

corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits determined under section 902 of the foreign corporation as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902-1(a)(1) through (4) are met if the special effective date of § 1.902-1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the

carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985-6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed

earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

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

Example 1. (i) From 1984 through 1988, 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 or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|------|--------|--------|-------|------|
| Current E & P (deficits) of Corp. A | 25u | (100u) | (25u) | 200u | 100u |
| Current Plus Accumulated E & P (Deficits) of Corp. A | 25u | (75u) | (100u) | 100u | 50u |
| Post-'86 Undistributed Earnings of Corp. A | | | | 100u | 50u |
| Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward) | | | | (50u) | 50u |
| Foreign Income Taxes (Annual) of Corp. A | 20u | 5u | -0- | \$100 | \$50 |
| Post-'86 Foreign Income Taxes of Corp. A | | | | \$100 | \$50 |
| 12/31 Distributions to Corp. M | -0- | -0- | -0- | 15u | -0- |
| 12/31 Distributions to Corp. Z | -0- | -0- | -0- | 135u | -0- |

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has \$100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under § 1.902-1(b), are \$10 ($\$100 \times 10\% [10u/100u]$). Corporation M includes this 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. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u-150u) and -0- post-1986 foreign income taxes, \$100 reduced by \$100 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 ($\$100 \times 100\% [100u/100u]$).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional

foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902-1(b)(4).

Example 2. (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 or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|--------|-------|--------|--------|-------|
| Current E & P (Deficits) of Corp. A | (100u) | 150u | (150u) | 100u | 250u |
| Current Plus Accumulated E & P (Deficits) of Corp. A | (100u) | 50u | (200u) | (100u) | 50u |
| Post-'86 Undistributed Earnings of Corp. A | | 50u | (200u) | (100u) | 50u |
| Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward) | | (50u) | (200u) | (200u) | -0- |
| Foreign Income Taxes (Annual) of Corp. A | -0- | \$120 | -0- | \$50 | \$100 |
| Post-'86 Foreign Income Taxes of Corp. A | | \$120 | -0- | \$50 | \$150 |
| 12/31 Distributions to Corp. M | -0- | 10u | -0- | 10u | 5u |
| 12/31 Distributions to Corp. Z | -0- | 90u | -0- | 90u | 45u |