

income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u-200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has \$60 (\$100 - [\$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation*—(1) *General rule.* If a foreign corporation pays a

dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless the ownership requirements of

paragraphs (a)(1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings.* Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\frac{\text{Foreign income taxes deemed paid by domestic shareholder (or upper-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}} = \frac{\text{Post-1986 foreign income taxes of first-tier corporation (or lower-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}} \times \frac{\text{Dividend paid to domestic shareholder (or upper-tier corporation) by first-tier corporation (or lower-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits.* After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated

profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902-3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987

taxable year and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumulated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Post-1986 Undistributed Earnings}}{\text{Total Dividends Paid To all Shareholders}} = \frac{\text{Post-1986 Undistributed Earnings}}{\text{Total Dividends Paid To all Shareholders}} \times \frac{\text{Dividend to Shareholder}}{\text{Total Dividends Paid To all Shareholders}}$$

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Accumulated Profits of a Particular Pre-1987 Taxable Year}}{\text{Total Dividends Paid to all Shareholders}} = \frac{\text{Dividend Paid Out of Pre-1987 Accumulated Profits with Respect to the Particular Pre-1987 Taxable Year}}{\text{Total Dividends Paid to all Shareholders}} \times \frac{\text{Dividend to Shareholder}}{\text{Total Dividends Paid to all Shareholders}}$$

(3) *Dividends paid out of pre-1987 accumulated profits.* If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10) and (13) of this section and §§ 1.902-3 and 1.902-4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2) if, as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b).

Example 1. Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals \$1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and \$40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits