

that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904-7(a).

(iii) *Reduction for foreign income taxes paid or accrued.* In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(7)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

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

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

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

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

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits.* The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued or deemed paid on or with respect to pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid on or with respect to a distribution or inclusion out of pre-1987 accumulated profits of that year, and by the amount of taxes that would have been deemed paid had section 902 applied to a distribution or inclusion with respect to a person not eligible for a section 902 credit. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution.

(11) *Dividend.* For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. The term dividend also includes deemed dividends under sections 304, 367(b), 551, and 1248, but not deemed inclusions under sections 951(a) and 1293.

(12) *Dividend received.* A dividend shall be considered received for purposes of section 902 when the cash

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

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

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

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

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

*Example.* As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals \$1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to \$100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign