thus, the $70 of interest paid to E with respect to the bond issued on March 1, 1993, and $40 of the $80 of interest paid to D with respect to the note issued on February 15, 1993, are not treated as branch interest. The interest paid to D is

no longer subject to tax under section 871(a), and D may claim a refund of amounts withheld with respect to the interest payments. There is no change in the tax consequences to E because the interest received by E was portfolio interest and was not subject to tax when it was treated as branch interest.

Example 2. Effect of election to specify liabilities. Assume the same facts as in *Example 1* except that A makes an election under paragraph (b)(6)(iii) of this section to specify which liabilities are not to be treated as giving rise to branch interest. A specifies the liability to D, who would be taxable at a rate of 15 percent on interest paid with respect to the liability, as a liability that does not give rise to branch interest, and D is therefore not subject to tax under section 871 (a) and is entitled to a refund of amounts withheld with respect to the interest payments. A also specifies the liability to C as a liability that gives rise to branch interest only in part. As a result, $30 of the $60 of interest paid to C is not treated as branch interest, and C is entitled to a refund with respect to the $30 of interest that is not treated as branch interest.

(7) *Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.* If a foreign corporation accrues an interest expense in a taxable year earlier than the taxable year of payment and elects under paragraph (c)(1) of this section to compute its excess interest as if the interest expense were branch interest paid in the year of accrual, the interest expense shall be treated as branch interest that is paid at the close of such year (and not in the actual year of payment) for all purposes of this section. Such interest shall thus be subject to tax under section 871(a) or 881(a) and withholding under section 1441 or section 1442, as if paid on the last day of the taxable year of accrual. Interest that is treated under paragraph (c)(1) of this section as paid in a later year for purposes of computing excess interest shall be treated as paid only in the actual year of payment for all purposes of this section other than paragraphs (a)(2) and (c)(1) of this section (relating to excess interest).

(8) *Effect of treaties*—(i) *Payor's treaty.* In the case of a foreign corporation's branch interest, relief shall be available under an article of an income tax treaty between the United States and the foreign corporation's country of residence relating to interest paid by the foreign corporation only if, for the taxable year in which the branch interest is paid (or if the branch interest is treated as paid in an earlier taxable year under paragraph (b)(7) of this section, for the earlier taxable year)—

(A) The foreign corporation meets the requirements of the limitation on benefits provision, if any, in the treaty, and either—

(*1*) The corporation is a qualified resident (as defined in § 1.884–5(a)) of that foreign country in such year; or

(*2*) The corporation meets the requirements of paragraph (b)(8)(iii) of this section in such year; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Recipient's treaty.* A foreign person (other than a foreign corporation) that derives branch interest is entitled to claim benefits under provisions of an income tax treaty between the United States and its country of residence relating to interest derived by the foreign person. A foreign corporation may claim such benefits if it meets, with respect to the branch interest, the requirements of the limitation on benefits provision, if any, in the treaty and—

(A) The foreign corporation meets the requirements of paragraphs (b)(8)(i)(A) or (B) of this section; and

(B) In the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation with a maturity not exceeding one year, each foreign corporation that beneficially owned the obligation prior to maturity was a qualified resident (for the period specified in paragraph (b)(8)(i) of this section) of a foreign country with which the United States has an income tax treaty or met the requirements of the limitation on benefits provision in a treaty with respect to the interest payment and such provision entered into force after December 31, 1986.

(iii) *Presumption that a foreign corporation continues to be a qualified resident.* For purposes of this paragraph (b)(8), a foreign corporation that was a qualified resident for the prior taxable year because it fulfills the requirements of § 1.884–5 shall be considered a qualified resident with respect to branch interest that is paid or received during the current taxable year if—

(A) In the case of a foreign corporation that met the stock ownership and base erosion tests in § 1.884–5(b) and (c) for the preceding taxable year, the foreign corporation does not know, or have reason to know, that either 50 percent of its stock (by value) is not beneficially owned (or treated as beneficially owned by reason of § 1.884–5(b)(2)) by qualifying shareholders at any time during the portion of the taxable year that ends with the date on which the interest is paid, or that the base erosion test is not met during the portion of the taxable year that ends with the date on which the interest is paid;

(B) In the case of a foreign corporation that met the requirements of § 1.884–5(d) (relating to publicly-traded corporations) for the preceding taxable year, the foreign corporation is listed on an established securities exchange in the United States or its country of residence at all times during the portion of the taxable year that ends with the date on which the interest is paid and does not fail the requirements of § 1.884–5(d)(4)(iii) (relating to certain closely-held corporations) at any time during such period; or

(C) In the case of a foreign corporation that met the requirements of § 1.884–5(e) (relating to the active trade or business test) for the preceding taxable year, the foreign corporation continues to operate (other than in a nominal degree), at all times during the portion of the taxable year that ends with the date on which the interest is paid, the same business in the U.S. and its country of residence that caused it to meet such requirements for the preceding taxable year.

(iv) *Treaties other than income tax treaties.* A treaty that is not an income tax treaty does not provide any benefits with respect to branch interest.

(v) *Effect of income tax treaties on interest paid by a partnership.* If a foreign corporation is a partner (directly or indirectly) in a partnership that is engaged in a trade or business in the United States and owns an interest of 10 percent or more (as determined under the attribution rules of section 318) in the capital, profits, or losses of the partnership at any time during the partner's taxable year, the relief that may be claimed under an income tax treaty with respect to the foreign corporation distributive share of interest paid or treated as paid by the partnership shall not exceed the relief that would be available under paragraphs (b)(8) (i) and (ii) of this section if such interest were branch interest of the foreign corporation. See paragraph (c)(2) of this section for the effect on a foreign corporation's excess interest of interest paid by a partnership of which the foreign corporation is a partner.

(vi) *Examples.* The following examples illustrate the application of this paragraph (b)(8).

Example 1. Payor's treaty. The income tax treaty between the United States and country X provides that the United States may not impose a tax on interest paid by a corporation that is a resident of that country (and that is not a domestic corporation) if the recipient of the interest is a nonresident alien or a foreign corporation. Corp A is a qualified

resident of country X and meets the limitation on benefits provision in the treaty. A's branch interest is not subject to tax under section 871(a) or 881(a) regardless of whether the recipient is entitled to benefits under an income tax treaty.

Example 2. Recipient's treaty and interest received from a partnership. A, a foreign corporation, and B, a nonresident alien, are partners in a partnership that owns and operates U.S. real estate and each has a distributive share of partnership interest deductions equal to 50 percent of the interest deductions of the partnership. There is no income tax treaty between the United States and the countries of residence of A and B. The partnership pays $1,000 of interest to a bank that is a resident of a foreign country, Y, and that qualifies under an income tax treaty in effect with the United States for a 5 percent rate of tax on U.S. source interest paid to a resident of country Y. However, the bank is not a qualified resident of country Y and the limitation on benefits provision of the treaty has not been amended since December 31, 1986. The partnership is required to withhold at a rate of 30 percent on $500 of the interest paid to the bank (i.e., A's 50 percent distributive share of interest paid by the partnership) because the bank cannot, under paragraph (b)(8)(iv) of this section, claim greater treaty benefits by lending money to the partnership than it could claim, if it lent money to A directly and the $500 were branch interest of A.

(c) *Rules relating to excess interest—(1) Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual*—(i) *General rule.* If branch interest is paid in one or more taxable years before or after the year in which the interest accrues, a foreign corporation may elect to compute its excess interest as if such branch interest were paid on the last day of the taxable year in which it accrues, and not in the taxable year in which it is actually paid. The interest expense will thus reduce the amount of the foreign corporation's excess interest in the year of accrual rather than in the year of actual payment. Except as provided in paragraph (c)(1)(ii) of this section, if an election is made for a taxable year, this paragraph (c)(1)(i) shall apply to all branch interest that is paid or accrued during that year. See paragraph (b)(7) of this section for the effect of an election under this paragraph (c)(1) on branch interest that accrues in a taxable year after the year of payment.

(ii) *Election not to apply in certain cases.* An election under this paragraph (c)(1) shall not apply to an interest expense that accrued in a taxable year beginning before January 1, 1987, and shall not apply to an interest expense that was paid in a taxable year beginning before such date unless the interest was income from sources within the United States. An election under this paragraph (c)(1) shall not apply to branch interest that accrues during the taxable year and is paid in an earlier taxable year if the branch interest reduced excess interest in such earlier year. However, a foreign corporation may amend its income tax return for such earlier taxable year so that the branch interest does not reduce excess interest in such year.

(iii) *Requirements for election.* A foreign corporation that elects to apply this paragraph (c)(1) shall attach to its income tax return (or to an amended income tax return) a statement that it elects to have the provisions of this paragraph (c)(1) apply, or shall provide written notice to the Commissioner during an examination that it elects to apply this paragraph (c)(1). The election shall be effective for the taxable year to which the return relates and for all subsequent taxable years unless the Commissioner consents to revocation of the election.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(1).

Example 1. Interest accrued before paid. Foreign corporation A, a calendar year, accrual method taxpayer, has $100 of interest apportioned to ECI under § 1.882–5 for 1993. A has $60 of branch interest in 1993 before application of this paragraph (c)(1). A has an interest expense of $20 that properly accrues for tax purposes in 1993 but is not paid until 1994. When the interest is paid in 1994 it will meet the requirements for branch interest under paragraph (b)(1) of this section. A makes a timely election under this paragraph (c)(1) to treat the accrued interest as if it were paid in 1993. A will be treated as having branch interest of $80 for 1993 and excess interest of $20 in 1993. The $20 of interested treated as branch interest of A in 1993 will not again be treated as branch interest in 1994.

Example 2. Interest paid before accrued. Foreign corporation A, a calendar year, accrual method taxpayer, has $60 of branch interest in 1993. The interest expense does not accrue until 1994 and the amount of interest apportioned to A's ECI under § 1.882–5 is zero for 1993 and $80 for 1994. A makes an election under this paragraph (c)(1) with respect to 1993. As a result of the election, A's $60 of branch interest in 1993 reduces the amount of A's excess interest for 1994 rather than in 1993.

(2) *Interest paid by a partnership*—(i) *General rule.* Except as otherwise provided in paragraphs (c)(2)(ii) and (ii) of this section, if a foreign corporation is a partner in a partnership that is engaged in trade or business in the United States, the amount of the foreign corporation's distributive share of interest paid or accrued by the partnership shall reduce (but not below zero) the amount of the foreign corporation's excess interest for the year to the extent such interest is taken into account by the foreign corporation in that year for purposes of calculating the interest apportioned to the ECI of the foreign corporation under § 1.882–5. A foreign corporation's excess interest shall not be reduced by its distributive share of partnership interest that is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to interest on liabilities incurred in the ordinary course of a foreign business or secured predominantly by assets that are not U.S. assets) or would be described in paragraph (b)(3)(iii) of this section if entered on the partner's books. See paragraph (b)(8)(v) of this section for the effect of income tax treaties on interest paid by a partnership.

(ii) *Special rule for interest that is paid and accrued in different years.* Paragraph (c)(2)(i) of this section shall not apply to any portion of a foreign corporation's distributive share of partnership interest that is paid and accrued in different taxable years unless the foreign corporation has an election in effect under paragraph (c)(1) of this section that is effective with respect to such interest and any tax due under section 871(a) or 881(a) with respect to such interest has been deducted and withheld at source in the earlier of the taxable year of payment or accrual.

(3) *Effect of treaties*—(i) *General rule.* The rate of tax imposed on the excess interest of a foreign corporation that is a resident of a country with which the United States has an income tax treaty shall not exceed the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation if the foreign corporation meets, with respect to the excess interest, the requirements of the limitations on benefits provision, if any, in the treaty and either—

(A) The corporation is a qualified resident (as defined in § 1.884–5(a)) of that foreign country for the taxable year in which the excess interest is subject to tax; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Provisions relating to interest paid by a foreign corporation.* Any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce the rate of such tax.

(4) *Example.* The application of paragraphs (c)(2) and (3) of this section is illustrated by the following example.

Example. Interest paid by a partnership. Foreign corporation A, a calendar year taxpayer, is not a resident of a foreign country with which the United States has an income tax treaty. A is engaged in the conduct of a trade or business both in the United States and in foreign countries, and owns a 50 percent interest in X, a calendar year partnership engaged in the conduct of a trade or business in the United States. For 1993, all of X's liabilities are of a type described in paragraph (b)(1) of this section (relating to liabilities on U.S. books) and none are described in paragraph (b)(3)(iii) of this section (relating to liabilities that may not give rise to branch interest). A's distributive share of interest paid by X in 1993 is $20. For 1993, A has $150 of interest apportioned to its ECI under § 1.882-5, $120 of which is attributable to branch interest. Thus, the amount of A's excess interest for 1993, before application of paragraph (c)(2)(i) of this section, is $30. Under paragraph (c)(2)(i) of this section, A's $30 of excess interest is reduced by $20, representing A's share of interest paid by X. Thus, the amount of A's excess interest for 1993 is reduced to $10. A is subject to a tax of 30 percent on its $10 of excess interest.

(d) *Stapled entities.* A foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 (f) and this section, notwithstanding section 269B and the regulations thereunder. Interest paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871 (a) or 881 (a), and to withholding under section 1441 and 1442, as applicable, to the extent such interest is not subject to tax by reason of section 884(f) and this section.

(e) *Effective dates.* This section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884 (f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. With respect to taxable years beginning before October 13, 1992 and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of § 1.884-4T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992) as they applied to the foreign corporation after issuance of Notice 89-80, 1989-2 C.B. 394, but only if the foreign corporation has made an election under § 1.884-1 (i) to apply § 1.884-1 in lieu of § 1.884-1T (as contained in the CFR edition revised as of April 1, 1992) for that year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years.

(f) *Transition rules*—(1) *Election under paragraph (c)(1) of this section.* If a foreign corporation has made an election described in § 1.884-4T(b)(7) (as contained in the CFR edition revised as of April 1, 1992) with respect to interest that has accrued and been paid in different taxable years, such election shall be effective for purposes of paragraph (c)(1) of this section as if the corporation had made the election under paragraph (c)(1) of this section of these regulations.

(2) *Waiver of notification requirement for non-banks under Notice 89-80.* If a foreign corporation that is not a bank has made an election under Notice 89-80 to apply the rules in part 2 of section I of the Notice in lieu of the rules in § 1.884-4T(b) (as contained in the CFR edition revised as of April 1, 1992) to determine the amount of its interest paid and excess interest in taxable years beginning prior to 1990, the requirement that the foreign corporation satisfy the notification requirements described in paragraph (b)(3)(ii) of this section is waived with respect to interest paid in taxable years ending on or before the date the Notice was issued.

(3) *Waiver of legending requirement for certain debt issued prior to January 3, 1989.* For purposes of sections 871(h), 881(c), and this section, branch interest of a foreign corporation that would be treated as portfolio interest under section 871(h) or 881(c) but for the fact that it fails to meet the requirements of section 163(f)(2)(B)(ii)(II) (relating to the legend requirement), shall nevertheless be treated as portfolio interest provided the interest arises with respect to a liability incurred by the foreign corporation before January 3, 1989, and interest with respect to the liability was treated as branch interest in a taxable year beginning before January 1, 1990.

§ 1.884-5 Qualified resident.

(a) *Definition of qualified resident.* A foreign corporation is a qualified resident of a foreign country with which the United States has an income tax treaty in effect if, for the taxable year, the foreign corporation is a resident of that country (within the meaning of such treaty) and either—

(1) Meets the requirements of paragraphs (b) and (c) of this section (relating to stock ownership and base erosion);

(2) Meets the requirements of paragraph (d) of this section (relating to publicly-traded corporations);

(3) Meets the requirements of paragraph (e) of this section (relating to the conduct of an active trade or business); or

(4) Obtains a ruling as provided in paragraph (f) of this section that it shall be treated as a qualified resident of its country of residence.

(b) *Stock ownership requirement*—(1) *General rule*—(i) *Ownership by qualifying shareholders.* A foreign corporation satisfies the stock ownership requirement of this paragraph (b) for the taxable year if more than 50 percent of its stock (by value) is beneficially owned (or is treated as beneficially owned by reason of paragraph (b)(2) of this section) during at least half of the number of days in the foreign corporation's taxable year by one or more qualifying shareholders. A person shall be treated as a qualifying shareholder only if such person meets the requirements of paragraph (b)(3) of this section and is either—

(A) An individual who is either a resident of the foreign country of which the foreign corporation is a resident or a citizen or resident of the United States;

(B) The government of the country of which the foreign corporation is a resident (or a political subdivision or local authority of such country), or the United States, a State, the District of Columbia, or a political subdivision or local authority of a State;

(C) A corporation that is a resident of the foreign country of which the foreign corporation is a resident and whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in that country or the United States or a domestic corporation whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in the United States;

(D) A not-for profit organization described in paragraph (b)(1)(iv) of this section that is not a pension fund as defined in paragraph (b)(8)(i)(A) of this section and that is organized under the laws of the foreign country of which the foreign corporation is a resident of the United States; or

(E) A beneficiary of certain pension funds (as defined in paragraph (b)(8)(i)(A) of this section) administered in or by the country in which the foreign corporation is a resident to the extent provided in paragraph (b)(8) of this section.

Beneficial owners of an association taxable as a corporation shall be treated as shareholders of such association for purposes of this paragraph (b)(1). If stock of a foreign corporation is owned

by a corporation that is treated as a qualifying shareholder under paragraph (b)(1)(i)(C) of this section, such stock shall not also be treated as owned, directly or indirectly, by any qualifying shareholders of such corporation for purposes of this paragraph (b). Notwithstanding the above, a foreign corporation will not be treated as a qualified resident unless it obtains the documentation described in paragraph (b)(3) of this section to show that the requirements of this paragraph (b)(1)(i) have been met and maintains the documentation as provided in paragraph (b)(9) of this section. See also paragraph (b)(1)(iii) of this section, which treats certain publicly-traded classes of stock as owned by qualifying shareholders.

(ii) *Special rules relating to qualifying shareholders.* For purposes of applying paragraph (b)(1)(i) of this section—

(A) Stock owned on any day shall be taken into account only if the beneficial owner is a qualifying shareholder on that day or, in the case of a corporation or not-for-profit organization that is a qualifying shareholder under paragraph (b)(1)(i) (C) or (D) of this section, for a one-year period that includes such day; and

(B) An individual, corporation or not-for-profit organization is a resident of a foreign country if it is a resident of that country for purposes of the income tax treaty between the United States and that country.

(iii) *Publicly-traded class of stock treated as owned by qualifying shareholders.* A class of stock of a foreign corporation shall be treated as owned by qualifying shareholders if—

(A) The class of stock is listed on an established securities market in the United States or in the country of residence of the foreign corporation seeking qualified resident status; and

(B) The class of stock is primarily and regularly traded on such market (within the meaning of paragraphs (d) (3) and (4) of this section, applied as if the class of stock were the sole class of stock relied on to meet the requirements of paragraph (d)(4)(i)(A)).

For purposes of this paragraph (b), stock in such class shall not also be treated as owned by any qualifying shareholders who own such stock, either directly or indirectly.

(iv) *Special rule for not-for-profit organizations.* A not-for-profit organization is described in paragraph (b)(1)(iv) of this section if it meets the following requirements—

(A) It is a corporation, association taxable as a corporation, trust, fund, foundation, league or other entity operated exclusively for religious, charitable, educational, or recreational purposes, and it is not organized for profit;

(B) It is generally exempt from tax in its country of organization by virtue of its not-for-profit status;

(C) Either—

(*1*) More than 50 percent of its annual support is expended on behalf of persons described in paragraphs (b)(1)(i)(A) through (E) of this section or on qualified residents of the country in which the organization is organized; or

(*2*) More than 50 percent of its annual support is derived from persons described in paragraphs (b)(1)(i) (A) through (E) of this section or from persons who are qualified residents of the country in which the organization is organized.

For purposes of meeting the requirements of paragraph (b)(1)(iv)(C) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine if such persons are resident in the country in which the not-for-profit organization is organized, provided that the addresses of record are not nonresidential addresses such as a post office box or in care of a financial intermediary, and the officers, directors or administrators of the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address.

(2) *Rules for determining constructive ownership*—(i) *General rules for attribution.* For purposes of this section, stock owned by a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors or other interest holders as provided in paragraph (b)(2)(ii) through (v) of this section. The proportionate interest rules of this paragraph (b)(2) shall apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period that is taken into account in determining whether a foreign corporation is a qualified resident. Except as otherwise provided, stock treated as owned by a person by reason of this paragraph (b)(2) shall, for purposes of applying this paragraph (b)(2), be treated as actually owned by such person.

(ii) *Partnerships.* A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock;

(B) The partner's percentage distributive share of gain from disposition of the stock by the partnership;

(C) The partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

For purposes of this paragraph (b)(2)(ii), however, all qualifying shareholders that are partners of a partnership shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualifying shareholders that are partners in a partnership are aggregated prior to determining the least of the three percentages.

(iii) *Trusts and estates*—(A) *Beneficiaries.* In general, a person shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the person's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(iii)(A), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualifying shareholders. In addition, a beneficiary's actuarial interest will be treated as zero to extent that a grantor is treated as owning the stock under paragraph (b)(2)(iii)(B) of this section. A substantially separate and independent share of a trust, within the meaning of section 663(c), shall be treated as a separate trust for purposes of this paragraph (b)(2)(iii)(A), provided that payment of income, accumulated income or corpus of a share of one beneficiary (or group of beneficiaries) cannot affect the proportionate share of income, accumulated income or corpus of another beneficiary (or group of beneficiaries).

(B) *Grantor trusts.* A person is treated as the owner of stock of a foreign corporation owned by a trust to the extent that the stock is included in the portion of the trust that is treated as owned by the person under sections 671

to 679 (relating to grantors and others treated as substantial owners).

(iv) *Corporations that issue stock.* A shareholder of a corporation that issues stock shall be treated as owning stock of a foreign corporation that is owned by such corporation on any day in a proportion that equals the value of the stock owned by such shareholder to the value of all stock of such corporation. If there is an agreement, express or implied, that a shareholder of a corporation will not receive distributions from the earnings of stock owned by the corporation, the shareholder will not be treated as owning that stock owned by the corporation.

(v) *Mutual insurance companies and similar entities.* Stock held by a mutual insurance company, mutual savings bank, or similar entity (including an association taxable as a corporation that does not issue stock interests) shall be considered owned proportionately by the policy holders, depositors, or other owners in the same proportion that such persons share in the surplus of such entity upon liquidation or dissolution.

(vi) *Pension funds.* See paragraphs (b)(8) (ii) and (iii) of this section for the attribution of stock owned by a pension fund (as defined in paragraph (b)(8)(i)(A)) to beneficiaries of the fund.

(vii) *Examples.* The rules of paragraph (b)(2)(ii) of this section are illustrated by the following examples.

Example 1. Stock held solely by qualifying shareholders through a partnership. A and B, residents of country X, are qualifying shareholders, within the meaning of paragraphs (b)(1)(i) (A) through (E) of this section, and the sole partners of partnership P. P's only asset is the stock of foreign corporation Z, a country X corporation seeking qualified resident status under this section. A's distributive share of P's income and gain on the disposition of P's assets is 80 percent, but A's distributive share of P's assets (or the proceeds therefrom) on P's liquidation is 20 percent. B's distributive share of P's income and gain is 20 percent and B is entitled to 80 percent of the assets (or proceeds therefrom) on P's liquidation. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 100 percent of the stock of Z owned by P.

Example 2. Stock held by both qualifying and non-qualifying shareholders through a partnership. Assume the same facts as in *Example 1* except that C, an individual who is not a qualifying shareholder, is also a partner in P and that C's distributive share of P's income is 60 percent. The distributive shares of A and B are the same as in *Example 1* except that A's distributive share of income is 20 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 40 percent of the stock of Z owned by P (i.e., the least of A and B's aggregate distributive shares of dividend income (40 percent), gain (100 percent), and liquidation rights (100 percent) with respect to the Z stock).

Example 3. Stock held through tiered partnerships. Assume the same facts as in *Example 1*, except that P does not own the stock of Z directly, but rather is a partner in partnership P1, which owns the stock of Z. Assume that P's distributive share of the dividend income, gain and liquidation rights with respect to the Z stock held by P1 is 40 percent. Assume that of the remaining partners of P1 only D is a qualifying shareholder. D's distributive share of P1's dividend income and gain is 15 percent; D's distributive share of P1's assets on liquidation is 25 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B, treated as a single partner, will own 40 percent of the Z stock owned by P1 (100 percent X 40 percent) and D will be treated as owning 15 percent of the Z stock owned by P1 (the least of D's dividend income (15 percent), gain (15 percent), and liquidation rights (25 percent) with respect to the Z stock). Thus, 55 percent of the Z stock owned by P1 is treated as owned by qualifying shareholders under paragraph (b)(2)(ii) of this section.

(3) *Required documentation*—(i) *Ownership statements, certificates of residency and intermediary ownership statements.* Except as provided in paragraphs (b)(3)(ii), (iii) and (iv) and paragraphs (b)(8) of this section, a person shall only be treated as a qualifying shareholder of a foreign corporation if—

(A) For the relevant period, the person completes an ownership statement described in paragraph (b)(4) of this section and, in the case of an individual who is not a U.S. citizen or resident, also obtains a certificate of residency described in paragraph (b)(5) of this section;

(B) In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary completes an intermediary ownership statement described in paragraph (b)(6) of this section; and

(C) Such ownership statements and certificates of residency are received by the foreign corporation on or before the earlier of the date it files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return or, in the case of a foreign corporation claiming treaty benefits under § 1.884–4(b)(8) (i) or (ii) (relating to branch interest) on or before the date on which such interest is paid.

(ii) *Substitution of intermediary verification statement for ownership statements and certificates of residency.* If a qualifying shareholder owns stock through an intermediary that is either a domestic corporation, a resident of the United States, or a resident (for treaty purposes) of a country with which the United States has an income tax treaty in effect, the intermediary may provide an intermediary verification statement (as described in paragraph (b)(7) of this section) in place of any relevant ownership statements and certificates of residency from qualifying shareholders, and in place of intermediary ownership statements (or, where applicable, intermediary verification statements) from all intermediaries standing in the chain of ownership between the qualifying shareholders and the intermediary issuing the intermediary verification statement. An intermediary verification statement generally certifies that the verifying intermediary holds the documentation described in the preceding sentence and agrees to make it available to the District Director on request. Such intermediary verification statements, along with an intermediary ownership statement from the verifying intermediary, must be received by the foreign corporation on or before the earlier of the date if files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return. An indirect owner of a foreign corporation is thus treated as a qualifying shareholder of a foreign corporation if the foreign corporation receives, on or before the time specified above, an intermediary verification statement and an intermediary ownership statement from the verifying intermediary and an intermediary ownership statement from all intermediaries standing in the chain of the verifying intermediary's ownership of its interest in the foreign corporation.

(iii) *Special rule for registered shareholders of widely-held corporations.* An ownership statement and a certificate of residency shall not be required in the case of an individual who is a shareholder of record of a corporation that has at least 250 shareholders if—

(A) The individual owns less than one percent of the stock (by value) (applying the attribution rules of section 318) of the corporation at all times during the taxable year;

(B) The individual's address of record is in the corporation's country of residence and is not a nonresidential address such as a post office box or in care of a financial intermediary or stock transfer agent; and

(C) The officers and directors of the corporation do not know or have reason to know that the individual does not reside at that address.

The rule in this paragraph (b)(3)(iii) may also be applied with respect to individual owners of mutual insurance companies, mutual savings banks or similar entities, provided that the same conditions set forth in this paragraph are met with respect to such individuals.

(iv) *Special rule for pension funds.* See paragraphs (b)(8) (ii) through (v) of this section for special documentation rules applicable to pension funds (as defined in paragraph (b)(8)(i)(A) of this section).

(v) *Reasonable cause exception.* If a foreign corporation does not obtain the documentation described in this paragraph (b)(3) or (b)(8) of this section in a timely manner but is able to show prior to notification of an examination of the return for the taxable year that the failure was due to reasonable cause and not willful neglect, the foreign corporation may perfect the documentation after the deadlines specified in paragraph (b)(3) or (b)(8) of this section. It may make such a showing by providing a written statement to the District Director having jurisdiction over the taxpayer's return or the Office of the Assistant Commissioner (International), as applicable, setting forth the reasons for the failure to obtain the documentation in a timely manner and a describing the documentation that was received after the deadline had passed. Whether a failure to obtain the documentation in a timely manner was due to reasonable cause shall be determined by the District Director or the Office of the Assistant Commissioner (International), as applicable, under all the facts and circumstances.

