

§ 1.865-2T Loss with respect to stock (temporary).

(a)-(b)(4)(ii) [Reserved] For further guidance, see § 1.865-2(a) through (b)(4)(ii).

(iii) *Matching rule.* To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock, the loss shall be allocated and apportioned against such income. This paragraph (b)(4)(iii) shall not apply to the extent a loss is related to a dividend recapture amount and § 1.865-2(b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) exempts the loss from § 1.865-2(b)(1)(i) (dividend recapture rule), unless the stock is held with a principal purpose of producing foreign source income and corresponding loss.

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Examples 1 and 2. [Reserved] For further guidance, see § 1.865-2(b)(4)(iv).

Example 3. (i) *Facts.* On January 1, 1999, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. *P* contributes \$900 to *R* in exchange for a 90-percent partnership interest and *Q* contributes \$100 to *R* in exchange for a 10-percent partnership interest. *R* purchases a dance studio in country *X* for \$1,000. On January 2, 1999, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2000. These contracts are prepaid by the dance studio customers on December 31, 1999, and *R* recognizes foreign source taxable income of \$500 from the prepayments (*R*'s only income in 1999). *P* takes into income its \$450 distributive share of partnership taxable income. On January 1, 2000, *P*'s basis in its partnership interest is \$1,350 (\$900 from its contribution under section 722, increased by its \$450 distributive share of partnership income under section 705). On September 22, 2000, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P*'s basis in *S* is \$1,350. On December

1, 2000, *P* sells *S* to an unrelated party for \$1050 and recognizes a \$300 loss.

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *S* stock, the \$300 loss is allocated against foreign source income under paragraph (b)(4)(iii) of this section.

Example 4. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year forms *N*, a foreign corporation. *P* contributes \$1,000 to the capital of *N* in exchange for 100 shares of common stock. *P* contributes an additional \$1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to 15-percent dividend but is redeemable by *N* on or after January 1, 2010, for \$1. Prior to January 10, 2005, *P* receives a total of \$750 of distributions from *N* with respect to its preferred shares, which *P* treats as foreign source general limitation dividends. On January 10, 2005, *P* sells its 100 preferred shares in *N* to an unrelated purchaser for \$600. Assume that this arrangement is not recharacterized under Notice 97-21 (1997-1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *N* stock, the \$400 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 5. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year, and *F*, a newly-formed controlled foreign corporation wholly-owned by *P*, form *N*, a foreign corporation. *P* contributes \$1,000 to the capital of *N* in exchange for 100 shares of common stock and \$1,000 to the capital of *F* in exchange for 100 shares of common stock. *F* contributes LC1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to a 65-percent LC dividend. At the time of the contributions, \$1=LC1. The LC is expected to depreciate significantly in relation to the U.S. dollar. Prior to June 10, 2005, *P* receives a total of \$1,900 of distributions from *F*, which it treats as foreign source general limitation dividends. On June 10, 2005, the *N* preferred stock has a fair market value of \$25 and *P* sells *F* for \$25 to an unrelated person. Assume that this arrangement is not recharacterized under Notice 97-21 (1997-1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *F* stock, the \$975 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 6. (i) *Facts.* On January 1, 1998, P, a domestic corporation, purchases N, a foreign corporation, for \$1000. On March 1, 1998, N sells its operating assets, distributes a \$400 general limitation dividend to P, and invests its remaining \$600 in short term government securities. N earns interest income from the securities. The income constitutes subpart F income that is included in P's income under section 951, increasing P's basis in the N stock under section 961(a). On March 1, 2002, P sells N and recognizes a \$400 loss.

(ii) *Loss allocation.* The \$400 dividend received by P resulted in a \$400 built-in loss in the N stock, which was locked in for P's four-year holding period. Because P recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the N stock, under paragraph (b)(4)(iii) of this section the \$400 loss is allocated against foreign source general limitation income.

(c)-(d) [Reserved]

(e) *Effective date*—(1) *In general.* This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and § 1.865-2 for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

[T.D. 8805, 64 FR 1514, Jan. 11, 1999]

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871-1 Classification and manner of taxing alien individuals.

(a) *Classes of aliens.* For purposes of the income tax, alien individuals are

divided generally into two classes, namely, resident aliens and nonresident aliens. Resident alien individuals are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. See § 1.1-1(b). Nonresident alien individuals are taxable only on certain income from sources within the United States and on the income described in section 864(c)(4) from sources without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States. However, nonresident alien individuals may elect, under section 6013 (g) or (h), to be treated as U.S. residents for purposes of determining their income tax liability under Chapters 1, 5, and 24 of the code. Accordingly, any reference in §§ 1.1-1 through 1.1388-1 and §§ 1.1491-1 through 1.1494-1 of this part to non-resident alien individuals does not include those with respect to whom an election under section 6013 (g) or (h) is in effect, unless otherwise specifically provided. Similarly, any reference to resident aliens or U.S. residents includes those with respect to whom an election is in effect, unless otherwise specifically provided.

(b) *Classes of nonresident aliens*—(1) *In general.* For purposes of the income tax, nonresident alien individuals are divided into the following three classes:

(i) Nonresident alien individuals who at no time during the taxable year are engaged in a trade or business in the United States.

(ii) Nonresident alien individuals who at any time during the taxable year are, or are deemed under § 1.871-9 to be, engaged in a trade or business in the United States, and

(iii) Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

An individual described in subdivision (i) or (ii) of this subparagraph is subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder. See §§ 1.871-7 and 1.871-8. The provisions of subpart A do not