

from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u-100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u×(5u/50u)). See § 1.902-1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No earnings and profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and \$60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are \$3

( $\$60 \times 5\% [5u/100u]$ ). Corporation M must include \$3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u-50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid had section 902 applied to the entire 50u dividend to Corporations M and Z, even though Corporation Z was not entitled to compute foreign taxes deemed paid on its share of the dividend. Section 1.902-1(a)(8). The amount of foreign income taxes that would have been deemed paid had section 902 applied to the entire 50u dividend is \$30 ( $\$60 \times 50\% [50u/100u]$ ). Thus, post-1986 foreign income taxes as of January 1, 1990, are \$30 ( $\$60 - \$30$ ).

*Example 2.* The facts are the same as in *Example 1*, except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is

deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u ( $120u \times 5u/150u$ ). See § 1.902-1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u (150u-50u) of earnings and profits and 80u (120u reduced by 40u [ $120u \times 5u/150u$ ]) of foreign taxes that would have been deemed paid had section 902 applied to the total dividend paid to all shareholders out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

*Example 3.* (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990	1991
Current E & P (deficits) of Corp. A .....	100u	(50u)	150u	75u	25u	-0-
Current plus accumulated E & P of Corp. A .....	100u	50u	200u	175u	200u	80u
Post-'86 undistributed earnings of Corp. A .....		(50u)	100u	75u	100u	-0-
Post-'86 undistributed earnings of Corp. A reduced by current year dividend distributions (increased by deficit carryback).		(50u)	-0-	75u	-0-	-0-
Foreign income taxes (annual) of Corp. A .....	80u	-0-	\$120	\$20	\$20	-0-
Post-'86 foreign income taxes of Corp. A .....		-0-	\$120	\$20	\$40	-0-
12/31 distributions to Corp. M .....	-0-	-0-	10u	-0-	12u	-0-
12/31 distributions to Corp. Z .....	-0-	-0-	90u	-0-	108u	-0-

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902-1(b)(1), to have paid \$12 ( $\$120 \times 10\% [10u/100u]$ ) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are -0- (100u - 100u). Its post-1986 foreign taxes as of January 1, 1989, also are -0-, \$120 reduced by \$120 of foreign income taxes paid that would have been deemed paid had section 902 applied to the entire 100u dividend distribution to Corporations M and Z ( $\$120 \times 100\% [100u/100u]$ ).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986

undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902-1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u ( $100u \times 12u/120u$ ) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u ( $100u \times 108u/120u$ ) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are \$4 ( $\$40 \times 10\% [10u/100u]$ ), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u ( $80u \times 2u/100u$ ). Corporation M must include \$4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a separate

limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are -0- (100u - 100u). 80u (100u - 20u) of earnings and profits remain with respect to 1986. Post-1986 foreign taxes as of January 1, 1991, are -0-, \$40 reduced by \$40 of foreign income taxes paid that would have been deemed paid had section 902 applied to the entire 100u dividend distribution out of post-1986 undistributed earnings to Corporations M and Z ( $\$40 \times 100\% [100u/100u]$ ). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [ $80u \times 20u/100u$ ] of foreign income taxes that would have been deemed paid had section 902 applied to the entire 20u dividend distribution to Corporations M and Z out of 1986 accumulated profits.

(b) *Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902—(1) General rule.* For purposes of computing foreign income taxes deemed paid under § 1.902-1(b) with respect to dividends paid by a first-, second-, or third-tier