(4) *Ownership statements from qualifying shareholders*—(i) *Ownership statements from individuals.* An ownership statement from an individual is a written statement signed by the individual under penalties of perjury stating—

(A) The name, permanent address, and country of residence of the individual and, if the individual was not a resident of the country for the entire taxable year of the foreign corporation seeking qualified resident status, the period during which it was a resident of the foreign corporation's country of residence;

(B) If the individual is a direct beneficial owner of stock in the foreign corporation, the name of the corporation, the number of shares in each class of stock of the corporation that are so owned, and the period of time during the taxable year of the foreign corporation during which the individual owned the stock (or, in the case of an association taxable as a corporation, the amount and nature of the owner's interest in such association);

(C) If the individual directly owns an interest in a corporation, partnership, trust, estate or other intermediary that owns (directly or indirectly) stock in the foreign corporation, the name of the intermediary, the number and class of shares or amount and nature of the interest of the individual in such intermediary (that is relevant for purposes of attributing ownership in paragraph (b)(2) of this section), and the period of time during the taxable year of the foreign corporation during which the individual held such interest; and

(D) To the extent known by the individual, a description of the chain of ownership through which the individual owns stock in the foreign corporation, including the name and address of each intermediary standing between the intermediary described in paragraph (b)(4)(i)(C) of this section and the foreign corporation.

(ii) *Ownership statements from governments.* An ownership statement from a government that is a qualifying shareholder is a written statement signed by either—

(A) An official of the governmental authority, agency or office that has supervisory authority with respect to the government's ownership interest who is authorized to sign such a statement on behalf of the authority, agency or office; or

(B) The competent authority of the foreign country (as defined in the income tax treaty between the United States and the foreign country).

Such statement shall provide the title of the official signing the statement and the name and address of the government agency, and shall provide the information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting "government" for "individual") with respect to the government's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status.

(iii) *Ownership statements from publicly-traded corporations.* An ownership statement from a corporation that is a qualifying shareholder under paragraph (b)(1)(i)(C) of this section is a written statement signed by a person authorized to sign a tax return on behalf of the corporation under penalties of perjury stating—

(A) The name, permanent address, and principal place of business of the corporation (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting "corporation" for "individual"); and

(C) That the corporation's stock is primarily and regularly traded on an established securities exchange (within the meaning of paragraph (d) of this section) in the United States or its country of residence.

(iv) *Ownership statements from not-for-profit organizations.* An ownership statement from a not-for-profit organization (other than a pension fund as defined in paragraph (b)(8)(i)(A) of this section) is a written statement signed by a person authorized to sign a tax return on behalf of the organization under penalties of perjury stating—

(A) The name, permanent address, and principal location of the activities of the organization (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting "not-for-profit organization" for "individual") with respect to the not-for-profit organization's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status; and

(C) That the not-for-profit organization satisfies the requirements of paragraph (b)(1)(iv) of this section.

(v) *Ownership through a nominee.* For purposes of this paragraph (b)(4) and paragraph (b)(6) of this section, a person who owns either stock in a foreign corporation seeking qualified resident status or an interest in an intermediary described in paragraph (b)(4)(i)(C) of this section through a nominee shall be treated as owning such stock or interest directly and must, therefore, provide the information described in paragraphs (b)(4) (i) through (iv) of this section, as applicable. Such person must also provide the name and address of the nominee.

(5) *Certificate of residency.* A certificate of residency must be signed by the relevant authorities (as described below) of the country of residence of the individual shareholder and must state that the individual is a resident of that country for purposes of its income tax laws or, if the authorities do not customarily make such a determination, that the individual has filed a tax return claiming resident status and subjecting the individual's income to tax on a resident basis for the taxable year or period that ends with or within the taxable year for which the corporation is seeking qualified resident status. In

the case of an individual who is not legally required to file a tax return in his or her country of residence or in any other country, a certificate of residency of a parent or guardian residing at such individual's address shall be considered sufficient to meet that individual's obligation under this paragraph (b)(5). The relevant authorities shall be the competent authority of the foreign country of which the foreign corporation is a resident, as defined in the income tax treaty between the foreign country and the United States, or such other governmental office of the foreign country (or political subdivision thereof) that customarily provides statements of residence. Notwithstanding the foregoing, the Commissioner may consult with the competent authority of a country regarding the procedures set forth in this paragraph (b)(5) and if necessary agree on additional or alternative procedures under which these certificates may be issued.

(6) *Intermediary ownership statement.* An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person that would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information:

(i) The name, address, country of residence, and principal place of business (in the case of a corporation or partnership) of the intermediary and, if the intermediary is a trust or estate, the name and permanent address of all trustees or executors (or equivalent under foreign law);

(ii) The information described in paragraphs (b)(4)(i) (B) through (D) (substituting "intermediary making the ownership statement" for "individual") with respect to the intermediary's direct or indirect ownership in the stock in the foreign corporation seeking qualified resident status;

(iii) If the intermediary is a nominee for a qualifying shareholder or another intermediary, the name and permanent address of the qualifying shareholder, or the name and principal place of business of such other intermediary;

(iv) If the intermediary is not a nominee for a qualifying shareholder or another intermediary, the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder (of if the direct holder is a nominee, of its beneficial shareholder, partner, beneficiary, grantor, or other interest holder) from which the intermediary received an ownership statement and the period of time during the taxable year for which the interest in the intermediary was owned by such shareholder, partner, beneficiary, grantor or other interest holder. For purposes of this paragraph (b)(6)(iv), the proportionate interest of a person in an intermediary is the percentage interest (by value) held by such person, determined using the principles for attributing ownership in paragraph (b)(2) of this section. If an intermediary is not required to receive an ownership statement from its individual registered shareholders or other interest holders by reason of paragraph (b)(3)(iii) of this section, then it must provide a list of the names and addresses of such registered shareholders or other interest holders and the aggregate proportionate interest in the intermediary of such registered shareholders or other interest holders.

(7) *Intermediary verification statement.* An intermediary verification statement that may be substituted for certain documentation under paragraph (b)(3)(ii) of this section is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or by a person that would be authorized to sign a tax return on behalf of the intermediary (if the verifying intermediary is not an individual) containing the following information—

(i) The name, principal place of business, and country of residence of the verifying intermediary;

(ii) A statement that the verifying intermediary has obtained either—

(A) An ownership statement and, if applicable, a certificate of residency from a qualifying shareholder with respect to the foreign corporation seeking qualified resident status, and an intermediary ownership statement from each intermediary standing in the chain of ownership between the verifying intermediary and the qualifying shareholder; or

(B) An intermediary verification statement substituting for the documentation described in paragraph (b)(7)(ii)(A) and an intermediary ownership statement from such intermediary and each intermediary standing in the chain of ownership between such intermediary and the verifying intermediary;

(iii) The proportionate interest (as computed using the documentation described in paragraph (b)(7)(ii) of this section) in the intermediary owned directly or indirectly by qualifying shareholders;

(iv) An agreement to make available to the Commissioner at such time and place as the Commissioner may request the underlying documentation described in paragraph (b)(7)(ii) of this section; and

(v) A specific and valid waiver of any right to bank secrecy or other secrecy under the laws of the country in which the verifying intermediary is located, with respect to any qualifying shareholder ownership statements, certificates of residency, intermediary ownership statements or intermediary verification statements that the verifying intermediary has obtained pursuant to paragraph (b)(7)(ii) of this section.

A foreign corporation may combine, in a single statement, the information in an intermediary ownership statement and the information in an intermediary verification statement.

(8) *Special rules for pension funds*—(i) *Definitions*—(A) *Pension fund.* For purposes of this section, the term "pension fund" shall mean a trust, fund, foundation, or other entity that is established exclusively for the benefit of employees or former employees of one or more employers, the principal purpose of which is to provide retirement, disability, and death benefits to beneficiaries of such entity and persons designated by such beneficiaries in consideration for prior services rendered.

(B) *Beneficiary.* For purposes of this section, the term "beneficiary" of a pension fund shall mean any person who has made contributions to the pension fund, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person's right to receive benefits from the fund has vested.

(ii) *Government pension funds.* An individual who is a beneficiary of a pension fund that would be a controlled entity of a foreign sovereign within the principles of § 1.892-2T(c)(1) of the regulations (relating to pension funds established for the benefit of employees or former employees of a foreign government) shall be treated as a qualifying shareholder of a foreign corporation in which the pension fund owns a direct or indirect interest without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if the foreign corporation is resident in the country of the foreign sovereign and the trustees, directors, or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement that the

fund is a controlled entity described in this paragraphs (b)(8)(ii). See paragraph (b)(4)(ii) of this section regarding an ownership statement from a pension fund that is an integral part of a foreign government.

(iii) *Non-government pension funds.* For purposes of this section, an individual who is a beneficiary of a pension fund not described in paragraph (b)(8)(ii) of this section shall be treated as a qualifying shareholder of a foreign corporation owned directly or indirectly by such pension fund without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if—

(A) The pension fund is administered in the foreign corporation's country of residence and is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country;

(B) The pension fund is generally exempt from income taxation in its country of administration;

(C) The pension fund has 100 or more beneficiaries;

(D) The beneficiary's address, as it appears on the records of the fund, is in the foreign corporation's country of residence or the United States and is not a nonresidential address, such as a post office box or in care of a financial intermediary, and none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country or the United States;

(E) In the case of a pension fund that has fewer than 500 beneficiaries, the beneficiary's employer provides (if the beneficiary is currently contributing to the fund) to the trustees, directors or other administrators a written statement that the beneficiary is currently employed in the country in which the fund is administered or is usually employed in such country but is temporarily employed by the company outside of the country; and

(F) The trustees, directors or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury declaring that the pension fund meets the requirements in paragraphs (b)(8)(iii) (A), (B), and (C) of this section and giving the number of beneficiaries who meet the requirements of paragraph (b)(8)(iii)(D) of this section, and, if applicable, paragraph (b)(6)(iii)(E) of this section.

(iv) *Computation of beneficial interests in non-government pension funds.* The number of shares in a foreign corporation that are held indirectly by beneficiaries of a pension fund who are qualifying shareholders may be computed based on the ratio of the number of such beneficiaries to all beneficiaries of the pension fund (rather than on the basis of the rules in paragraph (b)(2) of this section) if—

(A) The pension fund meets the requirements of paragraphs (b)(8)(iii) (A), (B), and (C) of this section;

(B) The trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that the ratio of the pension fund's beneficiaries who are residents of either the country in which the pension fund is administered or of the United States to all beneficiaries of the pension fund would differ significantly from the ratio of the sum of the actuarial interests of such residents in the pension fund to the actuarial interests of all beneficiaries in the pension fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries' actuarial interest in the pension fund, the ratio of actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(C) Either—

(*1*) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are qualified residents of the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(*2*) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(*3*) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(D) The trustees, directors or other administrators provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury certifying that the requirements in paragraphs (b)(8)(iv) (A), (B), and either (C)(*1*), (C)(*2*) or (C)(*3*) of this section have been met.

The statement described in paragraph (b)(8)(iv) (D) of this section may be combined, in a single statement, with the information required in paragraph (b)(8)(iv) (F) of this section.

(v) *Time for making determinations.* The determinations required to be made under this paragraph (b)(8) shall be made using information shown on the records of the pension fund for a date on or after the beginning of the foreign corporation's taxable year to which the determination is relevant.

(9) *Availability of documents for inspection*—(i) *Retention of documents by the foreign corporation.* The documentation described in paragraphs (b)(3) and (b)(8) of this section must be retained by the foreign corporation until expiration of the period of limitations for the taxable year to which the documentation relates and must be made available for inspection by the District Director at such time and place as the District Director may request.

(ii) *Retention of documents by an intermediary issuing an intermediary verification statement.* The documentation upon which an intermediary relies to issue an intermediary verification statement under paragraph (b)(7) of this section must be retained by the intermediary for a period of six years from the date of issuance of the intermediary verification statement and must be made available for inspection by the District Director at such time and place as the District Director may request.

(10) *Examples.* The application of this paragraph (b) is illustrated by the following examples.

Example 1. Foreign corporation A is a resident of country L, which has an income tax treaty in effect with the United States. Foreign corporation A has one class of stock issued and outstanding consisting of 1,000 shares, which are beneficially owned by the following alien individuals, directly or by application of paragraph (b)(2) of this section:

Individual	Shares owned, directly or indirectly by application of paragraph (b)(2) of this section	Percentage
T—resident of the U.S.	200	20
U—resident of country L	400	40
V—resident of country M	100	10
W—resident of country L	210	21
X—resident of country N	90	9
Total	1,000	100

(i) T owns his 200 shares directly and is a beneficial owner.

(ii) U and V own, respectively, an 80 percent and a 20 percent actuarial interest in foreign trust FT, (which interest does not differ from their respective interests in the stock owned by FT), which beneficially owns 100 percent of the stock of a foreign corporation B with bearer shares, which beneficially owns 500 shares of foreign corporation A. Foreign corporation B is incorporated in a country that does not have an income tax treaty with the United States. The foreign trust has deposited the bearer shares it owns in B with a bank in a foreign country that has an income tax treaty with the United States.

(iii) W beneficially owns all the shares of foreign corporation C, which are registered in the name of individual Z, a nominee, who resides in country L; foreign corporation C beneficially owns a 70 percent interest in foreign corporation D, which beneficially owns 300 shares of A. D's shares are bearer shares that C (not a resident of a country with which the United States has an income tax treaty) has deposited with a bank in a foreign country that has an income tax treaty with the United States.

(iv) X beneficially owns a 30 percent interest in foreign corporation D.

(v) A is a qualified resident of country L if it obtains the applicable documentation described in paragraph (b)(3) of this section either with respect to ownership by individuals U and W or with respect to ownership by individuals T and U, since either combination of qualifying shareholders of foreign corporation A will exceed 50 percent.

Example 2. Assume the same facts as in *Example 1* and assume that foreign corporation A chooses to obtain documentation with respect to individuals T and U.

(i) A must obtain, pursuant to paragraph (b)(3)(i) of this section, an ownership statement (as described in paragraph (b)(4)(i) of this section) signed by T. T is not required to furnish a certificate of residency because T is a U.S. resident.

(ii) U must provide foreign trust FT with an ownership statement and certificate of residency, as described in paragraphs (b)(4) and (b)(5) of this section. The trustees of FT must provide the depository bank holding foreign corporation B's bearer shares with an intermediary ownership statement concerning its beneficial ownership of B's shares and must attach to it the documentation provided by U. The depository bank must provide B with an intermediary ownership statement regarding its holding of B shares on behalf of FT and has the choice of attaching—

(A) The documentation from U and the intermediary ownership statement from FT; or

(B) An intermediary verification statement described in paragraph (b)(7) of this section, in which case foreign corporation B would not be provided with U's individual documentation or FT's intermediary ownership statement, both of which are retained by the depository bank.

(iii) In either case, B must then provide foreign corporation A with an intermediary ownership statement regarding its direct beneficial ownership of shares in A and, as the case may be, either—

(A) U's documentation and the intermediary ownership statements by FT and the depository bank; or

(B) The depository bank's intermediary ownership and verification statements.

(iv) Thus, with respect to U, A must obtain under paragraph (b)(3)(i) of this section the individual documentation regarding U and an intermediary ownership statement from each intermediary standing in the chain of U's indirect beneficial ownership of shares in A, i.e., from FT, the depository bank and B. In the alternative, A must obtain under paragraph (b)(3)(ii) of this section an intermediary verification statement issued by the depository bank and an intermediary ownership statement from the bank and from B, which, in this example, are the only intermediaries standing in the chain of ownership of the verifying intermediary (i.e., the depository bank).

Example 3. Assume the same facts as in *Example 1*. In addition, assume that foreign corporation A chooses to obtain documentation with respect to individuals U and W. With respect to U, A must obtain the same documentation that is described in *Example 2*. With respect to W, A must obtain, under paragraph (b)(3)(i) of this section, individual documentation regarding W and an intermediary ownership statement from each intermediary standing in the chain of W's indirect beneficial ownership of shares in A, i.e., from individual Z, foreign corporation C, the depository bank in the foreign treaty country, and foreign corporation D. In the alternative, A must obtain, under paragraph (b)(3)(ii) of this section, either—

(i) An intermediary verification statement by the depository bank in the foreign treaty country and an intermediary ownership statement from the bank and from D; or

(ii) An intermediary verification statement from Z and an intermediary ownership statement from Z and from each intermediary standing in the chain of ownership of shares in foreign corporation A, i.e., from C, the depository bank in the foreign treaty country and D. C may not issue an intermediary verification statement because it is not a resident of a country with which the United States has an income tax treaty.

(c) *Base erosion.* A foreign corporation satisfies the requirement relating to base erosion for a taxable year if it establishes that less than 50 percent of its income for the taxable year is used (directly or indirectly) to make deductible payments in the current taxable year to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the foreign country of which the foreign corporation is a resident and who are not citizens or residents (or, in the case of domestic corporations, qualified residents) of the United States. Whether a domestic corporation is a qualified resident of the United States shall be determined under the principles of this section. For purposes of this paragraph (c), the term "deductible payments" includes payments that would be ordinarily deductible under U.S. income tax principles without regard to other provisions of the Code that may require the capitalization of the expense, or disallow or defer the deduction. Such payments include, for example, interest, rents, royalties and reinsurance premiums. For purposes of this paragraph (c), the income of a foreign corporation means the corporation's gross income for the taxable year (or, if the foreign corporation has no gross income for the taxable year, the average of its gross income for the three previous taxable years) under U.S. tax principles, but not excluding items of income otherwise excluded from gross income under U.S. tax principles.

(d) *Publicly-traded corporations*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country for any taxable year in which—

(i) Its stock is primarily and regularly traded (as defined in paragraphs (d) (3) and (4) of this section) on one or more established securities markets (as defined in paragraph (d)(2) of this section) in that country, or in the United States, or both; or

(ii) At least 90 percent of the total combined voting power of all classes of stock of such foreign corporation entitled to vote and at least 90 percent of the total value of the stock of such foreign corporation is owned, directly or by application of paragraph (b)(2) of this section, by a foreign corporation that is a resident of the same foreign country or a domestic corporation and the stock of such parent corporation is primarily and regularly traded on an established securities market in that foreign country or in the United States, or both.

(2) *Established securities market*—(i) *General rule.* For purposes of section

884, the term "established securities market" means, for any taxable year—

(A) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(B) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f); and

(C) A domestic over-the-counter market (as defined in paragraph (d)(2)(iv) of this section).

(ii) *Exchanges with multiple tiers.* If a principal exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(iii) *Computation of dollar value of stock traded.* For purposes of paragraph (d)(2)(i)(A) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges, located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(iv) *Definition of over-the-counter market.* An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

(v) *Discretion to determine that an exchange qualifies as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that does not meet the requirements of paragraph (d)(2)(i)(A) of this section qualifies as an established securities market. Such a determination will be made only if it is established that—

(A) The exchange, in substance, has the attributes of an established securities market (including adequate trading volume, and comparable listing and financial disclosure requirements);

(B) The rules of the exchange ensure active trading of listed stocks; and

(C) The exchange is a member of the International Federation of Stock Exchanges.

(vi) *Discretion to determine that an exchange does not qualify as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that meets the requirements of paragraph (d)(2)(i) of this section does not qualify as an established securities market. Such determination shall be made if, in the view of the Commissioner—

(A) The exchange does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(B) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(3) *Primarily traded.* For purposes of this section, stock of a corporation is "primarily traded" on one or more established securities markets in the corporation's country of residence or in the United States in any taxable year if, with respect to each class described in paragraph (d)(4)(i)(A) of this section (relating to classes of stock relied on to meet the regularly traded test)—

(i) The number of shares in each class that are traded during the taxable year on all established securities markets in the corporation's country of residence or in the United States during the taxable year exceeds

(ii) The number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.

(4) *Regularly traded*—(i) *General rule.* For purposes of this section, stock of a corporation is "regularly traded" on one or more established securities markets in the foreign corporation's country of residence or in the United States for the taxable year if—

(A) One or more classes of stock of the corporation that, in the aggregate, represent 80 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year;

(B) With respect to each class relied on to meet the 80 percent requirement of paragraph (d)(4)(i)(A) of this section—

(1) Trades in each such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year (or 1/6 of the number of days in a short taxable year); and

(2) The aggregate number of shares in each such class that is traded on such market or markets during the taxable year is at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the number of days in the short taxable year divided by 365).

If stock of a foreign corporation fails the 80 percent requirement of paragraph (d)(4)(i)(A) of this section, but a class of such stock meets the trading requirements of paragraph (d)(4)(i)(B) of this section, such class of stock may be taken into account under paragraph (b)(1)(iii) of this section as owned by qualifying shareholders for purposes of meeting the ownership test of paragraph (b)(1) of this section.

(ii) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements.* A class of stock that is traded during the taxable year on an established securities market located in the United States shall be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if the stock is regularly quoted by brokers or dealers making a market in the stock. A broker or dealer makes a market in a stock only if the broker or dealer holds himself out to buy or sell the stock at the quoted price.

(iii) *Closely-held classes of stock not treated as meeting trading requirement*—(A) *General rule.* A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section (or the requirements of paragraph (d)(4)(ii) of this section) for a taxable year if, at any time during the taxable year, one or more persons who are not qualifying shareholders (as defined in paragraph (b)(1) of this section) and who each beneficially own 5 percent or more of the value of the outstanding shares of the class of stock own, in the aggregate, 50 percent or more of the outstanding shares of the class of stock for more than 30 days during the taxable year. For purposes of the preceding sentence, shares shall not be treated as owned by a qualifying shareholder unless such shareholder provides to the foreign corporation, by the time prescribed in paragraph (b)(3) of this section, the documentation described in paragraph (b)(3) of this section necessary to establish that it is a qualifying shareholder. For purposes of this paragraph (d)(4)(iii)(A), shares of stock

c vned by a pension fund, as defined in paragraph (b)(8)(i)(A) of this section, shall be treated as beneficially owned ' y the beneficiaries of such fund, as defined in paragraph (b)(8)(i)(B) of this section.

(B) *Treatment of related persons.* Persons related within the meaning of section 267(b) shall be treated as one person for purposes of this paragraph (d)(4)(iii). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Anti-abuse rule.* Trades between persons described in section 267(b) (as modified in paragraph (d)(4)(iii)(B) of this section) and trades conducted in order to meet the requirements of paragraph (d)(4)(i)(B) of this section shall be disregarded. A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if there is a pattern of trades conducted to meet the requirements of that paragraph. For example, trades between two persons that occur several times during the taxable year my be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d)(4)(i)(B) of this section.

(5) *Burden of proof for publicly-traded corporations.* A foreign corporation that relies on this paragraph (d) to establish that it is a qualified resident of a country with which the United States has an income tax treaty shall have the burden of proving all the facts necessary for the corporation to be treated as a qualified resident, except that with respect to paragraphs (d)(4) (iii) and (iv) of this section, a foreign corporation, with either registered or bearer shares, will meet the burden of proof if it has no reason to know and no actual knowledge of facts that would cause the corporation's stock not to be treated as regularly traded under such paragraphs. A foreign corporation that has shareholders of record must also maintain a list of such shareholders and, on request, make available to the District Director such list and any other relevant information known to the foreign corporation.

(e) *Active trade or business*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country with respect to any U.S. trade or business if, during the taxable year—

(i) It is engaged in the active conduct of a trade or business (as defined in paragraph (e)(2) of this section) in its country of residence;

(ii) It has a substantial presence (within the meaning of paragraph (e)(3) of this section) in its country of residence; and

(iii) Either—

(A) Such U.S. trade or business is an integral part (as defined in paragraph (e)(4) of this section) of an active trade or business conducted by the foreign corporation in its country of residence; or

(B) In the case of interest received by the foreign corporation for which a treaty exemption or rate reduction is claimed pursuant to § 1.884–4(b)(8)(ii), the interest is derived in connection with, or is incidental to, a trade or business described in paragraph (e)(1)(i) of this section.

A foreign corporation may determine whether it is a qualified resident under this paragraph (e) by applying the rules of this paragraph (e) to the entire affiliated group (as defined in section 1504 (a) without regard to section 1504(b) (2) or (3)) of which the foreign corporation is a member rather than to the foreign corporation separately. If a foreign corporation chooses to apply the rules of this paragraph (e) to its entire affiliated group as provided in the preceding sentence, then it must apply such rules consistently to all of its U.S. trades or businesses conducted during the taxable year.

(2) *Active conduct of a trade or business.* A foreign corporation is engaged in the active conduct of a trade or business only if either—

(i) It is engaged in the active conduct of a trade or business within the meaning of section 367(a)(3) and the regulations thereunder; or

(ii) It qualifies as a banking or financing institution under the laws of the foreign country of which it is a resident, it is licensed to do business with residents of its country of residence, and it is engaged in the active conduct of a banking, financing, or similar business within the meaning of § 1.864–4(c)(5)(i) in its country of residence.

A foreign corporation that is an insurance company within the meaning of § 1.801–3 (a) or (b) is engaged in the active conduct of a trade or business only if it is predominantly engaged in the active conduct of an insurance business within the meaning of section 952(c)(1)(B)(v) and the regulations thereunder.

(3) *Substantial presence test*—(i) *General rule.* Except as provided in paragraph (e)(3)(ii) of this section, a foreign corporation that is engaged in the active conduct of a trade or business in its country of residence has a substantial presence in that country if, for the taxable year, the average of the following three ratios exceeds 25 percent and each ratio is at least equal to 20 percent—

(A) The ratio of the value of the assets of the foreign corporation used or held for use in the active conduct of a trade or business in its country of residence at the close of the taxable year to the value of all assets of the foreign corporation at the close of the taxable year;

(B) The ratio of gross income from the active conduct of the foreign corporation's trade or business in its country of residence that is derived from sources within such country for the taxable year to the worldwide gross income of the foreign corporation for the taxable year; and

(C) The ratio of the payroll expenses in the foreign corporation's country of residence for the taxable year to the foreign corporation's worldwide payroll expenses for the taxable year.

(ii) *Special rules*—(A) *Asset ratio.* For purposes of paragraph (e)(3)(i)(A) of this section, the value of an asset shall be determined using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. An asset shall be treated as used or held for use in a foreign corporation's trade or business if it meets the requirements of § 1.367(a)–2T(b)(5). Stock held by a foreign corporation shall not be treated as an asset of the foreign corporation for purposes of paragraph (e)(3)(i)(A) of this section if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. The rules of § 1.954–2T(b)—(3) (other than § 1.954–2T(b)(3)(x)) shall apply to determine the location of assets used or held for use in a trade or business. Loans originated or acquired in the course of the normal customer loan activities of a banking, financing or similar institution, and securities and derivative financial instruments held by dealers, traders and insurance companies for use in a trade or business shall be treated as located in the country in which an office or other fixed place of business is primarily responsible for the acquisition of the

asset and the realization of income, gain or loss with respect to the asset.

(B) *Gross income ratio*—(1) *General rule.* For purposes of paragraph (e)(3)(i)(B) of this section, the term "gross income" means the gross income of a foreign corporation for purposes of financial reporting in its country of residence. Gross income shall not include, however, dividends, interest, rent, or royalties unless such corporation derives such dividends, interest, rents, or royalties in the active conduct of its trade or business. Gross income shall also not include gain from the disposition of stock if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. Except as provided in this paragraph (e)(3)(ii)(B), the principles of sections 861 through 865 shall apply to determine the amount of gross income of a foreign corporation derived within its country of residence.

(2) *Banks, dealers and traders.* Dividend income and gain from the sale of securities, or from entering into or disposing of derivative financial instruments by dealers and traders in such securities or derivative financial instruments shall be treated as derived within the country where the assets are located under paragraph (e)(3)(ii)(A) of this section. Other income, including interest and fees, earned in the active conduct of a banking, financing or similar business shall be treated as derived within the country where the payor of such interest or other income resides. For purposes of the preceding sentence, if a branch or similar establishment outside the country in which the payor resides makes a payment of interest or other income, such amounts shall be treated as derived within the country in which the branch or similar establishment is located.

(3) *Insurance companies.* The gross income of a foreign insurance company shall include only gross premiums received by the country.

(4) *Other corporations.* Gross income from the performance of services, including transportation services, shall be treated as derived within the country of residence of the person for whom the services are performed. Gross income from the sale of property by a foreign corporation shall be treated as derived within the country in which the purchaser resides.

(5) *Anti-abuse rule.* The Commissioner may disregard the source of income from a transaction determined under this paragraph (e)(3)(ii)(B) if it is determined that one of the principal purposes of the transaction was to increase the source of income derived within the country of residence of the foreign corporation for purposes of this section.

(C) *Payroll ratio.* For purposes of paragraph (e)(3)(i)(C) of this section, the payroll expenses of a foreign corporation shall include expenses for "leased employees" (within the meaning of section 414(n)(2) but without regard to subdivision (B) of that section) and commission expenses paid to employees and agents for services performed for or on behalf of the corporation. Payroll expense for an employee, agent or a "leased employee" shall be treated as incurred where the employee, agent or "leased employee" performs services on behalf of the corporation.

(iii) *Exception to gross income test for foreign corporations engaged in certain trades or businesses.* In determining whether a foreign corporation engaged primarily in selling tangible property or in manufacturing, producing, growing, or extracting tangible property has a substantial presence in its country of residence for purposes of paragraph (e)(3)(i) of this section, the foreign corporation may apply the ratio provided in this paragraph (e)(3)(iii) instead of the ratio described in paragraph (e)(i)(B) of this section (relating to the ratio of gross income derived from its country of residence). This ratio shall be the ratio of the direct material costs of the foreign corporation with respect to tangible property manufactured, produced, grown, or extracted in the foreign corporation's country of residence to the total direct material costs of the foreign corporation.

