

§ 1.883-1

and in *U*, the country *X* currency. Accordingly, *Z*'s U.S. assets are as follows:

	Average value
U.S. Dollar Assets	\$20,000
<i>U</i> Assets	<i>U</i> 5,000

(B) *Z*'s worldwide liabilities are also denominated in U.S. Dollars and in *U*. The average interest rates on *Z*'s worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in *U*. Assume that *Z* has properly elected to use its actual ratio of 95% to determine its U.S.-connected liabilities in Step 2, and has also properly elected to use the separate currency pools method provided in paragraph (e) of this section.

(i) *Determination of interest expense.* *Z* determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below.

(A) First, *Z* separates its U.S. assets into two currency pools, one denominated in U.S. dollars (\$20,000) and the other denominated in *U* (*U*5,000).

(B) Second, *Z* multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, *Z* has U.S.-connected liabilities of \$19,000 (\$20,000 x 95%), and *U*4750 (*U*5000 x 95%).

(C) Third, *Z* calculates its interest expense by multiplying each pool of its U.S.-connected liabilities by the relevant interest rates. Accordingly, *Z*'s allocable interest expense for the year is \$1140 (\$19,000 x 6%), the sum of the expense associated with its U.S. dollar liabilities, plus *U*570 (*U*4750 x 12%), the interest expense associated with its liabilities denominated in *U*. *Z* must translate its interest expense denominated in *U* in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Code that would disallow or defer any portion of its interest expense so determined.

Example 2. [Reserved]

(f) *Effective date—(1) General rule.* This section is effective for taxable years beginning on or after June 6, 1996.

(2) *Special rules for financial products.* [Reserved]

[T.D. 8658, 61 FR 9329, Mar. 8, 1996; 61 FR 15891, Apr. 10, 1996]

§ 1.883-1 Exclusions from gross income of foreign corporations.

(a) *Earnings of foreign ships or aircraft—(1) Basic rule.* So much of the income from sources within the United

States of a foreign corporation as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption—(i) Ships.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Income tax conventions.* Generally, income of any kind which is exempt, under the provisions of an income tax convention to which the United States is a party, from any tax imposed by subtitle A (relating to income taxes) is not included in the gross income of a foreign corporation. However, see paragraph (a) of § 1.894-1 for certain exceptions to this rule. Income on any tax which imposed by such subtitle is limited by an income tax convention is included in the gross income of a foreign corporation if it is not otherwise excluded from gross income. For the determination of the tax when the taxpayer has income upon which the tax is limited by an income tax convention, see § 1.871-12.

(c) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863 and the regulations thereunder, is not included in the gross income of a foreign corporation unless such income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business within the United States see section 864(c)(4) and §1.864-5.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.883-1 (Revised as of January 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32799, Nov. 28, 1973; 38 FR 34203, Dec. 12, 1973]

§ 1.884-0 Overview of regulation provisions for section 884.

(a) *Introduction.* Section 884 consists of three main parts: a branch profits tax on certain earnings of a foreign corporation's U.S. trade or business; a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business; and an anti-treaty shopping rule. A foreign corporation is subject to section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States. An international organization (as defined in section 7701(a)(18)) is not subject to the branch profits tax by reason of section 884(e)(5). A foreign government

treated as a corporate resident of its country of residence under section 892(a)(3) shall be treated as a corporation for purposes of section 884. The preceding sentence shall be effective for taxable years ending on or after September 11, 1992, except that, for the first taxable year ending on or after that date, the branch profits tax shall not apply to effectively connected earnings and profits of the foreign government earned prior to that date nor to decreases in the U.S. net equity of a foreign government occurring after the close of the preceding taxable year and before that date. Similarly, §1.884-4 shall apply, in the case of branch interest, only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in §1.884-1(d)(1)(iii). Except as otherwise provided, for purposes of the regulations under section 884, the term "U.S. trade or business" includes all the U.S. trades or businesses of a foreign corporation.

(1) *The branch profits tax.* Section 1.884-1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, section 884(a) imposes a 30-percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings have been reinvested in, or disinvested from, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax. The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. Section 1.884-2T contains special rules relating to the effect on