(4) *Integral part of an active trade or business in a foreign corporation's country of residence*—(i) *In general.* A U.S. trade or business of a foreign corporation is an integral part of an active trade or business conducted by a foreign corporation in its country of residence if the active trade or business conducted by the foreign corporation in both its country of residence and in the United States comprise, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services. Subject to the presumption and de minimis rule in paragraphs (e)(4) (iii) and (iv) of this section, if a U.S. trade or business of a foreign corporation sells goods that are not, in principal part, manufactured, produced, grown, or extracted by the foreign corporation in its country of residence, such business shall not be treated as an integral part of an active trade or business conducted in the foreign corporation's country of residence unless the foreign corporation takes physical possession of the goods in a warehouse or other storage facility that is located in its country of residence and in which goods of such type are normally stored prior to sale to customers in such country.

(ii) *Presumption for banks.* A U.S. trade or business of a foreign corporation that is described in § 1.864-4(b)(2) shall be presumed to be an integral part of an active banking business conducted by the foreign corporation in its country of residence provided that a substantial part of the business of the foreign corporation in its country of residence consists of receiving deposits and making loans and making loans and discounts.

(iii) *Presumption if business principally conducted in country of residence.* A U.S. trade or business of a foreign corporation shall be treated as an integral part of an active trade or business of a foreign corporation in its country or residence with respect to the sale or lease of property (or the performance of services) if at least 50 percent of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of such property for consumption, use, or disposition in the foreign corporation's country of residence (or from the performance of such services in the foreign corporation's country of residence). In determining whether property or services are of the same type, a foreign corporation shall follow recognized industry or trade usage or the three-digit major groups (or any narrower classification) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. The determination of whether income is of the same kind must be made in a consistent manner from year-to-year.

(iv) *De minimis rule.* If a foreign corporation is engaged in more than one U.S. trade or business and if at least 80 percent of the sum of the ECEP from the current year and the preceding two years is attributable to one or more trades or businesses that meet the integral part test of this paragraph (e)(4), all of the U.S. trades or businesses of the foreign corporation shall be treated as an integral part of an active or business conducted by the foreign corporation. If a foreign corporation has more than one U.S. trade or business and does not meet the requirements of the preceding

sentence but otherwise meets the requirements of this paragraph (e)(4) with regard to one or more trade or business, see § 1.884–1(g)(1) to determine the extent to which treaty benefits apply to such corporation.

(f) *Qualified resident ruling*—(1) *Basis for ruling.* In his or her sole discretion, the Commissioner may rule that a foreign corporation is a qualified resident of its country or residence if the Commissioner determines that individuals who are not residents of the foreign country of which the foreign corporation is a resident do not use the treaty between that country and the United States in a manner inconsistent with the purposes of section 884. The purposes of section 884 include, but are not limited to, the prevention of treaty shopping by an individual with respect to any article of an income tax treaty between the country of residence of the foreign corporation and the United States.

(2) *Factors.* In order to make this determination, the Commissioner may take into account the following factors, including, but not limited to:

(i) The business reasons for establishing and maintaining the foreign corporation in its country of residence;

(ii) The date of incorporation of the foreign corporation in relation to the date that an income tax treaty between the United States and the foreign corporation's country of residence entered into force;

(iii) The continuity of the historical business and ownership of the foreign corporation;

(iv) The extent to which the foreign corporation meets the requirements of one or more of the tests described in paragraphs (b) through (e) of this section;

(v) The extent to which the U.S. trade or business is dependent on capital, assets, or personnel of the foreign trade or business;

(vi) The extent to which the foreign corporation receives special tax benefits in its country of residence;

(vii) Whether the foreign corporation is a member of an affiliated group (as defined in section 1504(a) without regard to section 1504(b) (2) or (3)), that has no members resident outside the country of residence of the foreign corporation; and

(viii) The extent to which the foreign corporation would be entitled to comparable treaty benefits with respect to all articles of an income tax treaty that would apply to that corporation if it had been incorporated in the country or countries of residence of the majority of its shareholders. For purposes of the preceding sentence, shareholders taken into account shall generally be limited to persons described in paragraph (b)(1)(i) of this section but for the fact that they are not residents of the foreign corporation's country of residence.

(3) *Procedural requirements.* A request for a ruling under this paragraph (f) must be submitted on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year for which the ruling is requested. A foreign corporation receiving a ruling will be treated as a qualified resident of its country of residence for the taxable year for which the ruling is requested and for the succeeding two taxable years. If there is a material change in any fact that formed the basis of the ruling, such as the ownership or the nature of the trade or business of the foreign corporation, the foreign corporation must notify the Secretary within 90 days of such change and submit a new private letter ruling request. The Commissioner will then rule whether the change affects the foreign corporation's status as a qualified resident, and such ruling will be valid for the taxable year in which the material change occurred and the two succeeding taxable years, subject to the requirement in the preceding sentence to notify the Commissioner of a material change.

(g) *Effective dates.* This section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992 and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of the temporary regulations under 1.884–5T (as contained in the CFR edition revised as of April 1, 1992), but only if the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election shall apply to all subsequent taxable years.

(h) *Transition rule.* If a foreign corporation elects to apply this section in lieu of § 1.884–5T (as contained in the CFR edition revised as of April 1, 1992) as provided in paragraph (g) of this section, and the application of paragraph (b) of this section results in additional documentation requirements in order for the foreign corporation to be treated as a qualified resident, the foreign corporation must obtain the documentation required under that paragraph on or before March 11, 1993.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 7. Section 602.101(c) is amended by removing the entries for "1.884–0T, 1.884–1T, and 1.884–5T" and adding the following entries to the table:

CFR part or section where identified or described	Current OMB control No.
1.884–0	1545–1070
1.884–1	1545–1070
1.884–4	1545–1070
1.884–5	1545–1070

Shirley D. Peterson,
Commissioner of Internal Revenue.

Approved: July 30, 1992.

Fred T. Goldberg, Jr.,
Assistant Secretary of the Treasury.

[FR Doc. 92–21297 Filed 9–10–92; 8:45 am]
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Corrections

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8223]

Income Taxes; Branch Tax; Correction

Correction

In rule document 89-21831 appearing on page 37294 in the issue of Monday, September 26, 1988, make the following corrections:

§ 1.884-5T [Corrected]

1. In the second column, the section heading that reads "§ 1.844-5T [Corrected]" should read as set forth above.

2. In the same column, in Par. 3, in the first line, "§ 1.844-5T(b)(2)(i)(B)" should read "§ 1.884-5T(b)(2)(i)(B)".

3. In the same column, in Par. 4, in the first line, "§ 1.844-5T(b)(2)(i)(D)" should read "§ 1.884-5T(b)(2)(i)(D)".

BILLING CODE 1505-01-D

26 CFR Parts 1 and 602

[INTL—934–86]

Branch Tax; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to notice of public hearing on proposed regulations.

SUMMARY: This document contains a correction to a notice of a public hearing on proposed regulations relating to the branch tax. This regulation will provide immediate guidance to taxpayers concerning the imposition of tax on profits of a U.S. branch of a foreign corporation that are removed from the branch and on interest that is paid, or deemed paid, by the branch.

FOR FURTHER INFORMATION CONTACT: Angela D. Wilburn of the Regulations Unit, Assistant Chief Counsel (Corporate), Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, telephone 202–566–3935, (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On Tuesday, December 6, 1988, the Federal Register published a notice of public hearing on proposed regulations under section 884, as added to the Code by section 1241 of the Tax Reform Act of 1986. The notice of public hearing appeared in the Federal Register for Tuesday, December 6, 1988, at page 49208 (53 FR 49208).

Need for Correction

As published, the notice of public hearing contains an typographical error in the deadline date for submitting outlines of oral comments to be presented at the public hearing.

Correction of Publication

Accordingly, the publication of the notice of public hearing which was the subject of FR Doc. 88–28032 (53 FR 49208), is corrected as follows:

PARTS 1 AND 602—[AMENDED]

Par. 1. On page 49209, first column, sixth line from the top of the column should read, "January 3, 1989, an outline of the oral".

Dale D. Goode,

Chief, Regulations Unit, Assistant Chief Counsel (Corporate).

[FR Doc. 88–28462 12–9–88; 8:45 am]

BILLING CODE 4830–01–M

Internal Revenue Service

26 CFR Parts 1 and 602

[INTL-934-86]

Branch Tax; Public Hearing on Proposed Regulations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of public hearing on proposed regulations.

SUMMARY: This document provides notice of a public hearing on proposed regulations relating to the branch tax. This regulation will provide immediate guidance to taxpayers concerning the imposition of tax on profits of a U.S. branch of a foreign corporation that are removed from the branch and on interest that is paid, or deemed paid, by the branch.

DATES: The public hearing will be held on Tuesday, January 17, 1989, beginning at 10:00 a.m. Outlines of oral comments must be delivered or mailed by Tuesday, January 3, 1989.

ADDRESS: The public hearing will be held in the I.R.S. auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. The requests to speak and outlines of oral comments should be submitted to the Commissioner of Internal Revenue Service, Attn: CC:CORP:T:R, Room 4429, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Angela Wilburn of the Regulations Unit, Assistant Chief Counsel (Corporate), Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, telephone 202-566-3935 (not a toll free call).

SUPPLEMENTARY INFORMATION: The subject of the public hearing is proposed regulations under section 884, as added to the Code by section 1241 of the Tax Reform Act of 1986. The proposed regulations appeared in the Federal Register for Friday, September 2, 1988 at page 34120 (53 FR 34120).

The rules of § 601.601(a)(3) of the "Statement of Procedural Rules" (26 CFR Part 601) shall apply with respect to

the public hearing. Persons who have submitted written comments within the time prescribed in the notice of proposed rulemaking and who also desire to present oral comments at the hearing on the proposed regulations should submit not later than Tuesday, January 3, 1989 an outline of the oral comments to be presented at the hearing and the time they wish to devote to each subject.

Each speaker will be limited to 10 minutes for an oral presentation exclusive of the time consumed by the questions from the panel for the Government and answers to these questions.

Because of controlled access restriction, attendees cannot be permitted beyond the lobby of the Internal Revenue Building until 9:45 a.m.

An agenda showing the scheduling of the speakers will be made after outlines are received from the speakers. Copies of the agenda will be available free of charge at the hearing.

By direction of the Commissioner of Internal Revenue.

Cynthia E. Grigsby,

Acting Chief, Regulations Unit, Assistant Chief Counsel (Corporate).

[FR Doc. 88-28032 Filed 12-5-88; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8223]

Income Taxes; Branch Tax; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Corrections to temporary regulations.

SUMMARY: This document contains corrections to Treasury Decision 8223, which was published in the Federal Register for Friday, September 2, 1988 (53 FR 34045). The regulations provide guidance to taxpayers concerning the imposition of tax on profits of a U.S. branch of a foreign corporation that are removed from the branch and on interest that is paid, or deemed paid, by the branch.

FOR FURTHER INFORMATION CONTACT: Elizabeth Karzon of the Office of Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attn: CC:LR:T) Telephone 202-566-3160 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of these corrections provide guidance to taxpayers in the application of section 884 of the Internal Revenue Code of 1986. This section was added to the Code by section 1241 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2576).

Need for Correction

As published, T.D. 8223 contains typographical errors and omissions that, if not corrected, might cause confusion to taxpayer and practitioners.

Correction of Publication

Accordingly, the publication of temporary regulations (T.D. 8223), which was the subject of FR Doc. 88-19832, is corrected as follows:

§ 1.884-4T [Corrected]

Par. 1. In § 1.884-4T(b)(5)(i)(B), page 34066 third column, seventh line, the reference to "paragraph (b)(i)(iv)" is corrected to read as "paragraph (b)(1)(iv)".

Par. 2. In § 1.884-4T(b)(8)(v), Example (2), page 34069, second column, first line, the language "A, a foreign corporation and" is corrected to read "A, a foreign corporation, and".

§ 1.844-5T [Corrected]

Par. 3. In § 1.844-5T(b)(2)(i)(B), page 34070, third column, line six through line fifteen is correctly added to read: "(*1*) the partner's percentage distributive share of the partnership's dividend income from the stock, (*2*) the partner's percentage distributive share of gain from disposition of the stock by the partnership, or (*3*) the partner's percentage share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

Par. 4. In § 1.844-5T(b)(2)(i)(D), page 34070, third column, corrections appear in three locations. In the fifth line, the designation "(1)" is corrected to read "(*1*)". In the ninth line, the designation "(2)" is corrected to read "(*2*)". In the thirteeth line, the designation "(3)" is corrected to read "(*3*)".

Par. 5. In § 1.884-5T(d)(6), page 34075, first column, fifteenth line, the language "district director" is corrected to read "District Director".

PART 602—[AMENDED]

§ 602.101 [Corrected]

Par. 6. In § 602.101, Par. 4, page 34076, first column, the language "§ 1.884-3T. . . . 1545-1070" is added immediately following the language "§ 1.884-2T. . . . 1545-1070".

Dale D. Goode,

Chief, Technical Section, Legislation and Regulations Division.

[FR Doc. 88-21831 Filed 9-23-88; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8223] INTL-979-86

Income Taxes; Branch Tax

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary Income Tax Regulations relating to the branch tax. This regulation will provide immediate guidance to taxpayers concerning the imposition of tax on profits of a U.S. branch of a foreign corporation that is removed from the branch and on interest that is paid, or deemed paid, by the branch. The text of the temporary regulations set forth in this document also serves as the text of proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the Federal Register.

EFFECTIVE DATE: These regulations are effective for taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: Richard M. Elliott of the Office of the Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, Attention: CC:LR:T (INTL-979-86) (202-566-6457, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in this regulation has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1070.

The estimated annual burden per respondent/recordkeeper varies from .1 hour to 10.5 hours depending on individual circumstances, with an estimated average of .3 hour.

For further information concerning this collection of information, and where to submit comments on this collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section of this issue of the Federal Register.

Background

This document contains temporary Income Tax Regulations under section 884 of the Internal Revenue Code of 1986. This section was added to the Code by section 1241 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2576).

Need for Temporary Regulations

The proper application of section 884 is dependent upon the Internal Revenue Service's detailed specifications of the manner in which the requirements of the statute will be administered. These regulations are necessary to provide taxpayers with immediate guidance in the application of section 884, as added to the Code by section 1241 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2576).

Explanation of Provisions

Branch Profits Tax

Section 1.884-1T(b) provides rules for computing the dividend equivalent amount, the base on which the branch profits tax is imposed. The dividend equivalent amount is a foreign corporation's effectively connected earnings and profits for the taxable year reduced by any increase in U.S. net equity during the taxable year or increased by any decrease in U.S. net equity during the taxable year. An increase in U.S. net equity is treated as a reinvestment of effectively connected earnings and profits in a U.S. trade or business and a decrease in U.S. net equity is generally treated as a disinvestment of effectively connected earnings and profits accumulated in prior years. However, an increase in the dividend equivalent amount is limited to post-1986 effectively connected earnings and profits of a foreign corporation that have not been previously subject to the branch profits tax (non-previously taxed accumulated effectively connected earnings and profits).

Section 1.884-1T(c) defines the term "U.S. net equity" as a foreign corporation's U.S. assets reduced by its U.S. liabilities.

Under § 1.884-1T(d), property is a U.S. asset if all of the income from its use and all the gain from its disposition on the date on which a determination is made (if used or sold at a gain on that determination date), would be income that is effectively connected with the conduct of a U.S. trade or business. Rules are given for specific types of property, such as depreciable property, inventory, U.S. real property interests, and partnership interests. The amount taken into account as a U.S. asset with respect to property is the adjusted basis of the property for purposes of computing earnings and profits.

Section 1.884-1T(d)(11) provides that a foreign corporation may elect to treat a limited amount of marketable securities as U.S. assets. The purpose of this election is to provide relief from the requirement that effectively connected earnings and profits be reinvested as of the close of the year. Income from the securities is treated as effectively connected with the conduct of a U.S. trade or business.

Section 1.884-1T(d)(13) enumerates certain types of property that are not treated as U.S. assets even though the property would otherwise qualify as U.S. assets under § 1.884-1T(d). Such property includes property that produces income that is effectively connected with the conduct of a U.S. trade or business but does not produce effectively connected earnings and profits, and property that is acquired or used to artificially increase U.S. net equity.

Under § 1.884-1T(e), "U.S. liabilities" are determined on the basis of fungibility, *i.e.*, as the product of a foreign corporation's U.S. assets at the close of the taxable year and either the ratio of the foreign corporation's worldwide liabilities at the close of the taxable year to its worldwide assets at the close of the taxable year or, if the foreign corporation computes its interest deduction using a fixed ratio of liabilities to assets under § 1.882-5(b)(2)(i), the fixed ratio. A special rule is provided for computing the liabilities of a foreign corporation that is a partner in a partnership. Under an anti-abuse rule, an artificial decrease in the U.S. liabilities of the foreign corporation is disregarded.

As an alternative to fungibility, a booking method was considered for determining U.S. liabilities. However, the regulations adopt the fungibility approach for several reasons. First, section 884(c)(2)(C) provides that the regulations defining U.S. liabilities shall be consistent with the allocation of deductions under section 882(c)(1). Second, fungibility is, in general, more consistent with the principles of the branch profits tax. Because U.S. assets are generally defined as assets that produce effectively connected earnings and profits, which is the base for the branch profits tax, the regulations define U.S. liabilities as liabilities that produce deductions that reduce effectively connected earnings and profits.

Under the regulations, a foreign corporation's U.S. liabilities may shift as a function of the amount of profits generated by its U.S. assets relative to the profits generated by its foreign assets. Thus, if the U.S. assets have a higher profit rate than the foreign assets, the U.S. assets will attract more liabilities than the foreign assets. In such a case, U.S. net equity may not increase sufficiently to reduce the divided equivalent amount to zero even though all the current earnings remain invested in the U.S. trade or business. On the other hand, if the foreign assets have a higher profit rate than the U.S. assets, a corporation may not have a dividend equivalent amount even though it repatriates some of its current earnings. These results occur because the regulations view liabilities as fungible, *i.e.*, as supporting all the assets of the foreign corporation. If U.S. assets increase relative to foreign assets, the U.S. trade or business would be treated as assuming a larger share of the foreign corporation's worldwide liabilities. If the U.S. trade or business were conducted in a separate domestic subsidiary, such assumption would be treated as a dividend distribution by the subsidiary to its foreign parent to the extent of the liabilities assumed. If the U.S. trade or business is conducted in a branch, the assumption of additional liabilities by the branch will reduce U.S. net equity and give rise to a dividend equivalent amount. Similarly, if foreign assets increase relative to U.S. assets, the foreign operations can be viewed as assuming a larger share of the corporation's worldwide liabilities. In that case the assumption is equivalent to a capital contribution to the U.S. trade

or business, and results in an increase in U.S. net equity.

Section 1.884–1T(f)(1) defines the term "effectively connected earnings and profits" to mean earnings and profits attributable to income that is effectively connected with the conduct of a U.S. trade or business. The regulations do not reflect the amendment in H.R. 4333, S. 2238, 100th Cong., 2d Sess. (hereinafter the "technical corrections bill") dealing with certain unearned premium reserves.

Section 1.884–1T(f)(2) enumerates certain types of effectively connected income that do not produce effectively connected earnings and profits. This income includes certain income derived from the operation of ships or aircraft that is excluded from gross income under section 883(a)(1) or 883(a)(2), gain on the disposition of stock of a domestic corporation that is treated as a U.S. real property interest, and income that is exempt from tax under section 892.

Section 1.884–1T(f)(3) requires that, in determining a foreign corporation's effectively connected earnings and profits, deductions and other adjustments be allocated and apportioned under the principles of § 1.861–8 between income that is effectively connected with a U.S. trade or business and produces effectively connected earnings and profits and income that is effectively connected with a U.S. trade or business but does not produce effectively connected earnings and profits.

Section 1.884–1T(g) provides special rules for the calculation of effectively connected earnings and profits and U.S. assets of foreign corporations carrying on an insurance business in the United States.

Consistent with Notice 87–56, 1987–2 C.B. 357, § 1.884–1T(h) provides rules for the application of the branch profits tax to a foreign corporation that is a qualified resident (as defined in § 1.884–5T) of a country with which the United States has an income tax treaty. Section 1.884–1T(h)(1) provides that a foreign corporation that is a resident of a country with which the United States has an income tax treaty may claim an exemption or rate reduction with respect to a dividend equivalent amount for the taxable year only if either (1) the foreign corporation is a qualified resident of the treaty country because its stock is primarily and regularly traded on an established securities market in its country of residence or in the United States (within the meaning of § 1.884–5T(d)), or it is engaged in an active trade or business in its country of residence (within the meaning of § 1.884–5T(e)), or it has obtained a ruling described in § 1.884–5T(f), or (2) it meets, with respect to the dividend equivalent amount, the requirements of a limitation on benefits article in an income tax treaty and the article entered into force after December 31, 1986. A foreign corporation that is a qualified resident of its country of residence because it meets the stock ownership and base erosion requirements of § 1.884–5T (b) and (c) is required to establish its qualified residence status for a 36-month period which includes the year in which the dividend equivalent amount arises. A foreign corporation that fails that requirement and is not otherwise a qualified resident on other grounds may claim treaty benefits only with respect to the portions of its dividend equivalent amount that are attributable, on a last-in-first-out basis, to taxable years in which it was a qualified resident.

Section 1.884–1T(h)(3) provides that the branch profits tax will not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the qualified residence requirements (including the 36-month test where applicable) for a country listed in that section, so long as the income tax treaty between the United States and the country, as in effect on January 1, 1987, remains in effect and is not modified by subsequent agreement to expressly provide for the imposition of the branch profits tax. The effect on the branch profits tax of non-discrimination provisions in income tax treaties is currently under consideration in connection with the forthcoming Treasury Department study of the tax treaty program.

Section 1.884–1T(h)(4) provides that a foreign corporation that is a qualified resident of a country with which the United States has an income tax treaty but that is not entitled to exemption from the branch profits tax under § 1.884–1T(h)(3) may claim treaty benefits such as a reduction in the rate of the branch profits tax. The section lists the rate of tax on qualified residents under existing income tax treaties and provides rules for corporations that are qualified residents of Canada.

Section 1.884–1T(h)(5) reserves with respect to benefits under treaties other than income tax treaties (such as Friendship, Commerce and Navigation treaties) in view of provisions in the technical corrections bill.

Section 1.884–1T(i) provides that, if a foreign corporation and a domestic corporation are stapled entities within the meaning of section 269B(c)(2), the foreign corporation shall nonetheless be treated as a foreign corporation for all purposes of the branch tax.

Special Rules for the Termination or Incorporation of a U.S. Trade or Business or the Liquidation or Reorganization of a Foreign Corporation or its Domestic Subsidiary

Section 1.884–2T contains rules announced in Notice 86–17, 1986–2 C.B. 379. It provides special exemption rules for a foreign corporation that completely terminates all of its U.S. trade or business as well as rules for the application of the branch profits tax in the case of the tax-free reorganization or liquidation of a foreign corporation with a U.S. trade or business, the tax-free incorporation of a U.S. trade or business of a foreign corporation, and certain transactions with respect to a domestic subsidiary of a foreign parent corporation.

Under § 1.884–2T(a)(1), a foreign corporation's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits are extinguished as a result of a complete termination of all of the U.S. trade and business of a foreign corporation.

Section 1.884–2T(a)(2) states the four conditions for a foreign corporation to completely terminate all of its U.S. trade and business with respect to a particular taxable year: (1) At the end of that year, it must have no U.S. assets; (2) for the following three taxable years, it must have no income that is effectively connected with the conduct of a U.S. trade or business (other than by reason of section 864 (c)(6) or (c)(7)); (3) for the following three taxable years, neither itself nor a related corporation may use, directly or indirectly, any of the U.S. assets of the terminated U.S. trades or businesses, or property attributable to such property or to the foreign corporation's effectively connected earnings and profits earned in the year of complete termination of a U.S. trade or business; and (4) the foreign corporation must waive the period of limitations for the year of complete termination.

Under § 1.884–2T(b), a foreign corporation may elect, for a maximum two-year period, to treat marketable securities as U.S. assets. This election is a special relief measure designed for foreign corporations that may have liquidated all of their U.S. assets or retired them from use in a U.S. trade or business but continue to hold cash or property with the expectation of continuing a U.S. trade or business in the near future. The procedures applying to this election, including transitional

rules, and its effects, are similar to the election for expansion capital in § 1.884–1T(d)(11).

Section 1.884–2T(c) recognizes that the branch profits tax generally should not be imposed with respect to the transfer of U.S. assets by a foreign corporation merely as a result of a non-divisive tax-free reorganization (into a domestic or foreign corporation) or liquidation described in section 381(a). On the other hand, § 1.884–2T(c) reflects the fact that a foreign corporation that reorganizes does not completely terminate its U.S. trade and business and, therefore, cannot escape branch profits tax liability under the complete termination rules. That section provides rules for computing the dividend equivalent amount of the foreign corporation and its transferee in the year of the transaction and subsequent taxable years.

Consistent with Notice 86–17, 1986–2 C.B. 379, § 1.884–2T(d) provides that a foreign corporation may transfer part or all of its U.S. assets to a domestic corporation in a section 351(a) transfer without branch profits tax consequences provided that the foreign corporation owns, after the transaction, and without regard to other transferors, at least 80 percent of the voting stock and value of the transferee, the transferee agrees to be allocated an amount of the foreign corporation's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits in proportion to the U.S. assets transferred, and the foreign corporation agrees to an increase in its dividend equivalent amount in the event of its disposition of the stock or securities of the transferee received in the exchange.

Section 1.884–2T(e) provides special rules for certain transactions with respect to a domestic subsidiary of a foreign corporation.

Interaction of the Branch Profits Tax and Second-Tier Withholding

Section 1.884–3T reserves with respect to the interaction of the branch profits tax and second-tier withholding in view of the technical corrections bill.

Branch-Level Interest Tax

Section 1.884–4T(a) provides that, for purposes of sections 871, 881, 1441 and 1442, interest paid by a U.S. trade or business (within the meaning of § 1.884–4T(b)) of a foreign corporation that is engaged in trade or business in the United States is treated as paid by a domestic corporation. The technical corrections bill would make § 1.884–4T(a) effective for all purposes of Subtitle A of the Internal Revenue Code but this provision has not been incorporated in the regulations. Such interest is subject to withholding under section 1441 or 1442 unless exempt under the Code or an income tax treaty. A foreign corporation is treated as engaged in trade or business in the United States if, during the taxable year, it has U.S. assets (as defined in § 1.884–1T(d)) or gross income that is effectively connected with the conduct of a U.S. trade or business. The regulations do not incorporate the technical corrections bill's provision that would exempt interest paid by an international organization from the branch tax on interest.

Section 1.884–4T(a)(2) provides generally that, if the interest allowable as a deduction under § 1.882–5 in computing a foreign corporation's effectively connected taxable income exceeds certain interest paid by a U.S. trade or business of the foreign corporation, the excess shall be treated as interest paid to the foreign corporation by a wholly-owned domestic corporation and shall be subject to tax under section 881(a).

Section 1.884–4T(a)(3) provides that the term "interest" includes original issue discount, as defined in section 1273(a)(1).

Section 1.884–4T(b)(1) defines the term "interest paid by a U.S. trade or business" as interest that is paid with respect to one of four classes of liabilities. The first class consists of liabilities identified as liabilities of a U.S. trade or business on the foreign corporation's books. The remaining classes generally consist of liabilities that are treated as liabilities of a U.S. trade or business for regulatory or income tax purposes, that are predominantly secured by U.S. assets, or that give rise to certain nondeductible interest, such as capitalized interest, that is related to U.S. assets.

Section 1.884–4T(b)(2) generally requires that interest with respect to the class of liabilities that is booked to the U.S. trade or business must be treated as interest paid by a U.S. trade or business in all subsequent years.

Section 1.884–4T(b)(3) provides generally that liabilities in the class of liabilities booked to the U.S. trade or business will not give rise to interest paid by a U.S. trade or business of a foreign corporation if the foreign corporation receives a tax benefit from a foreign country with respect to the interest that is inconsistent with the treatment of the interest as paid by a U.S. trade or business, the liability is incurred in the ordinary course of a trade or business conducted by the foreign corporation outside the United States (subject to a special rule for bank deposits over $100,000), or the liability is predominantly secured by assets that are not U.S. assets.

Section 1.884–4T(b)(4) provides that interbranch liabilities are not treated as interest paid by a U.S. trade or business.

Section 1.884–4T(b)(5) generally requires that if 80 percent or more of a foreign corporation's assets are U.S. assets, the amount of interest paid by a U.S. trade or business will be increased, if necessary, to equal the foreign corporation's interest deduction under § 1.882–5 and its nondeductible interest. Where a foreign corporation conducts its business primarily in the United States, it comports more closely with economic reality to treat the foreign corporation's interest payments as being made from a domestic corporation to the actual recipients of the interest payments (*i.e.*, as interest paid by a U.S. trade or business) rather than to the foreign corporation (*i.e.*, as excess interest).

Section 1.884–4T(b)(6) generally provides for a reduction in interest paid by a U.S. trade or business of a foreign corporation where such interest exceeds the amount of the interest deduction allowed to the foreign corporation under § 1.882–5 and the amount of any nondeductible interest paid by a U.S. trade or business during the taxable year. Ordering rules are given for the reduction.

Section 1.884–4T(b)(7) permits a foreign corporation to elect to reduce its excess interest by the amount of interest paid by a U.S. trade or business that accrues in a different taxable year than the year in which the interest is paid. Under this election, the interest is treated as interest paid by a U.S. trade or business in the earlier of the year it is paid or accrues. This election prevents the same interest payment from being included as both interest paid by a U.S. trade or business and excess interest.

Section 1.884–4T(b)(8) describes the effect of treaties on interest paid by a U.S. trade or business. Section 1.884–4T(b)(8)(i) generally provides that relief is available under the payor foreign corporation's income tax treaty only if the foreign corporation is a qualified resident (as defined in § 1.884–5T(a)) of the treaty country for the taxable year in which the interest is paid or for the prior year and the portion of the current year that ends with the date of payment, or meets the requirements of the treaty's limitation on benefits article and the article entered into force after December 31, 1986. Section 1.884–4T(b)(8)(ii) generally provides that relief is available under a recipient foreign

corporation's income tax treaty under the tests described in the preceding sentence applied with respect to the recipient. Section 1.884–4T(b)(6)(iii) reserves with respect to the effect of treaties other than income tax treaties (such as Friendship, Commerce and Navigation treaties) on interest paid by a U.S. trade or business in view of the pending technical corrections bill.

Section 1.884–4T(c) provides rules for the computation of the tax on excess interest. Section 1.884–4T(c)(2) provides generally that a foreign corporation's distributive share of partnership interest will reduce the foreign corporation's excess interest. Under this rule, interest paid by the partnership is treated as if it were paid directly by the foreign corporation for purposes of determining the amount of the foreign corporation's excess interest, and interest paid by the partnership is not subject to taxation both under section 871(a) or 881 and as excess interest.

Section 1.884–4T(c)(3) provides that excess interest of a foreign corporation that is a qualified resident of a treaty country is taxed at a rate not exceeding the reduced rate of tax or exemption provided under such treaty for interest paid by a domestic corporation to a resident of the treaty country. However, exemptions or reduced rates of tax under treaty provisions dealing with interest paid by a resident of the treaty country do not apply to excess interest. The regulations reserve with respect to treaties other than income tax treaties. Section 1.884–4T(c)(3) does not address, the effect, if any, of non-discrimination provisions in income tax treaties. This issue is presently under consideration in connection with the forthcoming Treasury Department study of the tax treaty program.

Qualified Resident

Section 1.884–5T(a) provides that a foreign corporation that is a resident of a foreign country for purposes of an income tax treaty if a qualified resident of that country if either (1) it meets a stock ownership and base erosion test; (2) it is publicly-traded in its country of residence or in the United States; (3) it is engaged in the active conduct of a trade or business in its country of residence; or (4) it obtains a ruling that its establishment or maintenance in its country of residence is not for the purpose of obtaining treaty benefits.

Section 1.884–5T(b)(1) provides generally that a foreign corporation meets the ownership test if at least 50 percent (by value) of its stock is owned by individual residents of the foreign corporation's country of residence, or by U.S. citizens or residents, during at least half of the number of days in the foreign corporation's taxable year and it obtains the documentation required under § 1.884–5T(b)(3) to show that the ownership test has been met. The technical corrections bill would require more than 50 percent qualified ownership.

Section 1.884–5T(b)(2) sets forth constructive ownership rules under which stock owned by entities is treated as owned by individuals. Section 1.884–5T(b)(2)(i) provides rules for determining the extent to which stock owned indirectly by an individual through a corporation, partnership, trust or estate is treated as being owned by the individual. Section 1.884–5T(b)(2)(ii) treats stock owned by the government of a country as if it were owned by individual residents of that country.

Section 1.884–5T(b)(2)(iii) generally treats stock owned by a corporation that is publicly traded in its country of residence as if it were owned by individual residents of that country. Section 1.884–5T(b)(2)(iv) generally treats a class of stock of a corporation that is publicly traded in the corporation's country of residence as if it were owned by individual residents of that country.

Section 1.884–5T(b)(3) indicates the documentation a foreign corporation is required to obtain in order to establish that it satisfies the ownership test. This documentation may take one of two forms: Individual documentation (certification of the individual's direct or indirect stock ownership and residency) or an intermediary verification statement (certification by an intermediary that owns (directly or indirectly) stock of the foreign corporation that it holds individual documentation from an indirect individual shareholder of the foreign corporation). The purpose of the intermediary verification statement is to permit an individual who owns stock in a foreign corporation through a nominee, holding company, or other entity to preserve anonymity vis-a-vis the foreign corporation. Where stock of a foreign corporation is held indirectly by an individual, any intermediaries standing in the chain of the individual's ownership of stock in a foreign corporation must furnish an intermediary ownership statement declaring its direct ownership of another intermediary in the chain of ownership or its direct ownership of the stock of the foreign corporation.

Section 1.884–5T(c) describes the base erosion test, which generally requires that not more than 50 percent of a foreign corporation's income for the taxable year be used to meet liabilities to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the foreign corporation's country of residence and who are not U.S. citizens or residents (or, in the case of corporations, qualified residents).

Section 1.884–5T(d) prescribes rules under which a foreign corporation whose stock is primarily and regularly traded on one or more established securities markets in the foreign corporation's country of residence or the United States is treated as a qualified resident of its country of residence. In addition, a foreign corporation is treated as a qualified resident of its country of residence if 90 percent of its stock (by value and voting power) is owned by another corporation that is a resident of the same foreign country and whose stock is primarily and regularly traded on one or more established securities markets in that country or in the United States.

Section 1.884–5T(d)(2)(i) defines the term "established securities market" to include a foreign securities exchange that is officially recognized or supervised by a governmental authority in the country in which the exchange is located, is the principal exchange in that country, and has an annual share turnover exceeding $1 billion. A domestic exchange that is a national securities exchange registered under the Securities Act of 1934 and a domestic over-the-counter market are also treated as established securities markets.

Section 1.884–5T(d)(2)(v) gives the Commissioner authority to treat a foreign securities exchange that does not come within the definition of an established securities market but has the attributes of such a market as an established securities market. Similarly, § 1.884–5T(d)(2)(vi) gives the Commissioner authority to disqualify a foreign securities exchange that meets the definition of an established securities exchange but does not have adequate listing, financial disclosure or trading requirements, or does not enforce such requirements.

Section 1.884–5T(d)(3) provides that stock of a foreign corporation is primarily traded on an established securities market in its country of residence if more than 80 percent of the voting power and value of the stock of the foreign corporation is listed and regularly traded on one or more established securities markets and the volume of trading (on a class-by-class basis) on one or more established securities markets in the country of residence and in the United States exceeds the volume of trading on

established securities markets in any other foreign country.

Section 1.884–5T(d)(4)(i) states that a class of stock is regularly traded on an established securities market if stock in that class is traded, other than in *de minimis* quantities, on at least 60 days during the taxable year and there is a turnover during the taxable year equal to at least 30 percent of the shares in the class. In the case of a foreign corporation with 2,500 or more shareholders of record, the turnover requirement is reduced to 10 percent.

Under § 1.884–5T(d)(4)(ii), a class of stock that would otherwise be treated as regularly traded will not be treated as regularly traded if 100 or fewer persons own 50 percent or more of the outstanding shares of such class.

Section 1.884–5T(d)(4)(iii) contains an anti-abuse rule that disregards trades between related persons and trades conducted so that the class will meet the regularly traded requirement.

Section 1.884–5T(e) generally provides that a foreign corporation is treated as a qualified resident of its country of residence if it has a substantial presence in that country and conducts a U.S. trade or business that is an integral part of a trade or business that is actively conducted in that country.

Section 1.884–5T(e)(2) states that a foreign corporation is engaged in the active conduct of a trade or business if it meets the requirements of the regulations under section 367(a)(3). Special rules are provided for banks and insurance companies.

Under § 1.884–5T(e)(3), whether a foreign corporation has a substantial presence in its country of residence is determined by comparing the ratio of the assets, gross income and payroll expense of its active trades or businesses in its country of residence to its worldwide assets, gross income and payroll expenses. If each ratio is at least equal to 20 percent and the average of the ratios exceeds 25 percent, the foreign corporation has a substantial presence in its country of residence.

Section 1.884–5T(e)(4)(i) provides that a U.S. trade or business of a foreign corporation is an integral part of a trade or business that is actively conducted by the foreign corporation in its country of residence if the businesses are complementary and mutually interdependent steps in the production and sale or lease of goods, or the performance of services. If the U.S. trade or business sells goods that are not manufactured, grown or extracted by the foreign corporation in its country of residence, the business in no event shall be treated as an integral part of a trade or business actively conducted in the foreign corporation's country of residence if the foreign corporation does not take physical possession of the goods in its country of residence.

Section 1.884–5T(e)(4)(ii) treats a U.S. trade or business as an integral part of a trade or business that is actively conducted by a foreign corporation in its country of residence if the type of goods sold or services performed by the trade or business are substantially sold for consumption or disposition (or performed) in the foreign corporation's country of residence.

Section 1.884–5T(f) generally gives the Commissioner authority to rule that a foreign corporation will be treated as a qualified resident of its country of residence if the Commissioner determines that the establishment or maintenance of the foreign corporation in its country of residence does not have as one of its principal purposes obtaining benefits under the income tax treaty between the United States and that country.

Special Analyses

It has been determined that this temporary regulation is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Therefore, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these regulations is Richard M. Elliott of the Office of the Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.861-1 through 1.997-1

Income taxes, Corporate deductions, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, FSC, Sources of income, U.S. investments abroad.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 1 and 602 are 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 adding the following citations:

Authority: 26 U.S.C. 7805. * * * Sections 1.884–0T through 1.884–5T also issued under 26 U.S.C. 884(g). * * *

Section 1.884–1T(d) also issued under 26 U.S.C. 884(c)(2)(A). * * * Section 1.884–1T(c) also issued under 26 U.S.C. 884(c)(2)(B) * * *

Section 1.884–1T(d)(13)(i) also issued under 26 U.S.C. 884(c)(2) * * * Section 1 884–5T (e) and (f) also issued under 26 U.S.C. 884(e)(4)(C). * * *

Par. 2. New §§ 1.884–0T through 1.884–5T are added immediately following § 1.883–1 to read as follows:

§ 1.884–0T Branch Tax. (temporary)

(a) *Introduction.* Section 884 consists of three main parts: A branch profits tax on certain earnings of a foreign corporation's U.S. trade or business; a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business; and an anti-treaty shopping rule. For purposes of the regulations under section 884, the term "a U.S. trade or business" includes all the U.S. trades or businesses of a foreign corporation.

(1) *The branch profits tax.* Section 1.884–1T provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, section 884(a) imposes a 30-percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings have been reinvested in, or disinvested from, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior year's earnings that have not previously been subject to the branch profits tax. The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. Section 1.884–2T contains special rules relating to the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(2) *The branch-level interest tax.* Section 1.884–4T provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business (as defined in § 1.884–4T(b)) of a foreign corporation is treated as if it were paid by a domestic corporation and may be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442. In addition, if the interest allowable as a deduction under § 1.882–5 in computing a foreign corporation's effectively connected taxable income exceeds certain interest paid by a U.S. trade or business of the foreign corporation, the excess is treated as interest paid to the foreign corporation by a wholly-owned domestic corporation and is subject to tax under section 881(a).

(3) *Qualified residents.* Section 1.884–5T provides rules for determining whether a foreign corporation is a qualified resident of a foreign country. In general, a foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

(b) *Outline of topics in §§ 1.884–1T through 1.884–5T.* This paragraph lists the headings in §§ 1.884–1T through 1.884–5T.

§ 1.884–1T Branch Profits Tax. (temporary)

(a) General rule
(b) Dividend equivalent amount
  (1) Definition
  (2) Adjustment for increase in U.S. net equity
  (3) Adjustment for decrease in U.S. net equity
    (i) In general
    (ii) Limitation based on non-previously taxed accumulated effectively connected earnings and profits
  (4) Examples
(c) U.S. net equity
(d) U.S. assets
  (1) General rule
  (2) Depreciable and amortizable property
  (3) Inventory
  (4) Receivables arising from the sale of inventory, performance of services, or lease of property
  (5) U.S. real property interests
    (i) In general
    (ii) Shared appreciation loans and similar interests
  (6) Money
  (7) Installment obligations
  (8) Marketable securities
  (9) Partnership interests
    (i) General rule
    (ii) Computation of basis in partnership
    (iii) Computation of share of partnership liabilities
    (iv) Partnership operated to increase a foreign corporation's U.S. assets artificially
    (v) Example
  (10) Trusts and Estates
  (11) Election to treat expansion capital as a U.S. asset
    (i) General rule
    (ii) Treatment of income from deemed U.S. assets
    (iii) Method of election
    (iv) Ruling to permit an increase in expansion capital in cases of involuntary conversion
  (12) Losses involving U.S. assets
  (13) Property that is not a U.S. asset
    (i) Property that does not give rise to effectively connected earnings and profits
    (ii) Section 864(c)(7) property
    (iii) Assets acquired to increase U.S. net equity artificially
  (14) Examples
(e) U.S. liabilities
  (1) General rule
  (2) Liabilities of a partnership
  (3) Artificial decrease in U.S. liabilities
(f) Effectively connected earnings and profits
  (1) In general
  (2) Income that does not produce effectively connected earnings and profits
  (3) Allocation of deductions attributable to income that does not produce effectively connected earnings and profits
  (4) Examples
(g) Special rule for foreign insurance companies
(h) Corporations resident in countries with which the United States has an income tax treaty
  (1) General rule
  (2) Special rules for foreign corporations that are qualified residents on the basis of their ownership
    (i) General rule
    (ii) Rules of application
  (3) Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987
  (4) Modifications with respect to other income tax treaties
    (i) Limitation on rate of tax
    (ii) Limitations other than rate of tax
    (iii) Limitations under the Canadian treaty
  (5) Benefits under treaties other than income tax treaties
  (6) Example
(i) Stapled entities
(j) Effective date

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) Complete termination of a U.S. trade or business
  (1) General rule
  (2) Operating rules
    (i) Definition of complete termination
    (ii) Waiver of period of limitations
    (iii) Property subject to reinvestment prohibition rule
    (iv) Related corporation
    (v) Direct or indirect use of U.S. assets
  (3) Complete termination in the case of a section 338 election
  (4) Complete termination in the case of a foreign corporation with income under section 864 (c)(6) or (c)(7)
  (5) Coordination with second-level withholding tax
(b) Election to remain engaged in a U.S. trade or business
(c) Liquidation, reorganization, etc. of a foreign corporation
  (1) Inapplicability of paragraph (a)(1) to section 381(a) transactions
  (2) Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs
    (i) U.S. net equity
    (ii) Effectively connected earnings and profits
    (iii) Waiver of period of limitations and transferee agreement
  (3) Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381(a) transaction occurs
  (4) Earnings and profits of the transferor carried over to the transferee pursuant to the section 381(a) transaction
    (i) Amount
    (ii) Retention of character
    (iii) Treatment of distributions by a domestic transferee out of non-previously taxed accumulated effectively connected earnings and profits
  (5) Determination of U.S. net equity of a transferee that is a foreign corporation
  (6) Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor
    (i) General rule
    (ii) Operating rule
(d) Incorporation under section 351
  (1) In general
  (2) Inapplicability of paragraph (a)(1) of this section to section 351 transactions
  (3) Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs
    (i) U.S. net equity
    (ii) Effectively connected earnings and profits
    (iii) Limitation on dividend equivalent amount
  (4) Election to increase earnings and profits
    (i) General rule
    (ii) Amount of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee
    (iii) Effect of election on transferor
  (5) Dispositions of stock or securities of the transferee by the transferor
    (i) General rule
    (ii) Exception for certain tax-free dispositions
    (iii) Distribution governed by section 355
    (iv) Filing of statement
  (6) Example
(e) Certain transactions with respect to a domestic subsidiary
(f) Effective date

§ 1.884–1T Branch Profits Tax (temporary).

(a) *General rule.* A foreign corporation shall be liable for a branch profits tax in an amount equal to 30 percent of the foreign corporation's dividend equivalent amount for the taxable year. The branch profits tax shall be in addition to the tax imposed by section 882 and shall be reported on a foreign corporation's income tax return for the taxable year. The tax shall be due and payable as provided in section 6151 and such other provisions of Subtitle F of the Internal Revenue Code as apply to the income tax liability of corporations. However, no estimated tax payments shall be due with respect to a foreign corporation's liability for the branch profits tax. See paragraph (h) of this section for the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty, and § 1.884–2T for the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(b) *Dividend equivalent amount*—(1) *Definition.* The term "dividend equivalent amount" means a foreign corporation's effectively connected earnings and profits (as defined in paragraph (f)(1) of this section) for the taxable year subject to the adjustments in paragraphs (b) (2) and (3) of this section. The dividend equivalent amount cannot be less than zero.

(2) *Adjustment for increase in U.S. net equity.* If a foreign corporation's U.S. net equity (as defined in paragraph (c) of this section) as of the close of the taxable year exceeds the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's effectively connected earnings and profits for the taxable year shall be reduced (but not below zero) by the amount of such excess.

(3) *Adjustment for decrease in U.S. net equity*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section and in § 1.884–2T, if a foreign corporation's U.S. net equity as of the close of the taxable year is less than the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's effectively connected earnings and profits for the taxable year shall be increased by the amount of such difference.

(ii) *Limitation based on non-previously taxed accumulated effectively connected earnings and profits.* The increase of a foreign corporation's effectively connected earnings and profits under paragraph (b)(3)(i) of this section shall not exceed the non-previously taxed accumulated effectively connected earnings and profits of the foreign corporation as of the close of the preceding taxable year. The term "non-previously taxed accumulated effectively connected earnings and profits" means the excess of the aggregate amount of effectively connected earnings and profits of a

foreign corporation for preceding taxable years over the aggregate dividend equivalent amounts for such preceding taxable years. The aggregate amount of effectively connected earnings and profits for preceding taxable years shall not include effectively connected earnings and profits for taxable years beginning before January 1, 1987.

(4) *Examples.* The principles of paragraphs (b) (2) and (3) of this section are illustrated by the following examples.

Example (1). Foreign corporation A, a calendar year taxpayer, had $1,000 U.S. net equity as of the close of 1986 and $100 of effectively connected earnings and profits for 1987. A acquires $100 of additional U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,100. In computing A's dividend equivalent amount for 1987, A's effectively connected earnings and profits of $100 are reduced under paragraph (b)(2) of this section by the $100 increase in U.S. net equity between the close of 1986 and the close of 1987. A has no dividend equivalent amount for 1987.

Example (2). Assume the same facts as in *Example (1)* for 1987. A has no effectively connected earnings and profits for 1988. A's U.S. net equity decreases by $40 during 1988 and its U.S. net equity is $1,060 as of the close of 1988. A has a dividend equivalent amount of $40 for 1988, even though it has no effectively connected earnings and profits for 1988. A's effectively connected earnings and profits of $0 for 1988 are increased under paragraph (b)(3)(i) of this section by the $40 reduction in U.S. net equity (subject to the limitation in paragraph (b)(3)(ii) of this section of $100 of non-previously taxed accumulated effectively connected earnings and profits).

Example (3). Assume the same facts as in *Example (1)* except that A acquires $40 of U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,040. In computing A's dividend equivalent amount for 1987, A's effectively connected earnings and profits of $100 are reduced under paragraph (b)(2) of this section by the $40 increase in U.S. net equity between the close of 1986 and the close of 1987. A has a dividend equivalent amount of $60 for 1987.

Example (4). Assume the same facts as in *Example (3)* for 1987. For 1988, A has $125 of effectively connected earnings and profits and its U.S. net equity decreases by $50. A's U.S. net equity as of the close of 1988 is $990 ($1,040–$50). In computing A's dividend equivalent amount, the $125 of effectively connected earnings and profits for 1988 is not increased under paragraph (b)(3)(i) by the full amount of the $50 decrease in U.S. net equity during 1988, because the increase in effectively connected earnings and profits resulting from a decrease in U.S. net equity is limited to A's non-previously taxed accumulated effectively connected earnings and profits as of the close of 1987. A had $100 of effectively connected earnings and profits for 1987 and a dividend equivalent amount of $60 for that year, so A has $40 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1987. The increase in effectively connected earnings and profits resulting from a decrease in U.S. net equity is thus limited to $40, and the dividend equivalent amount for 1988 is $165 ($125 effectively connected earnings and profits + $40 decrease in U.S. net equity).

Example (5). (i) Foreign corporation A, a calendar year taxpayer, has $150 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1990, and has a $90 deficit in effectively connected earnings and profits for 1991. A has U.S. net equity of $450 as of the close of 1990 and U.S. net equity of $350 as of the close of 1991 (*i.e.*, a $100 decrease in U.S. net equity). A has a dividend equivalent amount of $10 for 1991, resulting from A's deficit of $90 in effectively connected earnings and profits for 1991 increased by $100, the decrease in A's U.S. net equity during 1991. A portion of the reduction in U.S. net equity in 1991 is attributable to A's deficit in effectively connected earnings and profits for that year and triggers a dividend equivalent amount only to the extent the reduction in U.S. net equity exceeds the current year deficit in effectively connected earnings and profits for 1991.

(ii) For 1992, A has no effectively connected earnings and profits and its U.S. net equity decreases by $150 (to $200) during the year. Because A has no effectively connected earnings and profits for 1992, its dividend equivalent amount for the year is equal to the decrease in U.S. net equity during the year ($150) limited to the amount of its non-previously taxed accumulated effectively connected earnings and profits as of the close of the preceding taxable year. A has $50 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1991 (*i.e.*, its non-previously taxed accumulated effectively connected earnings and profits of $150 as of the close of 1990 less its $90 deficit in earnings and profits for 1991 less its dividend equivalent amount of $10 for 1991) and therefore has a dividend equivalent amount of $50 for 1992.

Example (6). Foreign corporation A, a calendar year taxpayer, had a deficit in effectively connected earnings and profits of $100 for 1987 and $100 for 1988, and has $90 of effectively connected earnings and profits for 1989. A had $2,000 U.S. net equity as of the close of 1988 and has $2,000 U.S. net equity as of the close of 1989. A has a dividend equivalent amount of $90 for 1989, its effectively connected earnings and profits for the year, even though it has a net deficit of $110 in effectively connected earnings and profits for the period 1987–1989.

(c) *U.S. net equity.* The term "U.S. net equity" means, as of the close of the taxable year, the U.S. assets (as defined in paragraph (d)(1) of this section) of a foreign corporation on such date reduced (including below zero) by the U.S. liabilities (as defined in paragraph (e)(1) of this section) of the foreign corporation on such date.

(d) *U.S. assets*—(1) *General rule.* Except as provided in paragraphs (d)(13) and (g) of this section, the term "U.S. assets" means—

(i) Property of a corporation that is described in paragraphs (d) (2) through (12) of this section and is held by the foreign corporation on the day on which a determination of whether the property is a U.S. asset is made (the "determination date"), and

(ii) Property of a foreign corporation (other than property described in paragraph (d)(1)(i) of this section) that is held on the determination date if all income from the use, and all gain from the disposition, of the property on the determination date is effectively connected with the conduct of a trade or business in the United States (or would be effectively connected if the property were used or sold on that date). Except as otherwise specifically provided in this paragraph (d), the amount of a U.S. asset shall be the adjusted basis of property for purposes of computing earnings and profits, and the taxable year referred to in this paragraph (d) shall be the taxable year in which the determination date falls. Income that is effectively connected with the conduct of a trade or business in the United States includes income that is treated as effectively connected income under any provision of the Code. See paragraph (d)(13)(ii) of this section regarding property described in section 864(c)(7).

(2) *Depreciable and amortizable property.* Depreciable personal property (other than a U.S. real property interest described in section 897(c)(1)(A)(i)) and amortizable intangible property shall be treated as a U.S. asset of a foreign corporation in the same proportion that the amount of the depreciation or amortization with respect to the property that is allowable as a deduction, or is includible in cost of goods sold, for the taxable year in computing the taxable income of the foreign corporation that is effectively connected with the conduct of a trade or business in the United States bears to the total amount of depreciation or amortization computed for the taxable year with respect to the property.

(3) *Inventory.* Inventory property (as defined in section 865(h)(1)) held on the determination date shall be treated as a U.S. asset in the same proportion that the anticipated amount of gross sales from the sale or exchange of the property that is reasonably anticipated to be effectively connected with the conduct of a trade or business in the United States bears to the anticipated total amount of gross sales from the sale or exchange of the property.

(4) *Receivables arising from the sale of inventory, performance of services, or*

lease of property. An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the sale or exchange of inventory property (as defined in section 865(h)(1)) or from the performance of services or the leasing of property in the ordinary course of a foreign corporation's trade or business shall be treated as a U.S. asset of the foreign corporation in the same proportion that the amount of gross income represented by the receivable that is effectively connected with the conduct of a trade or business in the United States bears to the total amount of gross income represented by the receivable.

(5) *U.S. real property interests*—(i) *In general.* A U.S. real property interest described in section 897(c)(1)(A)(i) shall be treated as a U.S. asset.

(ii) *Shared appreciation loans and similar interests.* [Reserved]

(6) *Money.* Money needed in a U.S. trade or business within the meaning of § 1.864–4(c)(2)(iii)(*a*) shall be treated as a U.S. asset.

(7) *Installment obligations.* An obligation received in connection with the installment sale (as defined in section 453(b)) of a U.S. asset shall be treated as a U.S. asset in an amount equal to the sum of—

(i) The amount of income that would be effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States if the obligation were satisfied in full on the determination date and

(ii) The basis of the obligation on such date (as determined for purposes of section 453B) attributable to the amounts that would be treated as income that is effectively connected with the conduct of a trade or business in the United States, if the obligation were satisfied in full on the determination date.

(8) *Marketable securities.* Except as provided in paragraph (d)(11) of this section (relating to expansion capital) and in § 1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business, or the reorganization or liquidation of a foreign corporation or its domestic subsidiary), a marketable security shall be treated as a U.S. asset only if all of the income derived from such security during the taxable year is effectively connected with the conduct of a trade or business in the United States and either—

(i) Any gain or loss from the sale or exchange of the security on the determination date would be effectively connected with the conduct of a trade or business in the United States, or

(ii) Such security had a yield for the taxable year (or for the portion of the taxable year during which the security was held) of at least 50 percent of the average of the monthly Federal short-term rates (as determined under section 1274(d)(1)(C)(i)) during such period.

The yield of a marketable security means, for purposes of this paragraph (d)(8), the ratio of gross amounts derived by the foreign corporation during the taxable year from the security (including income accrued or imputed with respect to such security under any provision of the Code, or regulations thereunder) to the adjusted basis of such security on the determination date. For purposes of this paragraph (d), the term "marketable security" means a security (including stock) that is part of an issue any portion of which is regularly traded on an established securities market (within the meaning of § 1.884–5T(d) (2) and (4)) and a deposit described in section 871(i)(3) (A) or (B).

(9) *Partnership interests*—(i) *General rule.* Except as provided in paragraph (d)(9)(iv) of this section, a foreign corporation that is a partner in a partnership shall be treated as having a U.S. asset in an amount equal to the product of the foreign corporation's adjusted basis in the partnership interest (as determined under paragraph (d)(9)(ii) of this section) and the ratio of its distributive share of partnership gross income for the taxable year that is effectively connected with the conduct of a trade or business in the United States to its distributive share of all partnership gross income for the taxable year.

(ii) *Computation of basis in partnership.* For purposes of this section, a foreign corporation's adjusted basis in a partnership interest shall be the foreign corporation's basis in such interest (as determined under section 705)—

(A) Reduced by the foreign corporation's share of the liabilities of the partnership (as determined under section 752),

(B) Increased by the foreign corporation's share of the liabilities of the partnership (as determined under paragraph (d)(9)(iii) of this section), and

(C) Adjusted to take into account any differences between the foreign corporation's distributive share of partnership income, gain, or loss for purposes of computing the taxable income of the foreign corporation and the foreign corporation's distributive share of partnership income, gain, or loss from the partnership for purposes of computing the earnings and profits of the foreign corporation.

(iii) *Computation of share of partnership liabilities.* For purposes of this section, a foreign corporation shall share in any liability of a partnership in the same proportion that it shares for income tax purposes in the interest expenses attributable to such liability for the taxable year.

(iv) *Partnership operated to increase a foreign corporation's U.S. assets artificially.* If the district director determines that one of the principal purposes of the acquisition of a partnership interest or the acquisition or ownership of certain properties by a partnership is to increase the U.S. assets of a foreign corporation artificially, the district director may compute the portion of the foreign corporation's interest in the partnership that is a U.S. asset using a method that more accurately reflects the foreign corporation's interest in partnership properties that would be U.S. assets if held directly by the foreign corporation. Whether a partnership interest is acquired, or partnership property is acquired or owned, for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered include whether the partnership conducts unrelated businesses or whether the partnership accumulates investment property unrelated to its trade or business or liquid assets in excess of the reasonable needs of its business. For purposes of this paragraph (d)(9)(iv), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(v) *Example.* The application of paragraph (d)(9)(iv) of this section is illustrated by the following example.

Example. Foreign corporation A is a partner in partnership X and is entitled to 50 percent of the income of X and 50 percent of the value of all property of X upon X's liquidation. X is engaged in an active U.S. real estate business which, during the taxable year, produces $100 of gross income that is effectively connected with the conduct of a trade or business in the United States. In the same taxable year, X acquires securities (from funds that are either generated by its business, borrowed or contributed) that produce $50 of gross income not effectively connected with the conduct of a trade or business in the United States. The securities are unrelated to the real estate business and substantially exceed the reasonable needs of the business. The real estate and the securities each have an adjusted basis of $1,000. Under paragraph (d)(9)(i) of this section, two-thirds (50/75) of A's distributive share of partnership gross income is effectively connected with the conduct of a trade or business in the United States, and two-thirds of A's basis in its partnership interest (as determined under paragraph

(d)(9)(ii) of this section) would therefore be treated as a U.S. asset. However, because the securities acquired by X are unrelated to X's real estate business and exceed the reasonable needs of the business, the district director may determine that a principal purpose of X's acquisition of the securities is to increase artificially the U.S. assets of A. The district director may, therefore, compute the portion of A's interest in X that is treated as a U.S. asset by, for example, using the ratio of A's pro rata share of the adjusted basis of the property of X that produces income that is effectively connected with the conduct of a trade or business in the United States ($500) to A's pro rata share of all property of X ($1,000). As a result, A would be treated as having a U.S. asset in an amount equal to half of A's basis in X (as determined under paragraph (d)(9)(ii) of this section).

(10) *Trusts and Estates.* [Reserved]

(11) *Election to treat expansion capital as a U.S. asset*—(i) *General rule.* A foreign corporation may elect, for any taxable year, to treat as U.S. assets marketable securities (as defined in paragraph (d)(8) of this section) that are not otherwise U.S. assets provided that the fair market value of each such security on the date the security is identified as a U.S. asset under paragraph (d)(11)(iii) of this section is not less than its adjusted basis on such date. The adjusted basis of marketable securities that may be treated as U.S. assets for any taxable year shall not exceed 25 percent of the sum of the foreign corporation's effectively connected earnings and profits for the taxable year and the non-previously taxed accumulated effectively connected earnings and profits attributable to the two preceding taxable years. The securities must be held for the entire taxable year following the year for which the election is made or, if disposed of during that taxable year, must be replaced on the date of disposition by other marketable securities that are purchased on or before such date, or are received in exchange for the securities that have been disposed of, and the fair market value of which as of the date of substitution is not less than their adjusted basis.

(ii) *Treatment of income from deemed U.S. assets.* The income or gain from marketable securities subject to an election under this paragraph (d)(11) that arises in the taxable year following the taxable year for which the election is made shall be treated as effectively connected with the conduct of a trade or business in the United States (other than for purposes of section 864(c)(7)), and losses from the disposition of such marketable securities shall be allocated entirely to income that is effectively connected with the conduct of a trade or business in the United States. The marketable securities that are held on the last business day of the following taxable year shall be treated as sold for their fair market value on that day, and any gain (but not loss) and accrued interest shall be taken into account in such following taxable year as income that is effectively connected with the conduct of a trade or business in the United States. The adjusted basis of such property shall be increased by the amount of any gain recognized by reason of this paragraph (d)(11).

(iii) *Method of election.* An election under this paragraph (d)(11) to treat marketable securities as U.S. assets may be made only with respect to securities identified on the books and records of the U.S. trade or business within 30 days after the close of the taxable year for which the election is made. The election shall be made by the foreign corporation for any taxable year by attaching to its income tax return for the taxable year a statement—

(A) Identifying the marketable securities that it elects to treat as U.S. assets under this paragraph (d)(11),

(B) Setting forth the adjusted bases of such securities, and

(C) Agreeing to treat any income, gain or loss from such securities (or replacement securities) as provided in paragraph (d)(11)(ii) of this section. Such statement must be filed on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year. For taxable years ending on or before December 1, 1988, the election may be made, and securities identified on the books and records of the foreign corporation, on the later of the date on which the return is due (including extensions) or 120 days after September 2, 1988.

(iv) *Ruling to permit an increase in expansion capital in cases of involuntary conversion.* If property that is a U.S. asset of a foreign corporation is compulsorily or involuntarily converted into property not similar or related in service or use to the converted property, the foreign corporation may apply to the Commissioner for a ruling to increase the amount of marketable securities that may be treated as U.S. assets. The Commissioner may prescribe terms and conditions for the treatment of marketable securities as U.S. assets under this paragraph (d)(11)(iv).

(12) *Losses involving U.S. assets.* If a foreign corporation sustains a loss with respect to property that is a U.S. asset and is not allowed a deduction under section 165 for the entire amount of the loss because there exists a reasonable prospect of recovering compensation for the loss, the property shall be treated as a U.S. asset from the date of the loss in an amount equal to its adjusted basis immediately before the loss reduced (but not below zero) by—

(i) The amount of any deduction claimed under section 165 by the foreign corporation with respect to the loss and

(ii) Any compensation received with respect to the loss.

(13) *Property that is not a U.S. asset*—(i) *Property that does not give rise to effectively connected earnings and profits.* U.S. assets shall not include property of a foreign corporation if, on the determination date, income from the use of the property, or gain or loss from the disposition of the property, would be described in paragraph (f)(2) of this section (relating to certain income that does not produce effectively connected earnings and profits).

(ii) *Section 864(c)(7) property.* U.S. assets shall not include property that would qualify as a U.S. asset under the provisions of paragraph (d)(1) of this section solely by reason of section 864(c)(7) (relating to the tax treatment of property that ceases to be used or held for use in connection with a U.S. trade or business).

(iii) *Assets acquired to increase U.S. net equity artificially.* U.S. assets shall not include money or property acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether money or property is acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using such property is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from, or disposed of to, a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on the determination date. For purposes of this paragraph (d)(13)(iii), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(14) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

Example (1). Foreign corporation A, a calendar year taxpayer, is engaged in a trade or business in the United States. A owns equipment that is used in its manufacturing business in country X and in the United

States. The equipment has an adjusted basis (for purposes of computing earnings and profits) of $100 at the beginning of 1987. Under § 1.861–8, A's depreciation deduction is allocated to sales income and is apportioned 70 percent to income that is effectively connected with the conduct of a trade or business in the United States and 30 percent to income that is not effectively connected with the conduct of a trade or business in the United States. A's depreciation deduction (for purposes of computing earnings and profits) with respect to the equipment is $10. As of the close of 1987, the machine is treated as a U.S. asset with an adjusted basis of $63 (*i.e.*, 70 percent of $100 reduced by $7 of depreciation in 1987).

Example (2). (i) For 1987, foreign corporation A, a calendar year taxpayer, has $100 of effectively connected earnings and profits and has no non-previously taxed accumulated effectively connected earnings and profits. A elects under paragraph (d)(11) of this section to treat marketable securities with an adjusted basis of $25 as U.S. assets (*i.e.*, 25 percent of its effectively connected earnings and profits for 1987), the maximum amount permitted. A also reinvests $75 in 1987 in other U.S. assets. As a result of the reinvestment and election, A has no dividend equivalent amount for 1987.

(ii) For 1988, A has $100 of effectively connected earnings and profits and $100 of non-previously taxed accumulated effectively connected earnings and profits attributable to its preceding taxable year. A elects to treat as U.S. assets marketable securities with an adjusted basis of $50 (*i.e.*, 25 percent of $200), the maximum amount permitted. A's U.S. net equity decreases by $20 during 1988 after taking into account the marketable securities which A elects to treat as U.S. assets. A's dividend equivalent amount for 1988 is $120 ($100 effectively connected earnings and profits increased by the $20 decrease in U.S. assets). The dividend equivalent amount in the current year does not affect the calculation of the amount of marketable securities that A may elect to treat as U.S. assets under paragraph (d)(11) of this section.

(iii) For 1989, A has $56 of effectively connected earnings and profits. Its non-previously taxed accumulated effectively connected earnings and profits attributable to the two preceding taxable years are $80 (*i.e.*, $200 of effectively connected earnings and profits for the two preceding taxable years, reduced by the dividend equivalent amount of $120 for its 1988 taxable year). Thus, the maximum amount of marketable securities that A may elect under paragraph (d)(12) of this section to treat as U.S. assets for 1989 is $34 (*i.e.*, 25 percent of the sum of $56 and $80).

Example (3). Foreign corporation A owns a condominium apartment in the United States. Assume that holding the apartment does not constitute a U.S. trade or business. The condominium apartment constitutes a U.S. asset of A by reason of paragraph (d)(5) of this section. Thus, the disposition by A of the condominium apartment at a gain may give rise to a branch profits tax liability unless the gain is exempt from the branch profits tax under paragraph (h)(1) of this section (relating to the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty) or § 1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation).

(e) *U.S. liabilities*—(1) *General rule.* The term "U.S. liabilities" means the product of (i) the U.S. assets of a foreign corporation as of the close of the taxable year and either (ii) the ratio of the foreign corporation's worldwide liabilities as of the close of the taxable year to its worldwide assets as of the close of the taxable year or, (iii) if the foreign corporation computes its interest deduction using a fixed ratio of liabilities to assets (as determined under § 1.882–5(b)(2)(i)), such fixed ratio. The asset valuation method used for purposes of this paragraph (e) must be the same asset valuation method used for determining the amount of the foreign corporation's interest deduction that is apportioned to effectively connected income under § 1.882–5.

(2) *Liabilities of a partnership.* If a foreign corporation is a partner in a partnership, the worldwide liabilities of the foreign corporation shall include, for purposes of this section, the foreign corporation's share of the liabilities of the partnership (as determined under paragraph (d)(9)(iii) of this section).

(3) *Artificial decrease in U.S. liabilities.* If a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to decrease artificially its U.S. liabilities on the determination date, then such decrease shall not be taken into account for purposes of computing the foreign corporation's U.S. net equity. Whether the U.S. liabilities of a foreign corporation are artificially decreased will depend on all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for the repayment or decrease of the liabilities is to decrease artificially the U.S. liabilities of a foreign corporation shall include whether the aggregate liabilities are temporarily decreased as of the close of the taxable year by, for example, the repayment of liabilities or the acquisition with contributed funds of passive-type assets that are not U.S. assets. For purposes of this paragraph (e)(3), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(f) *Effectively connected earnings and profits*—(1) *In general.* Except as provided in paragraph (f)(2) of this section and as modified by § 1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation or its domestic subsidiary), the term "effectively connected earnings and profits" means the earnings and profits (or deficits therein) determined under section 312 and this paragraph (f) that are attributable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected earnings and profits shall not be reduced by distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest (as defined in § 1.884–4T(a)(2)) paid by the foreign corporation. Earnings and profits are attributable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States regardless of whether the earnings and profits are taken into account under section 312 in an earlier or later taxable year than the taxable year in which the income is taken into account.

(2) *Income that does not produce effectively connected earnings and profits.* The term "effectively connected earnings and profits" shall not include any earnings and profits attributable to—

(i) Income excluded from gross income under section 883(a)(1) or 883(a)(2) (relating to certain income derived from the operation of ships or aircraft),

(ii) Income treated as effectively connected with the conduct of a trade or business in the United States under section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation or nonresident alien) that is not otherwise effectively connected with the conduct of a trade or business in the United States,

(iii) Gain on the disposition of a U.S. real property interest described in section 897(c)(1)(A)(ii) (relating to certain interests in a domestic corporation) that is not otherwise effectively connected with the conduct of a trade or business in the United States,

(iv) Income treated as effectively connected with the conduct of a trade or business in the United States under section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as effectively connected with the conduct of a trade or business in the United States) that is not otherwise effectively

connected with the conduct of a trade or business in the United States, and

(v) Income that is exempt from tax under section 892 and the regulations thereunder.

(3) *Allocation of deductions attributable to income that does not produce effectively connected earnings and profits.* In determining the amount of a foreign corporation's effectively connected earnings and profits for the taxable year, deductions and other adjustments shall be allocated and apportioned under the principles of § 1.861–8 between income that is effectively connected with the conduct of a trade or business in the United States and that gives rise to effectively connected earnings and profits and income described in paragraph (f)(2) of this section (relating to income that is effectively connected with the conduct of a trade or business in the United States but does not give rise to effectively connected earnings and profits).

(4) *Examples.* The principles of paragraph (f)(2) of this section are illustrated by the following examples.

Example (1). Foreign corporation A owns a tax-exempt municipal bond that is a U.S. asset as of the close of its 1989 taxable year. The municipal bond gives rise in 1989 to income that is effectively connected with the conduct of a trade or business in the United States (even though the income is excluded from gross income under section 103(a) and is not gross income of a foreign corporation by reason of section 882(b)), and therefore gives rise to effectively connected earnings and profits in 1989.

Example (2). Foreign corporation A derives income that is effectively connected with the conduct of a trade or business in the United States but is not included in A's gross income, and is exempt from tax, under section 894(a) because, under an income tax treaty, it constitutes business profits that are not attributable to a permanent establishment maintained by A in the United States. However, the income gives rise to effectively connected earnings and profits. Such earnings and profits may be exempt from the branch profits tax by reason of paragraph (h) of this section (relating to the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty).

(g) *Special rules for foreign insurance companies.* A foreign corporation described in section 842(a) (relating to foreign companies carrying on insurance business in the United States) that, for the taxable year, includes in taxable income net investment income as computed under section 842(b), shall—

(1) Treat as effectively connected earnings and profits for the taxable year the amount of minimum effectively connected investment income determined under section 842(b), as adjusted under section 312 to arrive at earnings and profits; and

(2) Determine its U.S. assets solely under this paragraph (g).

A foreign corporation described in this paragraph (g) shall have U.S. assets for the taxable year in which it includes in taxable income net investment income as computed under section 842(b) in an amount equal to the same proportion of the foreign corporation's worldwide assets as of the close of the taxable year that the sum of its effectively connected earnings and profits for the taxable year and non-previously taxed accumulated effectively connected earnings and profits bear to its worldwide current and accumulated earnings and profits for the taxable year.

(h) *Corporations resident in countries with which the United States has an income tax treaty*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a corporation that is a resident of a country with which the United States has an income tax treaty in effect for a taxable year in which it has a dividend equivalent amount and that meets the requirements, if any, of the limitation on benefits provisions of such treaty with respect to the dividend equivalent amount shall not be subject to the branch profits tax on such amount (or will qualify for a reduction in the amount of tax with respect to such amount) only if—

(i) The foreign corporation is a qualified resident of such country for the taxable year, within the meaning of § 1.884–5T(a) or

(ii) The limitation on benefits provisions entered into force after December 31, 1986.

(2) *Special rules for foreign corporations that are qualified residents on the basis of their ownership*—(i) *General rule.* A foreign corporation that, in any taxable year, is a qualified resident of a country with which the United States has an income tax treaty in effect solely by reason of meeting the requirements of § 1.884–5T (b) and (c) (relating, respectively, to stock ownership and base erosion) shall be exempt from the branch profits tax or subject to a reduced rate of branch profits tax under paragraph (h)(1) of this section with respect to the portion of its dividend equivalent amount for the taxable year attributable to non-previously taxed accumulated effectively connected earnings and profits if the foreign corporation is a qualified resident of such country within the meaning of § 1.884–5T(a) for the taxable years includable, in whole or in part, in a 36-month period that includes the taxable year of the dividend equivalent amount. A foreign corporation that fails the 36-month test described in the preceding sentence shall be exempt from the branch profits tax or subject to the branch profits tax at a reduced rate under paragraph (h)(1) of this section with respect to non-previously taxed accumulated effectively connected earnings and profits (determined on a last-in-first-out basis) accumulated only during prior years in which the foreign corporation was a qualified resident of such country within the meaning of § 1.884–5T(a).

(ii) *Rules of application.* A foreign corporation that has not satisfied the 36-month test as of the close of the taxable year of the dividend equivalent amount but satisfies the test with respect to such dividend equivalent amount by meeting the 36-month test by the close of the second taxable year succeeding the taxable year of the dividend equivalent amount shall be subject to the branch profits tax for the year of the dividend equivalent amount without regard to paragraph (h)(1) of this section on the portion of the dividend equivalent amount attributable to non-previously taxed accumulated effectively connected earnings and profits derived in a taxable year in which the foreign corporation was not a qualified resident within the meaning of § 1.884–5T(a). Upon meeting the 36-month test, the foreign corporation shall be entitled to claim by amended return a refund for the tax paid with respect to the dividend equivalent amount in excess of the branch profits tax calculated by taking into account paragraph (h)(2)(i) of this section, provided the foreign corporation establishes in the amended return for the taxable year that it has met the requirements of such paragraph. For purposes of section 6611 (dealing with interest on overpayments), any overpayment of branch profits tax by reason of this paragraph (h)(2)(ii) shall be deemed not to have been made before the filing date for the taxable year in which the foreign corporation establishes that it has met the 36-month test.

(3) *Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.* The branch profits tax shall not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraph (h) (1) and (2) of this section for a country listed below, so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect, except

to the extent the treaty is modified on or after January 1, 1987, to expressly provide for the imposition of the branch profits tax:

Aruba	Jamaica
Austria	Japan
Belgium	Korea
People's Republic of China	Luxembourg
Cyprus	Malta
Denmark	Morocco
Egypt	Netherlands
Finland	Netherlands Antilles
Germany	Norway
Greece	Pakistan
Hungary	Philippines
Iceland	Sweden
Ireland	Switzerland
Italy	United Kingdom

(4) *Modifications with respect to other income tax treaties*—(i) *Limitation on rate of tax*—(A) *General rule.* If, under paragraphs (h) (1) and (2) of this section, a corporation qualifies for a reduction in the amount of the branch profits tax and paragraph (h)(3) of this section does not apply, the rate of tax shall be the rate of tax on branch profits specified in the treaty between the United States and the corporation's country of residence or, if no rate of tax on branch profits is specified, the rate of tax that would apply under such treaty to dividends paid to the foreign corporation by a wholly-owned domestic corporation.

(B) *Certain treaties in effect on January 1, 1987.* The branch profits tax shall be imposed at the following rates on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (h) (1) and (2) of this section for a country listed below, for as long as the relevant provisions of those income tax treaties remain in effect and are not modified or superseded by subsequent agreement:

Australia (15%)
Barbados (5%)
Canada (10%)
France [reserved]
New Zealand (5%)
Poland (5%)
Romania (10%)
South Africa (30%)
Trinidad & Tobago (10%)
U.S.S.R. (30%)

(ii) *Limitations other than rate of tax.* If, under paragraphs (h) (1) and (2) of this section, a foreign corporation qualifies for a reduction in the amount of branch profits tax and paragraph (h)(3) of this section does not apply, then—

(A) The foreign corporation shall be entitled to the benefit of any limitations on imposition of a tax on branch profits (in addition to any limitations on the rate of tax) contained in the treaty, and

(B) No branch profits tax shall be imposed with respect to effectively connected earnings and profits of the foreign corporation unless attributable to a permanent establishment in the United States or, if not otherwise prohibited under the treaty, to gain from the disposition of a U.S. real property interest described in section 897(c)(1)(A)(i), except to the extent the treaty specifically permits the imposition of the branch profits tax on such earnings and profits.

No article in such treaty shall be construed to provide any limitations on imposition of the branch profits tax other than as provided in this paragraph (h)(4).

(iii) *Limitations under the Canadian treaty*—(A) *Effect of deficits in earnings and profits.* In the case of a foreign corporation that is a qualified resident of Canada, the dividend equivalent amount for any taxable year shall not exceed the foreign corporation's non-previously taxed accumulated effectively connected earnings and profits as of the close of the current taxable year. Thus, for example, if a foreign corporation that is a qualified resident of Canada has a deficit in non-previously taxed accumulated effectively connected earnings and profits of $200 as of the close of the preceding taxable year and effectively connected earnings and profits of $100 for the current taxable year, it will have no dividend equivalent amount for the taxable year because, as of the close of its current taxable year, it has a $100 deficit in non-previously taxed accumulated effectively connected earnings and profits. For purposes of this paragraph (h)(4)(iii)(A), any net deficit in accumulated earnings and profits attributable to taxable years beginning before January 1, 1987, shall be includible in determining non-previously taxed accumulated effectively connected earnings and profits.

(B) *One-time exemption of Canadian $500,000*—(*1*) *General rule.* In the case of a foreign corporation that is a qualified resident of Canada, the branch profits tax shall be imposed only with respect to that portion of the dividend equivalent amount for the taxable year that, when translated into Canadian dollars and added to the dividend equivalent amounts for preceding taxable years translated into Canadian dollars, exceeds Canadian $500,000. The value of the dividend equivalent amount in Canadian currency shall be determined by translating the effectively connected earnings and profits for each taxable year that are includible in the dividend equivalent amount (as determined in U.S. dollars under the currency translation method used in determining the foreign corporation's taxable income for U.S. tax purposes) by the weighted average exchange rate for the taxable year (determined under the rules of section 989(b)(3)) during which the earnings and profits were derived.

(*2*) *Reduction in amount of exemption in the case of related corporations.* The amount of a foreign corporation's exemption under this paragraph (h)(4)(iii)(B) shall be reduced by the amount of any exemption that reduced the dividend equivalent amount of an associated foreign corporation with respect to the same or a similar business. For purposes of this paragraph (h)(4)(iii)(B), a foreign corporation is an associated foreign corporation if it is related to the foreign corporation for purposes of section 267(b) or it and the foreign corporation are stapled entities (within the meaning of section 269B(c)(2)) or are effectively stapled entities. A business is the same as or similar to another business if it involves the sale, lease, or manufacture of the same or a similar type of property or the provision of the same or a similar type of services. A U.S. real property interest described in section 897(c)(1)(A)(i) shall be treated as a business and all such U.S. real property interests shall be treated as businesses that are the same or similar.

(*3*) *Coordination with second-tier withholding tax.* The value of the dividend equivalent amount that is exempt from the branch profits tax by reason of paragraph (h)(4)(iii)(B)(*1*) of this section shall not be subject to tax under section 871(a) or 881, or to withholding under section 1441 or 1442, when distributed by the foreign corporation.

(5) *Benefits under treaties other than income tax treaties.* [Reserved]

(6) *Example.* The application of this paragraph (h) is illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer, is a resident of the United Kingdom. A has a dividend equivalent amount for its taxable year 1991 of $300, of which $100 is attributable to 1991 effectively connected earnings and profits and $200 to non-previously taxed accumulated effectively connected earnings and profits. A is a qualified resident for its taxable year 1991 because for that year it meets the requirements of § 1.884-5T (b) and (c), relating, respectively, to stock ownership and base erosion. For 1991 A does not meet the requirements of § 1.884-5T (d), (e), or (f) for qualified residence. A is not a qualified resident of the United Kingdom for its taxable year 1989 but is a qualified resident for its taxable years 1990 and 1992.

Because A is a qualified resident for the 3-year period (1990, 1991, and 1992) that includes the taxable year of the dividend equivalent amount (1991), A satisfies the 36-month test of paragraph (h)(2) of this section and no branch profits tax is imposed on the total $300 dividend equivalent amount. However, since A was not a qualified resident in 1989 and therefore cannot establish that it has satisfied the 36-month test until the taxable year following the year of the dividend equivalent amount, A must pay the branch profits tax for its taxable year 1991 with respect to the portion of the dividend equivalent amount attributable to non-previously taxed accumulated effectively connected earnings and profits relating to years prior to 1990 without regard to paragraph (h)(1) of this section. A may file for a refund of the branch profits tax paid with respect to its 1991 taxable year at any time after it establishes that it is a qualified resident for its 1992 taxable year.

(i) *Stapled entities.* Any foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for all purposes of section 884 and the regulations thereunder, notwithstanding section 269B or the regulations thereunder.

(j) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

§ 1.884-2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary. (temporary)

(a) *Complete termination of a U.S. trade or business*—(1) *General rule.* A foreign corporation shall not be subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business within the meaning of paragraph (a)(2) of this section. A foreign corporation's non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year of complete termination shall be extinguished for purposes of section 884 and the regulations thereunder, but not for other purposes (for example, sections 312, 316 and 381).

(2) *Operating rules*—(i) *Definition of complete termination.* A foreign corporation shall have completely terminated all of its U.S. trade or business for any taxable year ("the year of complete termination") only if—

(A) As of the close of that taxable year, the foreign corporation either has no U.S. assets, or its shareholders have adopted an irrevocable resolution in that taxable year to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year (also a "year of complete termination" for purposes of applying this paragraph (a)(2)), all of its U.S. assets are either distributed, used to pay off liabilities, or cease to be U.S. assets;

(B) Neither the foreign corporation nor a related corporation uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business, or property attributable thereto or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination, in the conduct of a trade or business in the United States at any time during a period of three years from the close of the year of complete termination;

(C) The foreign corporation has no income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States (other than solely by reason of section 864 (c)(6) or (c)(7)) during the period of three years from the close of the year of complete termination; and

(D) The foreign corporation attaches to its income tax return for each year of complete termination a waiver of the period of limitations, as described in paragraph (a)(2)(ii) of this section.

If a foreign corporation fails to completely terminate all of its U.S. trade or business because of the failure to meet any of the requirements of this paragraph (a)(2), then its branch profits tax liability for the taxable year and all subsequent taxable years shall be determined under the provisions of § 1.884-1T, without regard to any provisions in this paragraph (a), taking into account any reduction in U.S. net equity that results from a U.S. trade or business of the foreign corporation ceasing to have U.S. assets. Any additional branch profits tax liability that may result, together with interest thereon (charged at the underpayment rates determined under section 6621(a)(2) with respect to the period between the date that was prescribed for filing the foreign corporation's income tax return for the taxable year with respect to which the branch profits tax liability arises and the date on which the additional tax for that year is paid), and applicable penalties, if any, shall be the liability of the foreign corporation (or of any person who is a transferee of the foreign corporation within the meaning of section 6901).

(ii) *Waiver of period of limitations.* The waiver referred to in paragraph (a)(2)(i)(D) of this section shall be executed on such forms as are prescribed by the Commissioner and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that taxable year. Such waiver shall contain such other terms with respect to assessment as may be considered appropriate by the Commissioner to ensure the assessment and collection of the correct tax liability for each year for which the waiver is required. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. For taxable years ending on or before December 1, 1988, such waiver may be filed by attaching it to an amended Form 1120F and filing such document on or before January 3, 1988.

(iii) *Property subject to reinvestment prohibition rule.* For purposes of paragraph (a)(2)(i)(B) of this section—

(A) The term "U.S. assets of the terminated U.S. trade or business" shall mean all the money and other property that qualified as U.S. assets of the foreign corporation as of the close of the taxable year immediately preceding the year of complete termination; and

(B) Property attributable to U.S. assets or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination shall mean money or other property into which any part or all of such assets or effectively connected earnings and profits are converted at any time before the expiration of the three-year period specified in paragraph (a)(2)(i)(B) of this section by way of sale, exchange, or other disposition, as well as any money or other property attributable to the sale by a shareholder of the foreign corporation of its interest in the foreign corporation (or a successor corporation) at any time after a date which is 12 months before the close of the year of complete termination (24 months in the case of a foreign corporation that makes an election under paragraph (b) of this section).

(iv) *Related corporation.* For purposes of paragraph (a)(2)(i)(B) of this section, a corporation shall be related to a foreign corporation if either corporation is a 10-percent shareholder of the other corporation or, where the foreign corporation completely liquidates, if either corporation would have been a 10-percent shareholder of the other corporation had the foreign corporation remained in existence. For this purpose, the term "10-percent shareholder" means any person described in section 871(h)(3)(B) as well as any person who

owns 10 percent or more of the total value of the stock of the corporation, and stock ownership shall be determined on the basis of the attribution rules described in section 871(h)(3)(C).

(v) *Direct or indirect use of U.S. assets.* The use of any part or all of the property referred to in paragraph (a)(2)(i)(B) of this section shall include the loan thereof to a related corporation or the use thereof as security (as a pledge, mortgage, or otherwise) for any indebtedness of a related corporation.

(3) *Complete termination in the case of a section 338 election.* A foreign corporation whose stock is acquired by another corporation that makes (or is deemed to make) an election under section 338 with respect to the stock of the foreign corporation shall be treated as having completely liquidated as of the close of the acquisition date (as defined in section 338(h)(2)) and to have completely terminated all of its U.S. trade or business with respect to the taxable year ending on such acquisition date provided the foreign corporation that exists prior to the section 338 transaction complies with the requirements of paragraph (a)(2)(i) (B) and (D) of this section. For purposes of the preceding sentence, any of the money or other property paid as consideration for the acquisition of the stock in the foreign corporation (and for any debt claim against the foreign corporation) shall be treated as property attributable to the U.S. assets of the terminated U.S. trade or business and to the effectively connected earnings and profits of the foreign corporation earned in the year of complete termination.

(4) *Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).* No branch profits tax shall be imposed on effectively connected earnings and profits attributable to income that is treated as effectively connected with the conduct of a trade or business in the United States solely by reason of section 864(c)(6) or 864(c)(7) if—

(i) No income of the foreign corporation for the taxable year is, or is treated as, effectively connected with the conduct of a trade or business in the United States, without regard to section 864(c)(6) or 864(c)(7),

(ii) The foreign corporation has no U.S. assets as of the close of the taxable year, and

(iii) Such effectively connected earnings and profits would not have been subject to branch profits tax pursuant to the complete termination provisions of paragraph (a)(1) of this section if income or gain subject to section 864(c)(6) had not been deferred or if property subject to section 864(c)(7) had been sold immediately prior to the date the property ceased to have been used in the conduct of a trade or business in the United States.

(5) *Coordination with second-level withholding tax.* Effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of a foreign corporation that are exempt from branch profits tax by reason of the provisions of paragraph (a)(1) of this section shall not be subject to tax under section 871(a), 881(a), 1441 or 1442 when paid as a dividend by such foreign corporation (or a successor-in-interest).

(b) *Election to remain engaged in a U.S. trade or business.* A foreign corporation that would be considered to have completely terminated all of its U.S. trade or business for the taxable year under the provisions of paragraph (a)(2)(i) of this section, but for the provisions of paragraph (a)(2)(i)(B) of this section that prohibit reinvestment within a three-year period, may make an election under this paragraph (b) for the taxable year in which it completely terminates all its U.S. trade or business (as determined without regard to paragraph (a)(2)(i)(B) of this section) and, if it so chooses, for the following taxable year (but not for any succeeding taxable year). The election under this paragraph (b) is an election by the foreign corporation to designate an amount of marketable securities (as defined in § 1.884–1T(d)(8)) as U.S. assets for purposes of § 1.684–1T. In order to qualify for this election—

(1) The marketable securities must be identified within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets; and

(2) On the date a marketable security is identified, its adjusted basis must not exceed its fair market value.

The marketable securities identified pursuant to the election under this paragraph (b) shall be treated as being U.S. assets in an amount equal, in the aggregate, to the lesser of the adjusted basis of the U.S. assets that ceased to be U.S. assets during the taxable year in which the election is made (determined on the date or dates the U.S. assets ceased to be U.S. assets) or the adjusted basis of the marketable securities as of the end of the taxable year. The securities must be held from the date they are identified until the end of the taxable year for which the election is made, or, if disposed of during that taxable year, must be replaced on the date of disposition with other marketable securities that are acquired on or before that date and the fair market value of which as of the date of substitution is not less than their adjusted basis. Except as otherwise provided in this paragraph (b), the election under this paragraph (b) shall be made in accordance with the provisions of § 1.884–1T(d)(11), subject to the same conditions as are set forth in that section, and shall have the same consequences as provided in § 1.884–1T(d)(11)(ii) (including the marking to market of such securities at the close of each taxable year for which the election is effective) except that such consequences start with the first day of the taxable year for which the election is effective and continue until the earlier of the date of substitution by the foreign corporation of a U.S. asset for such marketable security or the close of the taxable year for which the election is effective. The securities shall be marked to market immediately prior to the date of substitution. An election under § 1.884–1T(d)(11) shall not be effective for any taxable year for which the election under this paragraph (b) is effective. A foreign corporation shall not be permitted to make an election under this paragraph (b) more than once. See § 1.884–1T(d)(11) for other rules regarding the effect and manner of making this election, including transition rules.

(c) *Liquidation, reorganization, etc. of a foreign corporation.* The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the "transferor") of its U.S. assets to another corporation (the "transferee") in a complete liquidation or reorganization described in section 381(a) (a "section 381(a) transaction") if the transferor is engaged (or deemed engaged) in the conduct of a U.S. trade or business immediately prior to the section 381(a) transaction. For purposes of this paragraph (c), a section 381(a) transaction is considered to occur in the taxable year that ends on the date of distribution or transfer (as defined in § 1.381(b)–1(b)) pursuant to the section 381(a) transaction.

(1) *Inapplicability of paragraph (c)(1) of this section to section 381(a) transactions.* Paragraph (a)(1) of this section (relating to the complete termination of a U.S. trade or business of a foreign corporation) does not apply to exempt the transferor from branch profits tax liability for the taxable year in which the section 381(a) transaction occurs or in any succeeding taxable year.

(2) *Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs.* The

dividend equivalent amount for the taxable year, including a short taxable year, in which a section 381(a) transaction occurs shall be determined under the provisions of § 1.884–1T, as modified under the provisions of this paragraph (c)(2).

(i) *U.S. net equity.* The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 381(a) transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 381(a) transaction. The transferor's adjusted basis (for earnings and profits purposes) in U.S. assets transferred to the transferee pursuant to a section 381(a) transaction shall be the adjusted basis of those assets (for earnings and profits purposes) immediately prior to the section 381(a) transaction, adjusted as provided under section 362(b), treating the transferor, for that purpose, as though it were the transferee and treating the gain taken into account for earnings and profits purposes as gain recognized.

(ii) *Effectively connected earnings and profits.* The transferor's effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs and its non-previously taxed accumulated effectively connected earnings and profits shall be determined without regard to the carryover to the transferee of the transferor's earnings and profits under section 381 (a) and (c)(2) and paragraph (c)(4) of this section. Effectively connected earnings and profits for the taxable year in which a section 381(a) transaction occurs shall be adjusted by the amount of any gain recognized to the transferor in that year pursuant to the section 381(a) transaction (to the extent taken into account for earnings and profits purposes).

(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of paragraph (c)(2)(i) of this section shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on such forms as are prescribed by the Commissioner and shall extend the period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. The waiver shall contain such other terms with respect to assessment as may be considered appropriate by the Commissioner to ensure the assessment and collection of the correct tax liability for such year. The waiver must be signed by the person authorized to sign Form 2045. For taxable years ending on or before December 1, 1988, Form 2045 and the waiver may be filed by attaching both documents to an amended Form 1120F on or before January 3, 1989.

(3) *Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381(a) transaction occurs.* Any decrease in U.S. net equity in any taxable year succeeding the taxable year in which the section 381(a) transaction occurs shall increase the transferor's dividend equivalent amount for those years without regard to the limitation in § 1.884–1T(b)(3)(ii), to the extent such decrease in U.S. net equity does not exceed the balance of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits carried over to the transferee pursuant to section 381 (a) and (c)(2), as determined under paragraph (c)(4) of this section.

(4) *Earnings and profits of the transferor carried over to the transferee pursuant to the section 381(a) transaction*—(i) *Amount.* The amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of the transferor that carry over to the transferee under section 381 (a) and (c)(2) shall be the effectively connected earnings and profits and the non-previously taxed accumulated effectively connected earnings and profits of the transferor immediately before the close of the taxable year in which the section 381(a) transaction occurs. For this purpose, the provisions in § 1.381(c)(2)–1 shall generally apply with proper adjustments to reflect the fact that effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits are not affected by distributions to shareholders but, rather, by dividend equivalent amounts. Therefore, the amounts of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee pursuant to those provisions are reduced by the transferor's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. Such amounts are also reduced to the extent of any dividend equivalent amount determined for any succeeding taxable year solely as a result of the provisions of paragraph (c)(3) of this section. For purposes of this paragraph (c)(4)(i), if the transferor accumulates non-previously taxed effectively connected earnings and profits, or incurs a deficit in effectively connected earnings and profits, attributable to a period that is after the close of the taxable year in which the section 381(a) transaction occurs and before the liquidation of the transferor, then such effectively connected earnings and profits, or deficits therein, shall be deemed to have been accumulated or incurred on or before the close of the taxable year in which the section 381(a) transaction occurs.

(ii) *Retention of character.* All of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee shall constitute non-previously taxed accumulated effectively connected earnings and profits of the transferee. In the case of a domestic transferee, such non-previously taxed accumulated effectively connected earnings and profits shall also constitute accumulated earnings and profits of the transferee for purposes of section 316(a)(2).

(iii) *Treatment of distributions by a domestic transferee out of non-previously taxed accumulated effectively connected earnings and profits.* In the event the transferee is a domestic corporation, distributions out of the transferee's non-previously taxed accumulated effectively connected earnings and profits that are received by a foreign distributee shall qualify for benefits under an applicable income tax treaty only (A) if the distributee qualifies for the benefits under such treaty and (B) to the extent that the transferor foreign corporation would have qualified under the principles of § 1.884–1T(h) (1) and (2)(i) for an exemption or reduction in rate with respect to the branch profits tax if the non-previously taxed accumulated effectively connected earnings and profits had been reflected in a dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. (The tax rate on dividends

specified in the treaty between the distributee's country of residence and the United States shall apply to any dividends received by a distributee who qualifies for a treaty benefit under the preceding sentence.) In addition, distributions out of such non-previously taxed accumulated effectively connected earnings and profits shall retain their character in the hands of any domestic distributee up a chain of corporate shareholders for purposes of applying this paragraph (c)(4)(iii) to distributions made by any such person to a foreign distributee. If a domestic transferee has non-previously taxed accumulated effectively connected earnings and profits carried over from the transferor as well as accumulated earnings and profits, then each category of earnings and profits shall be accounted for in two separate pools, and any distribution of earnings and profits shall be treated as a distribution out of each pool in proportion to the respective amount of undistributed earnings and profits in each pool. Section 871(i) (relating, in part, to dividends paid by a domestic corporation meeting the 80-percent foreign business requirements of section 861(c)(1)) shall not apply to any dividends paid by a domestic transferee out of its non-previously taxed accumulated effectively connected earnings and profits.

(5) *Determination of U.S. net equity of a transferee that is a foreign corporation.* In the event the transferee is a foreign corporation, then for purposes of determining the transferee's increase or decrease in U.S. net equity under § 1.884–1T for its taxable year during which the section 381(a) transaction occurs, its U.S. net equity as of the close of its immediately preceding taxable year shall be increased by the amount of U.S. net equity acquired by the transferee from the transferor pursuant to the section 381(a) transaction, taking into account the adjustments to the basis (for earnings and profits purposes) of U.S. assets under the principles of section 362(b).

(6) *Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor*—(i) *General rule.* This paragraph (c)(6)(i) shall apply where the transferee is a domestic corporation, subdivision (A), (B), or (C) of this paragraph applies and subdivision (D) of this paragraph applies.

(A) Shareholders of the transferor sell, exchange or otherwise dispose of stock in the transferor at any time during a 12-month period before the date of distribution or transfer (as defined in § 1.367(b)–1(b)) and the aggregate amount of such stock sold, exchanged or otherwise disposed of exceeds 25 percent of the value of the stock of the transferor, determined on a date that is 12 months before the date of distribution or transfer.

(B) Shareholders of the transferee (or of the transferee's parent in the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12 month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(C) In the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C), the transferee's parent sells, exchanges or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in subdivision (A) or (B) of this paragraph (c)(6)(i)), or the transferee's parent (subsequent to an event described in subdivision (C) of this paragraph (c)(6)(i)), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C)).

Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under § 1.884–1T, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i) (A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations thereunder.

(ii) *Operating rule.* For purposes of paragraph (c)(6)(i) of this section paragraphs (a)(2) (iii)(B), (iv) and (v) of this section shall apply for purposes of making the determinations under paragraph (c)(6)(i)(D) of this section.

(d) *Incorporation under section 351*—(1) *In general.* The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the "transferor") of part or all of its U.S. assets to a U.S. corporation (the "transferee") in exchange for stock or securities in the transferee in a transaction that qualifies under section 351(a) (a "section 351 transaction"), provided that immediately after the transaction, the transferor is in control (as defined in section 368(c)) of the transferee, without regard to other transferors.

(2) *Inapplicability of paragraph (a)(1) of this section to section 351 transactions.* Paragraph (a)(1) of this section does not apply to exempt the transferor from branch profits tax liability for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs and shall not apply for any subsequent taxable year of the transferor in which it, or a successor-in-interest, owns stock or securities of a transferee as of the close of the transferor's taxable year.

(3) *Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.* The dividend equivalent amount of the transferor for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs shall be determined under the provisions of § 1.884–1T, as modified by the provisions of this paragraph (d)(3) provided that the transferee elects under paragraph (d)(4) of this section to be allocated a proportionate amount of the

transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits and the foreign corporation files a statement as provided in paragraph (d)(5)(i) of this section and complies with the agreement included in such statement with respect to a subsequent disposition of the transferee's stock.

(i) *U.S. net equity.* The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 351 transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 351 transaction. The transferor's adjusted basis for earnings and profits purposes in U.S. assets transferred to the transferee pursuant to a section 351 transaction shall be the adjusted basis of those assets for earnings and profits purposes immediately prior to the section 351 transaction, increased by the amount of any gain recognized by the transferor on the transfer of such assets in the section 351 transaction to the extent taken into account for earnings and profits purposes.

(ii) *Effectively connected earnings and profits.* Subject to the limitation in paragraph (d)(3)(iii) of this section, the calculation of the transferor's dividend equivalent amount shall take into account the transferor's effectively connected earnings and profits for the taxable year in which a section 351 transaction occurs (including any amount of gain recognized to the transferor pursuant to the section 351 transaction to the extent the gain is taken into account for earnings and profits purposes) and, for purposes of applying the limitation of § 1.884-1(f)(3)(iii), its non-previously taxed accumulated effectively connected earnings and profits, determined without regard to the allocation to the transferee of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section.

(iii) *Limitation on dividend equivalent amount.* The dividend equivalent amount determined under this paragraph (d)(3) shall not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits determined after taking into account the allocation to the transferee of the transferor's earnings pursuant to an election under paragraph (d)(4)(i) of this section.

(4) *Election to increase earnings and profits*—(i) *General rule.* The election referred to in paragraph (d)(3) of this section is an election by the transferee to increase its earnings and profits by the amount determined under paragraph (d)(4)(ii) of this section. An election under this paragraph (d)(4)(i) shall be effective only if the transferee attaches a statement to its timely filed (including extensions) income tax return for the taxable year in which the section 351 transaction occurs, in which—

(A) It agrees to be subject to the rules of paragraph (c)(4) (ii) and (iii) of this section with respect to the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under this paragraph (d)(4)(i) in the same manner as if such earnings and profits had been carried over to the transferee pursuant to section 381 (a) and (c)(2), and

(B) It identifies the amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that are allocated from the transferor.

An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(4)(i) shall be attached.

(ii) *Amount of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee.* The amount referred to in paragraph (d)(4)(i) of this section is equal to the same proportion of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits (determined immediately prior to the section 351 transaction and without regard to this paragraph (d)(4) or any dividend equivalent amount for the taxable year) that the adjusted bases for purposes of computing earnings and profits in all the U.S. assets transferred to the transferee by the transferor pursuant to the section 351 transaction bear to the adjusted bases for purposes of computing earnings and profits in all the U.S. assets of the transferor, determined immediately prior to the section 351 transaction.

(iii) *Effect of election on transferor.* For purposes of computing the transferor's dividend equivalent amount for the taxable year succeeding the taxable year in which a section 351 transaction occurs, the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year in which the section 351 transaction occurs shall be reduced by the amount of its effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under paragraph (d)(4)(i) of this section (and by its dividend equivalent amount for the taxable year in which the section 351 transaction occurs).

(5) *Dispositions of stock or securities of the transferee by the transferor*—(i) *General rule.* The statement referred to in paragraph (d)(3) of this section is a statement executed by the transferor stating the transferor's agreement that, upon the disposition of part or all of the stock or securities it owns in the transferee (or a successor-in-interest), it shall treat as a dividend equivalent amount for the taxable year in which the disposition occurs an amount equal to the lesser of (A) the amount realized upon such disposition or (B) the total amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that was allocated from the transferor to that transferee pursuant to an election under paragraph (d)(4)(i) of this section, which amount shall be reduced to the extent previously taken into account by the transferor as dividends or dividend equivalent amounts for tax or branch profits tax purposes. The extent and manner in which such dividend equivalent amount may be subject to the branch profits tax in the taxable year of disposition shall be determined under the provisions of section 884 and the regulations thereunder, including the provisions of paragraph (a) of this section (relating to complete terminations), as limited under paragraph (d)(2) of this section. Except as otherwise provided in paragraph (d)(5)(ii) of this section, the term "disposition" means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and the regulations thereunder. This paragraph (d)(5)(i) shall apply regardless of whether the stock or securities of the transferee are U.S. assets in the hands

of the transferor at the time of sale, exchange or disposition.

(ii) *Exception for certain tax-free dispositions.* For purposes of paragraph (d)(5)(i) of this section, a disposition does not include a transfer of stock or securities of the transferee by the transferor in a transaction that qualifies as a transfer pursuant to a complete liquidation described in section 332(b) or a transfer pursuant to a reorganization described in section 368(a)(1)(F). Any other transfer that qualifies for non-recognition of gain or loss shall be treated as a disposition for purposes of paragraph (d)(5)(i) of this section, unless the Commissioner has, by published guidance or by prior ruling issued to the taxpayer upon its request, determined such transfer not to be a disposition for purposes of paragraph (d)(5)(i) of this section.

(iii) *Distributions governed by section 355.* In the case of a distribution or exchange of stock or securities of a transferee to which section 355 applies (or so much of section 356 as relates to section 355) and that is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D), § 1.312-10(b) (relating to the allocation of earnings and profits in certain corporate separations) shall not apply to reduce the transferor's effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits.

(iv) *Filing of statement.* The statement referred to in paragraph (d)(5)(i) of this section shall be attached to a timely filed (including extensions) income tax return of the transferor for the taxable year in which the section 351 transaction occurs. An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(5)(iv) shall be attached.

(5) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. Foreign corporation X has a calendar taxable year. X's only assets are U.S. assets and X computes its interest deduction using the actual ratio of liabilities to assets under § 1.882-5(b)(2)(ii). X's U.S. net equity as of the close of its 1988 taxable year is $2,000, resulting from the following amounts of U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
U.S. building A	$1,000	Mortgage A	800
U.S. building B	2,500	Mortgage B	1,500
Other U.S. assets	800		
Total	4,300		2,300

Assume that X's adjusted basis in its assets is equal to X's adjusted basis in its assets for earnings and profits purposes. On September 30, 1989, X transfers building A, which has a fair market value of $1,800, to a newly created U.S. corporation Y under section 351 in exchange for 100% of the stock of Y with a fair market value of $600, other property with a fair market value of $200, and the assumption of Mortgage A. Assume that under sections 11 and 351(b), tax of $30 is imposed with respect to the $200 of other property received by X. X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1988 taxable year are $200 and its effectively connected earnings and profits for its 1989 taxable year are $330, including $170 of gain recognized to X on the transfer as adjusted for earnings and profits purposes (*i.e.*, $200 of gain recognized minus $30 of tax paid with respect to the gain). Y takes a $1,200 basis in the building transferred from X, equal to the basis in the hands of X ($1,000) increased by the amount of gain recognized to X in the section 351 transaction ($200). Y makes an election in the manner described in paragraph (d)(4)(i) of this section to increase its earnings and profits by the amount described in paragraph (d)(4)(ii) of this section and X files a statement as provided in paragraph (d)(5)(i) of this section. The branch profits tax consequences to X and Y in the taxable year in which the section 351 transaction occurs and in subsequent taxable years are as follows:

(i) *X's dividend equivalent amount for 1989.* The determination of X's dividend equivalent amount for 1989 is a three-step process: determining X's U.S. net equity as of the close of its 1989 taxable year under paragraph (d)(3)(i) of this section; determining the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for its 1989 taxable year under paragraph (d)(3)(ii) of this section; and applying the limitation in paragraph (d)(3)(iii) of this section.

Step one: Pursuant to paragraph (d)(3)(i) of this section, X's U.S. net equity as of the close of its 1989 taxable year is calculated without regard to the section 351 transaction except that X's basis in its U.S. assets is increased by the $170 amount of gain it has recognized for earnings and profits purposes in connection with the section 351 transaction. Thus, X's U.S. net equity as of the close of its 1989 taxable year is $1,870, consisting of the following U.S. assets and liabilities, taking into account the fact that X's other U.S. assets have decreased to $500:

U.S. assets		U.S. liabilities	
Building A	$1,170	Mortgage A	800
Building B	2,500	Mortgage B	1,500
Other U.S. assets	500		
Total	4,170		2,300

Thus, X's U.S. net equity as of the close of its 1989 taxable year has decreased by $130 relative to its U.S. net equity as of the close of its 1988 taxable year.

Step two: Pursuant to paragraph (d)(3)(ii) of this section, X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for the taxable year are determined without taking into account the allocation to Y of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Thus, X's effectively connected earnings and profits for its 1989 taxable year are $330 and X's non-previously taxed accumulated effectively connected earnings and profits are $200. Thus, but for the limitation in paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for the taxable year would be $460, equal to X's effectively connected earnings and profits for the taxable year ($330), increased by the decrease in X's U.S. net equity ($130).

Step three: Pursuant to paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for its 1989 taxable year may not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year, after taking into account the allocation of the transferor's earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Based upon subdivision (ii) of this example, X's dividend equivalent amount for 1989 cannot exceed $423, which is equal to the total amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year without regard to the allocation of earnings and profits to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($530), reduced by the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($107). Thus, X's dividend equivalent amount for its 1989 taxable year is limited to $423.

(ii) *Amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits transferred to Y.* Pursuant to Y's election under paragraph (d)(4)(i) of this section, Y increases its earnings and profits by the amount prescribed in paragraph (d)(4)(ii) of this section. This amount is equal to the sum of X's effectively connected earnings and profits and non previously taxed accumulated effectively connected earnings and profits

determined immediately before the section 351 transaction, without regard to X's dividend equivalent amount for the year, allocated in the same proportion that X's basis in the U.S. assets transferred to Y bears to the bases of all of X's U.S. assets, which bases are determined immediately prior to the section 351(a) transaction. The amount of X's effectively connected earnings and profits immediately before the section 351 transaction is assumed to be $260. The total amount of effectively connected earnings and profits ($260) and non-previously taxed accumulated effectively connected earnings and profits ($200) determined immediately before the section 351 transaction is, therefore, $460. The portion of $460 that is allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section is $107, calculated as $467 multiplied by a fraction, the numerator of which is the basis of the U.S. assets transferred to Y pursuant to the section 351 transaction ($1,000), and the denominator of which is the basis of X's U.S. assets determined immediately before the section 351 transaction ($4,300). Pursuant to paragraph (d)(4)(i) of this section, the amount of $107 of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to paragraph (d)(4)(i) of this section constitutes non-previously taxed accumulated effectively connected earnings and profits of Y.

(iii) *X's non-previously taxed accumulated effectively connected earnings and profits for 1990.* Pursuant to paragraph (d)(4)(iii) of this section, X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1989 taxable year for purposes of computing its dividend equivalent amount for its taxable year 1990 are zero, *i.e.*, $530 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits reduced by $107 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y, and further reduced by X's $423 dividend equivalent amount for its 1989 taxable year.

(iv) *X's U.S. net equity for purposes of determining the dividend equivalent amount for succeeding taxable years.* For 1990, X must determine its U.S. net equity as of December 31, 1989, in order to determine whether there has been an increase or decrease in its U.S. net equity as of December 31, 1990. For this purpose, X's U.S. net equity as of December 31, 1989 is determined under the provisions of § 1.884–1T without regard to the special rules in paragraph (d)(3)(i) of this section. Thus, X's U.S. net equity as of December 31, 1989 is $1,500, consisting of the following U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
Building B	$2,500	Mortgage B	1,500
Other U.S. assets	500		
Total	3,000		1,500

(e) *Certain transactions with respect to a domestic subsidiary.* In the case of a section 381(a) transaction in which a domestic subsidiary of a foreign corporation transfers assets to that foreign corporation or to another foreign corporation with respect to which the first foreign corporation owns stock (directly or indirectly) meeting the requirements of section 1504(a)(2), the transferee's non-previously taxed accumulated effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs shall be increased by all of the domestic subsidiary's current earnings and profits and earnings and profits accumulated after December 31, 1986, that carry over to the transferee under sections 381(a) and (c)(1) (including non-previously taxed accumulated effectively connected earnings and profits, if any, transferred to the domestic subsidiary under paragraphs (c)(4) and (d)(4) of this section and treated as earnings and profits under paragraphs (c)(4)(ii) and (d)(4)(ii) of this section). For purposes of determining the transferee's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs, the transferee's U.S. net equity as of the close of its taxable year immediately preceding the taxable year during which the section 381(a) transaction occurs shall be increased by the greater of

(1) The amount by which the transferee's U.S. net equity computed immediately prior to the transfer would have increased due to the transfer of the subsidiary's assets and liabilities if U.S. net equity were computed immediately prior to the transfer and immediately after the transfer (taking into account in the earnings and profits basis of the assets transferred any gain recognized on the transfer to the extent reflected in earnings and profits), or

(2) The total amount of U.S. net equity transferred (directly or indirectly) by the foreign parent to the domestic subsidiary in one or more prior section 351 or 381(a) transactions.

(f) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

§ 1.884–3T Coordination of branch profits tax with second-tier withholding (temporary).

[Reserved]

§ 1.884–4T Branch-level interest tax (temporary).

(a) *General rule*—(1) *Tax on interest paid by a U.S. trade or business.* In the case of a foreign corporation engaged in trade or business in the United States, any interest paid by such trade or business (within the meaning of paragraph (b) of this section) shall be treated, for purposes of sections 871, 881, 1441, and 1442, as if it were paid by a domestic corporation (other than a corporation described in section 861(c)(1), relating to a domestic corporation that meets the 80-percent foreign business requirement). Such interest shall thus be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, if received by a foreign person and not effectively connected with the conduct by the foreign person of a trade or business in the United States, unless the interest, if paid by a domestic corporation, would be exempt under section 871(h) or 881(c) (relating to exemption for certain portfolio interest received by a foreign person), section 871(i) or 881(d) (relating, in part, to exemption for certain bank deposit interest received by a foreign person), or another provision of the Code. See paragraph (b)(8) of this section for the effect of income tax treaties on interest paid by a U.S. trade or business of a foreign corporation. For purposes of this section, interest paid by a U.S. trade or business of a foreign corporation that would be treated as portfolio interest under section 871(h) or 881(c) but for the fact that it fails to meet the requirements of section 163(f)(2)(B)(ii)(II) (relating to the legend requirement) shall nevertheless be treated as portfolio interest provided the interest arises with respect to a liability incurred by the foreign corporation prior to January 3, 1988. For purposes of this section, a foreign corporation shall be treated as engaged in trade or business in the United States for a taxable year if it owns U.S. assets at any time during the taxable year or it derives gross income during the taxable year that is effectively connected (or deemed effectively connected) with the conduct of a trade or business in the United States.

(2) *Tax on excess interest.* If the amount of interest allowable as a deduction under § 1.882–5 in computing the effectively connected taxable income of a foreign corporation for the taxable year exceeds the interest paid by a U.S. trade or business of the foreign corporation within the meaning of paragraph (b) of this section, the foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to the foreign corporation by a wholly-owned domestic corporation (other than a corporation described in section 861(c)(1)) on the last day of the foreign corporation's taxable year. Such interest

shall not be exempt from tax under any subsection of section 881. For purposes of this paragraph (a)(2), interest paid by a U.S. trade or business shall not include interest described in paragraph (b)(1)(iv) of this section (relating to certain nondeductible interest) or interest accruing in a taxable year beginning before January 1, 1987. For purposes of this § 1.884–4T, the term "excess interest" means interest described in this paragraph (a)(2).

(3) *Original issue discount.* For purposes of this section, the term "interest" includes original issue discount, as defined in section 1273(a)(1).

(4) *Example.* The application of this paragraph (a) is illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer, is allowed an interest deduction of $150 under § 1.882–5 for 1991. The interest paid by a U.S. trade or business of A (within the meaning of paragraph (b) of this section) during 1991 is as follows: $55 of portfolio interest (as defined in section 871(h)(2)) to B, a nonresident alien; $35 of interest on deposits (within the meaning of section 871(i)(2)(A)) to C, a foreign corporation; $25 of interest to foreign corporation D, which owns 15 percent of the combined voting power of A's stock, with respect to bonds issued by A; and $20 to E, a domestic corporation. Neither B, C or D is engaged in the conduct of a trade or business in the United States. A, B, C and D are residents of countries with which the United States does not have an income tax treaty. The interest payments made to B, C and E are not subject to tax under section 871(a) or 881 and are not subject to withholding under section 1441 or 1442. The payment to D is subject to withholding of $7.50 ($25X30 percent). In addition, because A's interest deduction under § 1.882–5 ($150) exceeds the amount of interest paid by a U.S. trade or business of A ($135), A is subject to a tax of $4.50 ($15X30 percent) under section 881 on the amount of the excess.

(b) *Interest paid by a U.S. trade or business*—(1) *Definition of interest paid by a U.S. trade or business.* Except as provided in paragraph (b)(3) of this section, the term "interest paid by a U.S. trade or business" means, for purposes of this section, interest paid by a foreign corporation with respect to a liability that—

(i) Is specifically identified as a liability of a U.S. trade or business of the foreign corporation on books and records maintained in the United States by the foreign corporation and either

(A) Interest on the liability is allowed as a deduction (in whole or in part) by reason of § 1.882–5(b)(3)(i) or

(B) The liability is entered on such books and records on or before the earlier of 60 days after the liability is incurred by the foreign corporation or the date on which the first payment of interest is made with respect to the liability;

(ii) Is specifically identified as a liability of a U.S. trade or business of the foreign corporation on either

(A) Financial statements that are required to be provided to a regulatory agency of the United States, a State, or the District of Columbia or

(B) Books and records of the foreign corporation that are maintained in order to comply with regulatory requirements of any agency of the United States, a State, or the District of Columbia, and are used to prepare financial statements that are required to be provided to such regulatory agency;

(iii) Is secured (during at least half the days during the portion of the taxable year in which the interest accrues) predominantly by property of the foreign corporation that is a U.S. asset (as defined in § 1.884–1T(d)) unless such liability is secured by substantially all the property of the foreign corporation; or

(iv) Gives rise to interest for which a deduction is disallowed and either—

(A) The liability is incurred or continued to purchase a U.S. asset (as defined in § 1.884–1T(d)) or

(B) The basis of a U.S. asset is increased by the amount of the disallowed deduction.

A foreign corporation may comply with the time limits specified in paragraph (b)(1)(i)(B) of this section by identifying liabilities on its books and records on or before January 3, 1989.

(2) *Requirement that all interest paid with respect to certain liabilities be consistently treated.* Except as provided in paragraph (b)(3) of this section (relating to liabilities that do not give rise to interest paid by a U.S. trade or business), any interest paid by a U.S. trade or business with respect to a liability described in paragraph (b)(1)(i) of this section (relating to liabilities on U.S. books) shall be treated as interest paid by a U.S. trade or business for the entire taxable year, and for all subsequent taxable years, until the liability to which the interest is attributable has been satisfied in full.

(3) *Liabilities that do not give rise to interest paid by a U.S. trade or business.* For purposes of this section, a liability described in paragraph (b)(1)(i) of this section (relating to liabilities on U.S. books) that is not also described in paragraph (b)(1)(ii) through (iv) of this section (relating to liabilities on regulatory or tax books, secured by U.S. assets, or that give rise to certain nondeductible interest) shall not, for any taxable year, be treated as giving rise to interest paid by a U.S. trade or business of a foreign corporation if—

(i) Interest paid (or treated as paid by reason of paragraph (b)(2) of this section) with respect to the liability during the taxable year is taken into account for any taxable year for purposes of the income tax of any foreign country as a reduction of income from sources within such country for purposes of computing a foreign tax credit or, in the case of a foreign country that provides relief from double taxation by way of an exemption system, as a reduction of income from sources within that country, or is otherwise taken into account in a manner that is inconsistent with its treatment by the foreign corporation as interest stated on the books of a U.S. trade or business, or

(ii) Except in the case of a liability of a foreign corporation engaged in the active conduct of a banking, financing or similar business (as defined in § 1.884–4(c)(5)) that is a deposit within the meaning of section 871(i)(3)(A) and that exceeds $100,000, the liability is incurred in the ordinary course of a trade or business of the foreign corporation conducted outside the United States, or

(iii) The liability is secured (during more than half the days during the portion of the taxable year in which the interest accrues) predominantly by property that is not a U.S. asset (as defined in § 1.884–1T(d)) unless such liability is secured by substantially all the property of the foreign corporation.

(4) *Interbranch interest disregarded.* Interest with respect to liabilities to another office or branch of the same foreign corporation shall be disregarded for purposes of computing the interest paid by a U.S. trade or business.

(5) *Special rule where a U.S. business constitutes 80 percent or more of a foreign corporation's business*—(i) *General rule.* If—

(A) The U.S. assets (as defined in § 1.884–1T(d)) of a foreign corporation at the close of the taxable year equal or exceed 80 percent of all money and the adjusted bases (for purposes of computing earnings and profits) of all property of the foreign corporation, and

(B) The sum of the amount of interest allowable as a deduction to the foreign corporation under § 1.882–5 for the taxable year and the amount of interest paid by the foreign corporation with respect to liabilities described in paragraph (b)(1)(iv) of this section (relating to liabilities that give rise to certain nondeductible interest) exceeds the interest paid by a U.S. trade or business of the foreign corporation (without regard to this paragraph (b)(5)),

then the amount of interest paid by a U.S. trade or business of the foreign corporation for the taxable year shall be increased by the amount of the excess described in paragraph (b)(5)(i)(B) of this section. The interest that is treated as paid by a U.S. trade or business of the foreign corporation by reason of this paragraph (b)(5) shall be treated as being paid pro rata, first, with respect to liabilities of the foreign corporation that do not, for the taxable year, already give rise to interest paid by a U.S. trade or business of the foreign corporation and are not described in paragraph (b)(3) of this section (relating to liabilities that do not give rise to interest paid by a U.S. trade or business) and, second, with respect to liabilities of the foreign corporation that do not, for the taxable year, already give rise to interest paid by a U.S. trade or business of the foreign corporation and are described in paragraph (b)(3) of this section. This paragraph (b)(5) shall apply notwithstanding any other provision of this paragraph (b).

(ii) *Example.* The application of this paragraph (b)(5) is illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer, is allowed an interest deduction of $80 under § 1.882-5 for 1992. Before application of this paragraph (b)(5), the interest paid by the U.S. trade or business of A in 1992 is $40, of which $30 is attributable to liabilities described solely in paragraph (b)(1)(i) of this section and $10 is attributable to liabilities described in paragraph (b)(1)(iv) of this section. A pays $60 of other interest during 1992. The money and aggregate adjusted bases (for purposes of computing earnings and profits) of all property of A as of the close of 1992 is $1,000, and A has $800 of U.S. assets as of the close of 1992. Because 80 percent of the money and aggregate adjusted bases (for purposes of computing earnings and profits) of all property of A consists of U.S. assets as of the close of 1992, the interest paid by a U.S. trade or business of A in 1992 is treated as being $50 (*i.e.*, the sum of the interest deduction allowable to A under § 1.882-5 and the $10 of interest paid by A with respect to liabilities described in paragraph (b)(1)(iv) of this section). The interest paid by a U.S. trade or business of A is thus increased from $40 to $50, and ⅚ths ($50/$60) of each interest payment that, before application of this paragraph (b)(5), was not treated as paid by a U.S. trade or business of A, is treated as being paid by a U.S. trade or business of A. Such interest may be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442.

(6) *Special rule where interest paid exceeds deductible and non-deductible interest of a U.S. trade or business*—(i) *General rule.* If the amount of interest that is both paid by a U.S. trade or business of a foreign corporation during the taxable year and accrued for that year (including interest that the foreign corporation elects under paragraph (b)(7)(i) of this section to treat as paid during the taxable year) exceeds the sum of

(A) The amount of interest allowable to the foreign corporation as a deduction under § 1.882-5 for the taxable year, and

(B) The amount of interest attributable to liabilities described in paragraph (b)(1)(iv) of this section for which a deduction is disallowed for the taxable year,

Then the amount of interest paid by a U.S. trade or business of the foreign corporation shall be reduced by the amount of such excess. Except as provided in paragraph (b)(6)(ii) of this section (relating to an election to specify liabilities that do not give rise to interest paid by a U.S. trade or business), the amount of the excess shall reduce interest paid by a U.S. trade or business of the foreign corporation first with respect to liabilities described in paragraph (b)(1)(i) (relating to liabilities on U.S. books) that are not also described in paragraphs (b)(1) (ii) through (iv) of this section (relating to liabilities on regulatory or tax books, secured by U.S. assets, or that give rise to certain nondeductible interest), and then, if such interest has not been reduced to zero, with respect to the group of liabilities described in paragraphs (b)(1) (ii) and (iii) of this section. The reduction of interest paid with respect to each group of liabilities (*i.e.*, liabilities described solely in paragraph (b)(1)(i) of this section and liabilities described in paragraphs (b)(1) (ii) and (iii) of this section) shall be made beginning with interest attributable to the latest-incurred liability and continuing, in reverse chronological order, with interest paid with respect to the next-latest incurred liability. The interest paid with respect to a liability must be reduced to zero before a reduction is made with respect to interest attributable to the next-latest incurred liability. Where only a portion of the interest paid with respect to a liability is reduced by reason of this paragraph (b)(6)(i), the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next latest payment until the amount of interest paid by the U.S. trade or business has been reduced by the amount specified in this paragraph (b)(6)(i). The amount of interest paid by the U.S. trade or business that is not treated as interest paid by a U.S. trade or business of the foreign corporation by reason of this paragraph (b)(6)(i) shall not be subject to tax under section 871(a) or 881.

(ii) *Election to specify liabilities that do not give rise to interest paid by a U.S. trade or business.* For purposes of reducing the amount of interest paid by a U.S. trade or business under paragraph (b)(6)(i) of this section, a foreign corporation may, instead of using the method described in paragraph (b)(6)(i) of this section, elect for any taxable year to specify which liabilities will not be treated as giving rise to interest paid by a U.S. trade or business or will be treated as giving rise only in part to such interest. The election may be made only with respect to liabilities described in paragraph (b)(1)(i) of this section that are not also described in paragraphs (b)(1) (ii) through (iv) of this section and that were not identified as a liability of a U.S. trade or business during a preceding taxable year. The interest paid during the taxable year with respect to a liability specified under this paragraph (b)(6)(ii) must be reduced to zero before a reduction is made with respect to interest attributable to the next specified liability. If all interest payments with respect to a specified liability, when added to all interest payments with respect to other liabilities specified under this paragraph (b)(6)(ii), would exceed the amount of the reduction under paragraph (b)(6)(i) of this section, then only a portion of the interest paid with respect to that specified liability shall be reduced under this paragraph (b)(6)(ii), and the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next-latest payment until the amount of interest paid by a U.S. trade or business has been reduced by the amount of the reduction under paragraph (b)(6)(i) of this section. A foreign corporation that elects to have this paragraph (b)(6)(ii) apply shall note on its books and records maintained in the United States that the liability is not to be treated as giving rise to interest paid by a U.S. trade or business, or is to be treated as giving rise to such interest only in part. Such notation must be made after the close of the taxable year in which the foreign corporation pays the interest and prior to the due date (with extensions) of the foreign corporation's income tax return for the taxable year. The amount of interest paid by a U.S. trade or business that is not treated as interest paid by a U.S. trade or business by reason of this

paragraph (b)(6)(ii) shall not be subject to tax under section 871(a) or 881.

(iii) *Examples.* The application of this paragraph (b)(6) is illustrated by the following examples.

Example (1). Foreign corporation A, a calendar year, accrual method taxpayer, is allowed an interest deduction of $200 for 1990 under § 1.882-5. The amount of interest paid by a U.S. trade or business of A during 1990 is as follows:

(1) $100 to B, a domestic corporation, with respect to a note issued on March 10, 1990, and secured by real property located in the United States;

(2) $80 to C, an individual resident of country X who is entitled to a 10 percent rate of withholding on interest payments under the income tax treaty between the United States and X, with respect to a note issued on October 15, 1989, which gives rise to interest subject to tax under section 871(a);

(3) $80 to D, an individual resident of country Y who is entitled to a 15 percent rate of withholding on interest payments under the income tax treaty between the United States and Y, with respect to a note issued on February 15, 1990, which gives rise to interest subject to tax under section 871(a);

(4) $70 of portfolio interest (as defined in section 871(h)(2)) to E, a nonresident alien, with respect to a bond issued on March 1, 1990; and

(5) $30 to F, a foreign corporation that is a qualified resident of country X, with respect to a note issued on January 10, 1990.

The interest paid by a U.S. trade or business of A during 1990 accrues during 1990 for purposes of calculating A's interest deduction under § 1.882-5 except that the amount of interest paid to F increases A's basis in a U.S. asset under section 263A but is not deductible as an interest expense in 1990. A does not make an election under paragraph (b)(6)(ii) of this section to specify liabilities that do not give rise to interest paid by a U.S. trade or business. The amount of interest paid by a U.S. trade or business of A in 1990 is limited under paragraph (b)(6)(i) of this section to $230, the sum of the interest allowable to A as a deduction for 1990 ($200) and the amount of interest paid during 1990 to F that increases the basis in a U.S. asset of A ($30). The amount of interest paid by a U.S. trade or business of A must thus be reduced by $110 ($340-$230) under paragraph (b)(6)(i) of this section. The reduction is first made with respect to interest attributable to liabilities described only in paragraph (b)(1)(i) of this section (i.e., liabilities not on regulatory books or connected with U.S. assets) and, within the group of liabilities described only in paragraph (b)(1)(i) of this section, is first made with respect to the latest incurred liability. Thus, the $70 of interest paid to E with respect to the bond issued on March 1, 1990, and $40 of the $80 of interest paid to D with respect to the note issued on February 15, 1990, are not treated as paid by a U.S. trade or business of A. The interest paid to D is no longer subject to tax under section 871(a), and A may claim a refund of amounts withheld with respect to the interest payments. There is no change in the tax consequences to E because the interest received by E was portfolio interest and was not subject to tax when it was interest paid by a U.S. trade or business.

Example (2). Assume the same facts as in *Example (1)* except that A makes an election under paragraph (b)(6)(ii) of this section to specify which liabilities are not to be treated as giving rise to interest paid by a U.S. trade or business. Also assume that the liability to C was identified in 1989 as a liability that gives rise to interest paid by a U.S. trade or business. A may not specify, as liabilities that do not give rise to interest paid by a U.S. trade or business, the liabilities to B or F, which are described in paragraphs (b)(1)(iii) and (iv) of this section, respectively, or the liability to C, which was identified in a preceding taxable year as a liability that gives rise to interest paid by a U.S. trade or business. A specifies the liability to D, who would be taxable at a rate of 15 percent on interest paid with respect to the liability, as a liability that does not give rise to interest paid by a U.S. trade or business, and D is therefore not subject to tax under section 871(a) and is entitled to a refund of amounts withheld with respect to the interest payments. A also specifies the liability to E as a liability that gives rise to interest paid by a U.S. trade or business only in part. As a result, $30 of the $70 of interest paid to E is not treated as interest paid by a U.S. trade or business of A, but this does not change the tax consequences to E because the interest is portfolio interest that is not subject to tax.

(7) *Election to reduce excess interest where interest is paid and accrued in different years*—(i) *Accrual before year of payment.* A foreign corporation that accrues an interest expense that would be interest paid by a U.S. trade or business of the foreign corporation in one or more later taxable years (before application of this paragraph (b)(7)(i)) may elect under this paragraph (b)(7) to reduce its excess interest for the taxable year in which the interest accrues by the amount of such interest expense. In such case, the interest shall be treated as interest paid by a U.S. trade or business of the foreign corporation on the last day of the taxable year in which the interest expense accrues and shall not again be treated as interest paid by a U.S. trade or business of the foreign corporation in the taxable year in which it is actually paid. This paragraph (b)(7)(i) shall apply only if the election is in effect for both the taxable year in which the interest expense accrues and the taxable year in which the interest is paid. This paragraph (b)(7)(i) shall not apply to interest expenses that accrued in a taxable year beginning before January 1, 1987.

(ii) *Payment before year of accrual.* In the case of interest paid by a U.S. trade or business of a foreign corporation that will accrue as an expense in one or more later taxable years, the foreign corporation may elect under this paragraph (b)(7) to reduce (but not below zero) the amount of its excess interest for such later taxable year by the amount of such interest. The preceding sentence shall apply only if the election is in effect for both the taxable year in which the interest is paid and the taxable year in which the interest expense accrues. With respect to interest paid in a taxable year beginning before January 1, 1987, this paragraph (b)(7)(ii) shall apply only if the interest was income from sources within the United States and an election under this paragraph (b)(7) is in effect for the taxable year in which the interest accrues.

(iii) *Requirements for election.* A foreign corporation electing the provisions of this paragraph (b)(7) shall attach to its timely-filed income tax return a statement that it elects to have the provisions of both paragraph (b)(7)(i) and (ii) apply. The election shall be effective for the taxable year to which the return relates and for all subsequent taxable years unless the Commissioner consents to revocation of the election. In the case of interest paid or accrued in a taxable year ending on or before December 1, 1988, an election may be made by attaching the statement to an amended Form 1120F and filing both documents on or before January 3, 1988. If interest is deemed paid before January 3, 1988, by reason of paragraph (b)(7)(i) of this section, no penalties or interest shall be due with respect to any tax imposed under section 871(a) or 881 on such interest provided such tax is paid on or before January 3, 1989.

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(7).

Example (1). Foreign corporation A, a calendar year, accrual method taxpayer, is allowed an interest deduction of $100 under § 1.882-5 for 1987. A has $60 of interest paid by a U.S. trade or business in 1987 before application of this paragraph (b)(7). A has an interest expense of $20 which properly accrues for tax purposes in 1987 but is not paid until 1988. When the interest is paid in 1988 it will meet the requirements for interest paid by a U.S. trade or business under paragraph (b)(1) of this section. A makes a timely election under this paragraph (b)(7) to treat the accrued interest as if it were paid in 1987. A will be treated as having interest paid by a U.S. trade or business of $80 for 1987 and excess interest of $20 in 1987. The $20 of interest treated as interest paid by a U.S. trade or business of A in 1987 will not again be treated as interest paid by a U.S. trade or business of A in 1988.

Example (2). Foreign corporation A, a calendar year, accrual method taxpayer, has $60 of interest paid by a U.S. trade or business in 1987. The interest expense does not accrue until 1988 and the interest deduction that is allowable to A under

§ 1.882-5 is zero for 1987 and $60 for 1988. A makes an election under this paragraph (b)(7) with respect to 1987. As a result of the election, the $60 of interest paid by a U.S. trade or business of A in 1987 reduces the amount of A's excess interest for 1988.

(8) *Effect of treaties*—(i) *Payor's treaty.* In the case of interest paid by a U.S. trade or business of a foreign corporation, relief shall be available under an article of an income tax treaty between the United States and the foreign corporation's country of residence relating to interest paid by the foreign corporation only if—

(A) The corporation is a qualified resident (as defined in § 1.884-5T(a)) of that foreign country for the taxable year in which the interest is paid by a U.S. trade or business (or is treated as paid by a U.S. trade or business under paragraph (b)(7) of this section) or for the prior taxable year and such portion of the current taxable year that ends with the date of the interest payment or

(B) The foreign corporation meets, with respect to the interest payment, the requirements of the limitation on benefits or similar article in the treaty and such article entered into force after December 31, 1986.

(ii) *Recipient's treaty.* A foreign person (other than a foreign corporation) that derives interest that is interest paid by a U.S. trade or business (or is treated as paid by a U.S. trade or business under paragraph (b)(7) of this section) shall be entitled to claim benefits under provisions of an income tax treaty between the United States and its country of residence relating to interest derived by the foreign person. A foreign corporation may claim such benefits if it meets, with respect to the interest payment, the requirements of the limitation on benefits or similar article in the treaty and such article entered into force after December 31, 1986. A foreign corporation may otherwise claim such benefits only if

(A) The foreign corporation is a qualified resident (as defined in § 1.884-5T(a)) of the foreign country for the taxable year in which the interest is paid by a U.S. trade or business (or is treated as paid by a U.S. trade or business under paragraph (b)(7) of this section) or for the prior taxable year and such portion of the current taxable year that ends with the date of the interest payment and

(B) In the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation with a maturity not exceeding one year, each foreign corporation that beneficially owned the obligation prior to maturity was a qualified resident (as defined in § 1.884-5T(a)) of a foreign country with which the United States has an income tax treaty or met the requirements of the limitation on benefits or similar article in a treaty with respect to the interest payment and such article entered into force after December 31, 1986.

(iii) *Treaties other than income tax treaties.* [Reserved]

(iv) *Effect of income tax treaties on interest paid by a partnership.* If a foreign corporation is a partner (directly or indirectly) in a partnership that is engaged in a trade or business in the United States, the relief that may be claimed under an income tax treaty with respect to the foreign corporation's distributive share of interest paid or treated as paid by the partnership shall not exceed the relief that would be available under paragraph (b)(8) (i) and (ii) of this section if such interest were interest paid by a U.S. trade or business of the foreign corporation. See paragraph (c)(2) of this section for the effect on a foreign corporation's excess interest of interest paid by a partnership of which the foreign corporation is a partner.

(v) *Examples.* The following examples illustrate the application of this paragraph (b)(8).

Example (1). The income tax treaty between the United States and country X, of which foreign corporation A is a qualified resident, provides that the United States may not impose a tax on interest paid by a corporation that is a resident of that country (and that is not a domestic corporation) if the recipient of the interest is a nonresident alien or a foreign corporation. Interest paid by a U.S. trade or business of A is not subject to tax under section 871(a) or 881 regardless of whether the recipient is entitled to benefits under an income tax treaty.

Example (2). A, a foreign corporation and B, a nonresident alien, are partners in a partnership that owns and operates U.S. real estate and each has a distributive share of partnership interest deductions equal to 50 percent of the interest deductions of the partnership. There is no income tax treaty between the United States and the countries of residence of A and B. The partnership pays $1,000 of interest to a bank that is a resident (but not a qualified resident) of foreign country Y, which has an income tax treaty in effect with the United States providing that the rate of tax on U.S. source interest paid to a resident of that country may not exceed 5 percent. The partnership is required to withhold at a rate of 30 percent on $500 of the interest paid to the bank (i.e., A's 50 percent distributive share of interest paid by the partnership) because the bank is not a qualified resident of Y and cannot, under paragraph (b)(8)(iv) of this section, claim greater treaty benefits than it could claim if the $500 were interest paid by a U.S. trade or business of A.

(c) *Excess interest*—(1) *Reporting and payment of tax on excess interest.* The amount of tax due under section 884(f) and this section with respect to excess interest of a foreign corporation shall be reported on the foreign corporation's income tax return for the taxable year in which the excess interest is treated as paid under section 884(f)(1)(B) and paragraph (a)(2) of this section, and shall not be subject to withholding under section 1441 or 1442. The tax shall be due and payable as provided in section 6151 and such other sections of Subtitle F of the Internal Revenue Code as apply.

(2) *Interest paid by a partnership*—(i) *General rule.* Except as otherwise provided in this paragraph (c)(2)(i) and in paragraph (c)(2)(ii) of this section, if a foreign corporation is a partner in a partnership that is engaged in trade or business in the United States, the amount of the foreign corporation's distributive share of interest paid or accrued by the partnership shall reduce (but not below zero) the amount of the foreign corporation's excess interest for the year in which such interest is taken into account by the foreign corporation for purposes of calculating the interest deduction allowable to the foreign corporation under § 1.882-5. A foreign corporation's excess interest shall not be reduced by its distributive share of partnership interest that is attributable to a liability described in paragraph (b)(3) of this section (relating to certain liabilities that do not give rise to interest paid by a U.S. trade or business) or would be described in such paragraph (b)(3) if entered on the partner's books. The amount that reduces the foreign corporation's excess interest under this paragraph (c)(2) shall not in any taxable year exceed that proportion of the foreign corporation's distributive share of interest paid or accrued by the partnership that is allowed to the foreign corporation as a deduction under § 1.882-5. See paragraph (b)(8)(iv) of this section for the effect of income tax treaties on interest paid by a partnership.

(ii) *Special rule for interest that is paid and accrued in different years.* Paragraph (c)(2)(i) of this section shall not apply to any portion of a foreign corporation's distributive share of partnership interest that is paid and accrued in different taxable years unless the foreign corporation has an election in effect under paragraph (b)(7) of this section that is effective with respect to such interest and any tax due under section 871(a) or 881 with respect to such interest has been deducted and

withheld at source in the earlier of the taxable year of payment or accrual.

(3) *Effect of treaties*—(i) *General Rule.* The rate of tax imposed on the excess interest of a foreign corporation that is a qualified resident of a country with which the United States has an income tax treaty shall not exceed the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation.

(ii) *Provisions in income tax treaties relating to interest paid by a foreign corporation.* Any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce the rate of such tax.

(iii) *Treaties other than income tax treaties.*

[Reserved]

(4) *Examples.* The following examples illustrate the application of paragraph (c) (2) and (3) of this section.

Example (1). Foreign corporation A, a calendar year taxpayer, is not a resident of a foreign country with which the United States has an income tax treaty. A is engaged in the conduct of a trade or business both in the United States and in foreign countries, and owns a 50 percent interest in partnership X, a calendar year taxpayer engaged in the conduct of a trade or business in the United States. For 1989, all of X's liabilities are of a type described in paragraph (b)(1) of this section (relating to liabilities on U.S. books) and none are described in paragraph (b)(3)(i) of this section (relating to certain interest giving rise to a foreign tax benefit). A's distributive share of interest paid by X in 1989 is $20. For 1989, A is allowed a deduction of $150 under § 1.882–5, $120 of which is attributable to interest paid by a U.S. trade or business. Thus, the amount of A's excess interest for 1989, before application of paragraph (c)(2)(i) of this section, is $30. Under paragraph (c)(2)(i) of this section, A's $30 of excess interest is reduced by $20, representing A's pro rata share of interest paid by X. Thus, the amount of A's excess interest for 1989 is reduced to $10. A is subject to a tax of 30 percent on its $10 of excess interest.

(d) *Stapled entities.* For treatment of a foreign corporation that is a stapled entity by reason of section 269B, see § 1.884–1T(i).

(e) *Effective date.* This section is effective for taxable years beginning after December 31, 1986, and for payments of interest described in section 884(f)(1)(A) made during taxable years of the payor beginning after December 31, 1986.

§ 1.884–5T Qualified resident (temporary).

(a) *Definition of a qualified resident.* A foreign corporation is a qualified resident of a foreign country with which the United States has an income tax treaty in effect if the foreign corporation is a resident of that country within the meaning of the income tax treaty between the United States and that country and the foreign corporation either—

(1) Meets the requirements of paragraph (b) of this section (relating to stock ownership) and the requirements in paragraph (c) of this section (relating to base erosion),

(2) Meets the requirements of paragraph (d) of this section (relating to a foreign corporation whose stock is primarily and regularly traded on an established securities market in its country of residence or in the United States),

(3) Meets the requirements of paragraph (e) of this section (relating to a foreign corporation engaged in an active trade or business in its country of residence), or

(4) Obtains a ruling as provided in paragraph (f) of this section.

(b) *Stock ownership requirement*—(1) *General rule.* A foreign corporation satisfies the stock ownership requirement of this paragraph (b) for the taxable year or a portion of the taxable year if—

(i) 50 percent or more of its stock (by value) is beneficially owned, or is treated as beneficially owned by reason of paragraph (b)(2) of this section, during at least half of the number of days in the foreign corporation's taxable year (or at least half the number of days in the portion of the taxable year) by individuals who are either residents of the foreign country of which the foreign corporation is a resident or citizens or individual residents of the United States,

(ii) It obtains the documentation required under paragraph (b)(3) (i) or (ii) of this section to show that the requirements of paragraph (b)(1)(i) have been met, and

(iii) Such documentation is maintained and made available to the District Director as provided in paragraph (b)(7) of this section.

(2) *Rules for determining ownership*—(i) *Constructive ownership*—(A) *General rules for attribution.* For purposes of this section, stock owned by a corporation, partnership, trust or estate shall be treated as owned proportionately by its shareholders, partners, or beneficiaries. The proportionate interest rules of this paragraph (b)(2)(i) shall apply successively upward through a chain of ownership. Except as otherwise specifically provided, stock treated as owned by a person by reason of this paragraph (b)(2)(i) shall, for purposes of applying this paragraph (b)(2)(i), be treated as actually owned by such person.

(B) *Partnerships.* A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the lesser of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock, (B) The partner's percentage distributive share of gain from disposition of the stock by the partnership, or (C) The partner's percentage share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

(C) *Trusts and Estates.* In general, a beneficiary of a trust (including a grantor thereof) or a beneficiary of an estate shall be treated as having an interest in stock owned by a trust or estate in proportion to the beneficiary's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B) and the regulations thereunder, except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock and the interest rate used to compute the income beneficiary's actuarial interest in the trust shall equal the income beneficiary's actual rate of return on the fair market value of the stock for the taxable year. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(i)(C), shall not be considered owned by an individual who is a resident of a country with which the United States has an income tax treaty in effect unless all potential beneficiaries with respect to the stock are qualified residents.

(D) *Corporations.* A shareholder shall be treated as having an interest in stock of a foreign corporation owned by another corporation in a proportion equal to the lesser of (1) the shareholder's percentage share of current earnings and profits of the corporation as determined under the principles of section 1248, (2) the shareholder's percentage share of accumulated earnings and profits of the corporation as determined under the principles of section 1248, or (3) the shareholder's percentage share of assets upon liquidation of the corporation. If

there is an agreement, express or implied, that designated pools of earnings are to be paid only with respect to certain stock, then any shareholder not entitled to share in a designated pool of earnings shall not be considered to be a shareholder with respect to such stock.

(ii) *Governments treated as individual shareholders.* For purposes of this section, the government of the country of which a foreign corporation is a resident (or a political subdivision or local authority of such country), or the United States, a State, the District of Columbia, or a political subdivision or local authority of a State shall be treated as an individual resident of such foreign country or of the United States, as the case may be.

(iii) *Publicly-traded corporations treated as individual shareholders.* For purposes of this section—

(A) A domestic corporation whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in the United States shall be treated as an individual resident of the United States and

(B) A foreign corporation whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in the country of which it is a resident (within the meaning of the income tax treaty between the United States and such country) shall be treated as an individual resident of such country for purposes of determining the ownership of stock in another foreign corporation that is a resident of the same foreign country.

Stock that is treated as owned by individual residents by reason of this paragraph (b)(2)(iii) shall not be treated as owned by any other person for purposes of determining stock ownership under this paragraph (b).

(iv) *Publicly-traded stock treated as owned by individuals.* A class of stock of a corporation that is primarily and regularly traded on an established securities exchange (within the meaning of paragraph (d) of this section) in the United States or in the foreign corporation's country of residence shall be treated as owned by individual residents of the United States or such foreign country, as the case may be.

(3) *Required documentation.* In order to satisfy the stock ownership requirement of paragraph (b)(1) of this section for a taxable year, a foreign corporation must, before the due date (including extensions) for filing its income tax return for the taxable year (or, where applicable, in the case of a foreign corporation claiming treaty benefits under § 1.884-4T(b)(8) (i) or (ii), before the interest payment) obtain the following written documentation from a sufficient number of its direct or indirect individual shareholders (including a government or corporation treated as an individual shareholder by reason of paragraph (b)(2) (ii) or (iii) of this section) to show that it has satisfied the 50 percent ownership test of paragraph (b)(1)(i) of this section:

(i) Individual documentation described in paragraph (b)(4) of this section and, if applicable, an intermediary ownership statement described in paragraph (b)(5) of this section from each intermediary standing in the chain of the individual shareholder's ownership of his interest in the foreign corporation, or

(ii) An intermediary verification statement described in paragraph (b)(6) of this section and, if applicable, an intermediary ownership statement described in paragraph (b)(5) of this section from each intermediary standing in the chain of the verifying intermediary's ownership of its interest in the foreign corporation.

(4) *Individual documentation.* The individual documentation shall consist of a statement described in paragraph (b)(4)(i) of this section from the individual shareholder (or from a government or corporation treated as an individual shareholder by reason of paragraph (b)(2) (ii) or (iii) of this section) and, in the case of any individual who is not a citizen or resident of the United States, a certificate of residency described in paragraph (b)(4)(ii) of this section.

(i) *Statement from individual shareholder or from government or corporation treated as an individual shareholder.* A statement from an individual shareholder shall be a written statement signed by the shareholder under penalties of perjury stating that the individual is a direct or indirect beneficial owner of an interest in the foreign corporation and that the individual does not own such interest on behalf of another person. In addition, the statement must include the following information:

(A) The number of shares owned directly or indirectly by the individual shareholder in each class of stock of the foreign corporation;

(B) The period of time during the taxable year during which the individual shareholder owned the stock;

(C) The name and permanent address of the individual shareholder;

(D) The country of residence of the individual shareholder, and

(E) If the stock in the foreign corporation is held indirectly by the individual shareholder through one or more intermediary, whether acting as nominees or beneficial interest holders, then the name and address of each such intermediary and the description of the chain of ownership through which the individual shareholder holds stock in the foreign corporation, to the extent known to the individual shareholder.

A statement from a government treated as an individual shareholder by reason of paragraph (b)(2)(ii) of this section shall be signed by the Competent Authority of the foreign country, as defined in the income tax treaty between the foreign country and the United States, shall state that the government is a direct or indirect beneficial owner of an interest in the foreign corporation, and shall contain the information specified in paragraph (b)(4)(i) (A), (B) and (E) of this section. A statement from a corporation that is treated as an individual shareholder under paragraph (b)(2)(iii) of this section shall be signed under penalties of perjury by a person authorized to sign a tax return on behalf of the corporation, shall state that the corporation is a direct or indirect beneficial owner of the foreign corporation and that the corporation's stock is primarily and regularly traded on an established security exchange (within the meaning of paragraph (d) of this section) in the United States or its country of residence, and shall contain the information specified in paragraph (b)(4)(i) (A) through (E).

(ii) *Certificate of residency.* A certificate of residency must be signed by the authorities of the country of residence of the individual shareholder and must state that the individual is a resident of that country for purposes of its income tax laws. The authorities shall be the Competent Authority of the foreign country, as defined in the income tax treaty between the foreign country and the United States, or such other governmental office of the foreign country that customarily provides statements of residence. Such statement shall have the official seal of the Competent Authority (or such other governmental office of the named foreign country that customarily provides statements of residence) if it generally affixes such a seal to official documents. An individual shall be considered a resident of a country with which the United States has an income tax treaty if such individual is considered a resident of such country under the provisions, if any, of the income tax treaty between the United

States and such country or, if there are no such provisions, if such individual is considered a resident of such country for purposes of such country's income tax laws.

(5) *Inter...ediary ownership statement.* An intermediary ownership statement must be obtained from each intermediary in the relevant chain of ownership described in paragraph (b)(3)(i) or (ii) of this section regardless of whether the intermediary is merely a legal owner or recordholder acting as nominee for an individual or for another intermediary, or a beneficial owner through which an individual or another intermediary indirectly owns stock in the foreign corporation. The intermediary ownership statement shall be signed under penalties of perjury by a person that would be authorized to sign a tax return on behalf of the intermediary and shall contain the following information:

(i) The number of shares owned directly or indirectly by the intermediary in each class of stock of the foreign corporation;

(ii) The period of time during the taxable year during which the intermediary owned directly or indirectly the stock described in paragraph (b)(5)(i) of this section;

(iii) The name and principal place of business of the intermediary (*i.e.*, the name of a corporation or partnership and the address of its principal place of business, or the name and permanent address of all trustees of a trust (or equivalent under foreign law) or of all executors of an estate (or equivalent under foreign law));

(iv) The country of residence of the intermediary;

(v) If the stock is held as nominee for an individual or another intermediary, the name and permanent address of the individual, or the name and principal place of business of such other intermediary;

(vi) If the stock is not held as nominee for an individual or another intermediary, the amount and nature of the interest owned in the intermediary issuing the statement by its direct shareholder, partner or beneficiary which indirectly owns an interest in the foreign corporation and the period of time during the taxable year for which the interest in the intermediary was owned by such stockholder, partner, or beneficiary; and

(vii) If the intermediary owns stock in the foreign corporation indirectly through one or more other intermediaries as nominees or beneficial interest holders, the name and principal place of business of each such intermediary and a description of the chain of ownership through which the intermediary holds the stock described in paragraph (b)(5)(i) of this section to the extent known by the intermediary.

(6) *Intermediary verification statement.* An intermediary verification statement is a statement from any intermediary standing in the chain of the ultimate individual shareholder's ownership of his interest in the foreign corporation (or in the chain of ownership of a government or corporation treated as an individual shareholder under paragraph (b)(1)(ii) or (iii) of this section) certifying that stock in the foreign corporation owned by the verifying intermediary as a nominee or beneficial interest holder is owned directly or indirectly by one or more individuals described in paragraph (b)(1)(i) of this section. An intermediary verification statement may be made only by a domestic corporation, a resident of the United States, or a resident (for treaty purposes) of a country with which the United States has an income tax treaty in effect. The intermediary verification statement shall be signed under penalties of perjury by the individual (if the verifying intermediary is an individual) or by a person that would be authorized to sign a tax or tax information return on behalf of the intermediary (if the verifying intermediary is not an individual) and shall contain the following information:

(i) A statement that the verifying intermediary has obtained individual documentation described in paragraph (b)(4) of this section (or an intermediary verification statement described in this paragraph (b)(6) that is received from an upper-tier intermediary) that establishes that the stock of the foreign corporation that is the subject of the verification is in fact owned by individuals described in paragraph (b)(1)(i) of this section or by a government or corporation treated as such an individual by reason of paragraph (b)(2)(ii) or (iii) of this section;

(ii) A statement that the verifying intermediary has obtained an intermediary ownership statement described in paragraph (b)(5) of this section from every intermediary standing in the chain of ownership between the verifying intermediary and any indirect individual shareholder for whom documentation described in paragraph (b)(6)(i) of this section is obtained (or between the verifying intermediary and any upper-tier intermediary that has issued an intermediary verification statement described in this paragraph (b)(6));

(iii) An agreement to make available to the Commissioner at such time and place as the Commissioner may request the underlying documentation described in paragraphs (b)(6)(i) and (ii) of this section;

(iv) A specific and valid waiver of any right to bank secrecy or other secrecy under the laws of the country in which the verifying intermediary is located, with respect to any individual documentation, intermediary verification statement and intermediary ownership statement which the verifying intermediary has obtained pursuant to paragraphs (b)(6)(i) and (ii) of this section;

(v) The number of shares in each class of stock of the foreign corporation that are owned directly or indirectly by the verifying intermediary and that is covered by the intermediary verification statement;

(vi) The period of time during the taxable year during which the verifying intermediary owned directly or indirectly the stock described in paragraph (b)(6)(v) of this section;

(vii) The name and the principal place of business of the verifying intermediary;

(viii) The country of residence of the verifying intermediary; and

(ix) If the verifying intermediary owns stock in the foreign corporation indirectly through one or more other intermediaries as nominees or beneficial interest holders, the name and principal place of business of each such intermediary and a description of the chain of ownership through which the verifying intermediary holds the stock described in paragraph (b)(6)(v) of this section, to the extent known to the verifying intermediary.

(7) *Availability of documents for inspection*—(i) *Retention of documents by the foreign corporation.* The documentation described in paragraph (b)(3) of this section must be retained by the foreign corporation until expiration of the period of limitations for the taxable year to which the documentation relates and must be made available for inspection by the District Director at such time and place as the District Director may request.

(ii) *Retention of documents by an intermediary issuing an intermediary verification statement.* The documentation upon which an intermediary relies to issue an intermediary verification statement under paragraph (b)(6) of this section must be retained by the intermediary for a period of six years from the date of issuance of the intermediary verification statement and must be made available for inspection by the District Director at such time and place as the District Director may request.

(8) *Examples.* The application of this paragraph (b) is illustrated by the following examples.

Example (1). Foreign corporation A is a resident of country L which has an income tax treaty in effect with the issued and outstanding consisting of 1,000 shares, which are beneficially owned by the following alien individuals, directly or by application of paragraph (b)(2) of this section:

Individual.	Shares owned [1]	Percentage
T—resident of the U.S.	200	20
U—resident of country L	400	40
V—resident of country M	100	10
W—resident of country L	210	21
X—resident of country N	90	9
Total	1,000	100

[1] Shares owned, directly or by application of paragraph (b)(2) of this section.

(i) T owns his 200 shares directly and is a beneficial owner.

(ii) U and V each own respectively an 80 percent and a 20 percent actuarial interest in a foreign trust FT which beneficially owns 100 percent of the stock of a foreign corporation B with bearer shares which beneficially owns 500 shares of foreign corporation A. Foreign corporation B is incorporated in a country that does not have an income tax treaty with the United States. The foreign trust has deposited the bearer shares it owns in foreign corporation B with a bank in a foreign country which has an income tax treaty with the United States.

(iii) W beneficially owns all the shares of foreign corporation C, which are registered in the name of individual Z, a nominee, who resides in Country L. Foreign corporation C beneficially owns a 70 percent interest in foreign corporation D, which beneficially owns 300 shares of foreign corporation A. Foreign corporation D's shares are bearer shares which foreign corporation C (not a resident of a country with which the United States has an income tax treaty) has deposited with a bank in a foreign country that has an income tax treaty with the United States.

(iv) X beneficially owns a 30 percent interest in foreign corporation D.

(v) Countries M (where V resides) and N (where X resides) have no income tax treaty with the United States.

Foreign corporation A is a qualified resident of country L if it obtains the documentation either from individuals U and W or from individuals T and U, since either combination of qualifying ultimate individual shareholding in foreign corporation A will add up to at least 50 percent. The shareholdings of individuals V and X are ignored in determining whether foreign corporation A meets the stock ownership of this paragraph (b) since neither of them is a U.S. citizen or a resident of the United States or of a country with which the United States has an income tax treaty.

Example (2). Assume the same facts as in *Example (1)* and assume that foreign corporation A chooses to obtain documentation with respect to individuals T and U.

(i) With respect to T, foreign corporation A must obtain the individual documentation regarding T's shareholding in foreign corporation A which, pursuant to paragraph (b)(3)(i) and (b)(4) of this section, consists of an individual statement by T, as described in paragraph (b)(4)(i) of this section. No certificate of residency need be furnished since T is a U.S. resident.

(ii) As to U's shareholding in foreign corporation A, U must provide the foreign trust FT with the individual documentation described in paragraph (b)(4) of this section; the trustees of FT must provide the depository bank holding foreign corporation B's bearer shares with an intermediary ownership statement concerning its indirect beneficial ownership of foreign corporation A's shares and must attach to it the individual documentation provided by U. The depository bank has the choice of providing foreign corporation B with either (A) an intermediary ownership statement regarding its direct ownership of shares in foreign corporation B on behalf of FT, to which must then be attached the individual documentation issued by U and the intermediary ownership statement issued by FT, or (B) an intermediary verification statement as described in paragraph (b)(6) of this section, in which case foreign corporation B would not be provided with U's individual documentation or FT's intermediary ownership statement, both of which are retained by the depository bank. In either case, foreign corporation B must then provide foreign corporation A with an intermediary ownership statement regarding its direct beneficial ownership of shares in foreign corporation A and, as the case may be, either (A) U's individual documentation and the intermediary ownership statements by FT and the depository bank, or (B) the depository bank's intermediary verification statement. Thus, with respect to U, foreign corporation A must obtain under paragraph (b)(3)(i) of this section the individual documentation regarding U and an intermediary ownership statement from each intermediary standing in the chain of U's indirect beneficial ownership of shares in foreign corporation A, *i.e.*, from FT, the depository bank and foreign corporation B. In the alternative, foreign corporation A must obtain under paragraph (b)(3)(ii) of this section an intermediary verification statement issued by the depository bank and an intermediary ownership statement from foreign corporation B, which, in this example, is the only intermediary standing in the chain of ownership of the verifying intermediary (*i.e.*, the depository bank).

Example (3). Assume the same facts as in *Example (1).* In addition, assume that foreign corporation A chooses to obtain documentation with respect to individuals U and W. With respect to U, foreign corporation A must obtain the same documentation that is described in *Example (2).* With respect to W, foreign corporation A must obtain, under paragraph (b)(3)(i) of this section, individual documentation regarding W and an intermediary ownership statement from each intermediary standing in the chain of W's indirect beneficial ownership of shares in foreign corporation A, *i.e.*, from individual Z, foreign corporation C, the depository bank in the foreign treaty country, and foreign corporation D. In the alternative, foreign corporation A must obtain, under paragraph (b)(3)(ii) of this section, either (i) an intermediary verification statement by the depository bank in the foreign treaty country and an intermediary ownership statement from foreign corporation D or (ii) an intermediary verification statement from individual Z and an intermediary ownership statement from each intermediary standing in the chain of ownership of shares in foreign corporation A, *i.e.*, from foreign corporation C, the depository bank in the foreign treaty country and foreign corporation D. Corporation C may not issue an intermediary verification statement because it is not a resident of a country with which the United States has an income tax treaty.

(c) *Base erosion.* A foreign corporation satisfies the requirement relating to base erosion for a taxable year (or for a portion of a taxable year) if it establishes that less than 50 percent of its income for the taxable year (or for the portion of the taxable year) is used (directly or indirectly) to meet liabilities (such as liabilities to pay interest, rents, royalties, or reinsurance premiums) to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the foreign country of which the foreign corporation is a resident and who are not citizens or residents (or, in the case of domestic corporations, qualified residents) of the United States. Whether a domestic corporation is a qualified resident of the United States shall be determined under the principles of this section. The meeting of a liability does not include a repayment of the principal amount of an obligation. For purposes of this paragraph (c), a liability is met in the taxable year (or portion of the taxable year) in which the satisfaction, in whole or in part, of such liability gives rise (or would give rise if the portion of the taxable year were a short taxable year) to a tax benefit (including a deduction, an increase in the basis of an asset, or a tax credit) under U.S. tax principles. For purposes of this paragraph (c), the income of a foreign corporation means the corporation's gross income (or, if the foreign corporation has no gross income, gross receipts) under U.S. tax principles.

(d) *Publicly-traded corporations*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country for any taxable year in which—

(i) Its stock is primarily and regularly traded (as defined in paragraph (d)(3) and (4) of this section) on one or more established securities markets (as defined in paragraph (d)(2) of this

section) in that country, or in the United States, or both; or

(ii) It is wholly-owned (within the meaning of paragraph (d)(5) of this section) by a foreign corporation that is a resident of the same foreign country or a domestic corporation and the stock of such parent corporation is primarily and regularly traded on an established securities market in that foreign country or in the United States, or both.

(2) *Established securities market*—(i) *General rule.* For purposes of section 884, the term "established securities market" means, for any taxable year—

(A) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(B) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. section 78f); and

(C) A domestic over-the-counter market.

(ii) *Exchanges with multiple tiers.* If a principal exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(iii) *Computation of dollar value of stock traded.* For purposes of paragraph (d)(2)(i)(A) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges, located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(iv) *Definition of over-the-counter market.* An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

(v) *Discretion to determine that exchange qualifies as established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that does not meet the requirements of paragraph (d)(2)(i)(A) of this section qualifies as an established securities market. Such a determination will be made only if it is established that—

(A) The exchange, in substance, has the attributes of an established securities market (including adequate trading volume, and comparable listing and financial disclosure requirements);

(B) The rules of the exchange ensure active trading of listed stocks; and

(C) The exchange is a member of the International Federation of Stock Exchanges.

(vi) *Discretion to determine that market does not qualify as established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities market that meets the requirements of paragraph (d)(2)(i) of this section does not qualify as an established securities market. Such determination shall be made if, in the view of the Commissioner—

(A) The market does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(B) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(3) *Primarily traded.* For purposes of section 884, stock is "primarily traded" on an established securities market in the country of residence of a foreign corporation or in the United States in any taxable year in which—

(i) One or more classes of stock of the foreign corporation that in the aggregate, represent more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation, are listed on one or more established securities markets in such country or in the United States and each class is regularly traded on one or more established securities markets (within the meaning of paragraph (d)(4) of this section) in such countries; and

(ii) The number of shares in each class of stock described in subdivision (i) of this paragraph (d)(3) that are traded during the taxable year on all established securities markets in the foreign corporation's country of residence or in the United States on which the class is regularly traded exceeds the number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.

(4) *Regularly traded*—(i) *General rule.* For purposes of section 884, a class of stock of a foreign corporation listed during the taxable year on one or more established securities markets in the country of residence of the foreign corporation or in the United States is "regularly traded" on such established securities market or markets in that taxable year if—

(A) Trades in such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year (or ⅙ of the number of days in a short taxable year or in a portion of a taxable year where relevant under §§ 1.884-4T(b)(8) (i) and (ii)), and

(B) The aggregate number of shares of that class traded on such market or markets during the taxable year is at least 30 percent of the average number of shares outstanding in that class during the taxable year (or at least 10 percent in the case of a foreign corporation that establishes that it has at least 2,500 shareholders of record during the taxable year). In the case of a short taxable year or a portion of a taxable year where relevant under § 1.884-4T(b)(8) (i) or (ii), the applicable percentage shall equal 30 percent or 10 percent, respectively, times the number of days in the short taxable year or in the portion of a taxable year, divided by 365.

(ii) *Closely-held companies not treated as regularly traded.* If, at any time during the taxable year, 100 or fewer persons own 50 percent or more of the outstanding shares of a class of stock, then such class of stock shall not be treated as regularly traded for that year. Persons related within the meaning of section 267(b) shall be treated as one person for purposes of this paragraph (d)(4)(ii). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iii) *Anti-abuse rule.* Trades between persons described in section 267(b) (as modified in subdivision (ii) of this paragraph (d)(4)) and trades conducted

in order to meet the requirements of this paragraph (d)(4) shall be disregarded. The stock of a foreign corporation will not be treated as regularly traded if there is a pattern of trades designed to meet the requirements of this paragraph (d)(4). For example, trades between two persons that occur several times during the taxable year may be treated as an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(4).

(iv) *Stock traded on domestic established securities markets.* A class of stock that is traded during the taxable year on an established securities market located in the United States shall be treated as regularly traded if the stock is regularly quoted by brokers or dealers making a market in the stock. A broker or dealer makes a market in a stock only if the broker or dealer holds himself out to buy or sell the stock at the quoted price.

(5) *Stock treated as wholly-owned.* For purposes of paragraph (d)(1) of this section, stock of a foreign corporation shall be treated as wholly-owned by a corporation (the "parent corporation") if at least 90 percent of the total combined voting power of all classes of stock of such foreign corporation entitled to vote and at least 90 percent of the total value of the stock of such foreign corporation is owned, directly or by application of paragraph (b)(2) of this section, by the parent corporation.

(6) *Burden of proof for publicly-traded corporations.* A foreign corporation that relies on this paragraph (d) to establish that it is a qualified resident of a country with which the United States has an income tax treaty shall have the burden of proving all the facts necessary for the corporation to be treated as a qualified resident, except with respect to paragraph (d)(4)(ii) of this section. With respect to paragraph (d)(4)(ii) of this section, a foreign corporation must maintain a list of shareholders of record, and, on request, shall make available to the district director such list and any other relevant information known to the foreign corporation.

(e) *Active trade or business*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country if—

(i) It is engaged in the active conduct of a trade or business (as defined in paragraph (e)(2) of this section) in its country of residence,

(ii) It has a substantial presence (within the meaning of paragraph (e)(3) of this section) in its country of residence, and

(iii)(A) The activities that give rise to the income for which a treaty exemption or rate reduction is claimed constitute part of a U.S. trade or business in which the foreign corporation is engaged (or is deemed to be engaged) and such U.S. trade or business is an integral part (as defined in paragraph (e)(4) of this section) of an active trade or business conducted by the foreign corporation in its country of residence, or

(B) In the case of interest received by the foreign corporation for which a treaty exemption or rate reduction is claimed pursuant to § 1.881–4T(b)(8)(ii), the interest is derived in connection with, or is incidental to, the trade or business described in paragraph (e)(1)(i) of this section.

(2) *Active conduct of a trade or business.* A foreign corporation is engaged in the active conduct of a trade or business only if either—

(i) It is engaged in the active conduct of a trade or business within the meaning of section 367(a)(3) and the regulations thereunder or

(ii) It qualifies as a banking, financing or credit institution under the laws of the foreign country of which it is a resident and it is engaged in the active conduct of a banking, financing, or similar business within the meaning of § 1.864–4(c)(5)(i).

A foreign corporation that is an insurance company within the meaning of § 1.801–3 (a) or (b) is engaged in the active conduct of a trade or business only if it is predominantly engaged in the active conduct of an insurance business within the meaning of section 952(c)(1)(B)(v) and the regulations thereunder.

(3) *Substantial presence test.* A foreign corporation that is engaged in the active conduct of a trade or business in its country of residence has a substantial presence in that country if, for the taxable year, the average of the following three ratios exceeds 25 percent and each ratio is at least equal to 20 percent:

(i) The ratio of assets used or held for use in the active conduct of the foreign corporation's trade or business in its country of residence to the worldwide asset of the foreign corporation,

(ii) The ratio of the gross income from the active conduct of the foreign corporation's trade or business in its country of residence that is derived from sources within such country to the worldwide gross income of the foreign corporation, and

(iii) The ratio of the payroll expenses in the foreign corporation's country of residence to the foreign corporation's worldwide payroll expenses.

(4) *Integral part of an active trade or business in a foreign corporation's country of residence*—(i) *In general.* A U.S. trade or business of a foreign corporation is an integral part of an active trade or business conducted by a foreign corporation in its country of residence if an active trade or business conducted by the foreign corporation in both its country of residence and in the United States comprises, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services. Subject to the presumption in paragraph (e)(4)(ii) of this section, if a U.S. trade or business of a foreign corporation sells goods that are not, in principal part, manufactured, produced, grown or extracted by the foreign corporation in its country of residence, such business shall in no event be treated as an integral part of an active trade or business conducted in the foreign corporation's country of residence if the foreign corporation does not take physical possession of the goods in a warehouse or other storage facility that is located in its country of residence and in which goods of such type are normally stored prior to sale to customers in such country.

(ii) *Presumption if business principally conducted in country of residence.* A U.S. trade or business of a foreign corporation shall be treated as an integral part of an active trade or business of a foreign corporation in its country of residence with respect to the sale or lease of property (or the performance of services) if at least 50 percent of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of such property for consumption, use, or disposition in the foreign corporation's country of residence (or from the performance of such services in the foreign corporation's country of residence). A U.S. trade or business that is engaged in the active conduct of a banking or financial business and makes loans to the public shall be treated as an integral part of an active trade or business of the foreign corporation in its country of residence with respect to loans made to the public if the foreign corporation is engaged in the active conduct of a banking or financial business and makes loans to the general public and at least 50 percent of the principal amount of the foreign corporation's loans are to residents of the foreign corporation's country of residence. In determining whether property or services are of the

same type, a foreign corporation shall follow recognized industry or trade usage or the three-digit major groups (or any narrower classification) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. The determination of whether income is of the same kind must be made in a consistent manner from year to year.

(f) *Ruling that a foreign corporation is a qualified resident.* In his sole discretion, the Commissioner may rule that—

(i) The establishment or maintenance of a foreign corporation in its country of residence does not have as one of its principal purposes obtaining benefits under the income tax treaty between the United States and the foreign corporation's country of residence, and

(ii) The foreign corporation has substantial business reasons for residing in its country of residence.

In such case, the foreign corporation shall be treated as a qualified resident of its country of residence for the taxable year in which the ruling was obtained and the succeeding two taxable years. If there has been a material change in either the ownership or trade or business of the foreign corporation, the foreign corporation must notify the Secretary within 90 days of such change. The Commissioner will then rule whether the change affects the foreign corporation's status as a qualified resident, and such ruling will be valid for the taxable year in which the ruling was obtained and for the two succeeding taxable years, subject to the requirement in the preceding sentence to notify the Commissioner of a material change.

(g) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

OMB Control Numbers Under the Paperwork Reduction Act (26 U.S.C. Part 602)

PART 602—[AMENDED]

Par. 3. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 4 Section 602.101(c) is amended by inserting in the appropriate place in the table—

"§ 1.884–0T	1545–1070"
"§ 1.884–1T	1545–1070"
"§ 1.884–2T	1545–1070"
"§ 1.884–4T	1545–1070"
"§ 1.884–5T	1545–1070"

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved: August 3, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

[FR Doc. 88–19832 Filed 8–29–88; 1:29 pm]

BILLING CODE 4830–01–M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[INTL-934-86]

Income Taxes; Branch Tax

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document contains proposed Income Tax Regulations relating to the branch tax. In the Rules and Regulations portion of this Federal Register, the Internal Revenue Service is issuing temporary regulations relating to these matters. The text of these temporary regulations also serves as the

comment document for this proposed rulemaking.

DATES: These regulations are proposed to be effective for taxable years beginning after December 31, 1986. Written comments and requests for a public hearing must be delivered or mailed by November 1, 1988.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, (Attention: CC:LR:T, INTL-934-86), Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Richard M. Elliott of the Office of Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attn: CC:LR:T, INTL-934-86) (202-566-6457, not a toll-free call).

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 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, DC 20503, Attention: Desk Officer for Internal Revenue Service, with copies to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer TR:FP.

The collection of information in this regulation is in §§ 1.884-1T(d)(11), 1.884-2T(a)(2), 1.884-2T(b), 1.884-2T(c)(2), 1.884-2T(d)(1), 1.884-2T(d)(4), 1.884-2T(d)(5), 1.884-4T(b)(7), 1.884-4T(c)(1), 1.884-5T(b)(3) through (7), 1.884-5T(d)(6), and 1.884-5T(f). This information is required by the Internal Revenue Service to ensure the correct computation of tax under section 884. This information will be used in audits of taxpayers. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting and/or recordkeeping burden: 20,500 hours.

The estimated annual burden per respondent/recordkeeper varies from .5 to 10.5 hours depending on individual circumstances, with an estimated average of 6.5 hours.

Estimated number of respondents and/or recordkeepers: 3000

Estimated annual frequency of responses: Annually.

Background

The temporary regulations published in the Rules and Regulations portion of this issue of the Federal Register add new §§ 1.884-0T through 1.884-2T, 1.884-4T, and 1.884-5T. The final regulations that are proposed to be based on the temporary regulations would amend 26 CFR Parts 1 and 602. For the text of the temporary regulations, see FR Doc. 88-19832 [T.D. 8223] published in the Rules and Regulations portion of this issue of the Federal Register.

Special Analyses

These proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. 553 do not apply because the regulations proposed herein are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Comments and Request for a Public Hearing

Before adopting as final regulations these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is to be held, notice of the time and place will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Richard M. Elliott of the Office of the Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.861-1 through 1.9[illegible]-1

Income taxes, Corporate deductions, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, FSC, Source of income, U.S. investments abroad.

26 CFR Part 602

Reporting and recordkeeping requirements, Proposed Amendments to the Regulations.

PARTS 1 AND 602—[AMENDED]

The temporary regulations, FR Doc. 88-19832 [T.D. 8223], published in the Rules and Regulations portion of this issue of the Federal Register, are hereby also proposed as final regulations under section 884 of the Internal Revenue Code of 1986.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

[FR Doc. 88-19833 Filed 8-29-88, 1:29 pm]

BILLING CODE 4830-01-M