

**Authority:** Secs. 702(a)(5), 1601, 1602, 1611(c) and (e), and 1631(a)–(d) and (g) of the Social Security Act (42 U.S.C. 902(a)(5), 1381, 1381a, 1382(c) and (e), and 1383(a)–(d) and (g)); 31 U.S.C. 3720A.

2. Section 416.590 is added to read as follows:

**§ 416.590 Are there additional methods for recovery of title XVI benefit overpayments?**

(a) *General.* In addition to the methods specified in §§ 416.560, 416.570 and 416.580, we may recover an overpayment under title XVI of the Act from you under the rules in subpart D of part 422, provided:

(1) The overpayment occurred after you attained age 18;

(2) You are no longer entitled to benefits under title XVI of the Act; and

(3) Pursuant to paragraph (b) of this section, we have determined that the overpayment is otherwise unrecoverable under section 1631(b) of the Act.

(b) *When we consider an overpayment to be otherwise unrecoverable.* We consider an overpayment under title XVI of the Act to be otherwise unrecoverable under section 1631(b) of the Act if all of the following conditions are met:

(1) We have completed our billing system sequence (i.e., we have sent you an initial notice of the overpayment, a reminder notice, and a past-due notice) or we have suspended or terminated collection activity under applicable rules, such as, the Federal Claims Collection Standards in 31 CFR 903.2 or 903.3.

(2) We have not entered into an installment payment arrangement with you or, if we have entered into such an arrangement, you have failed to make any payment for two consecutive months.

(3) You have not requested waiver pursuant to § 416.550 or § 416.582 or, after a review conducted pursuant to those sections, we have determined that we will not waive collection of the overpayment.

(4) You have not requested reconsideration of the initial overpayment determination pursuant to §§ 416.1407 and 416.1409 or, after a review conducted pursuant to § 416.1413, we have affirmed all or part of the initial overpayment determination.

(5) We cannot recover your overpayment pursuant to § 416.570 by adjustment of benefits payable to any individual other than you. For purposes of this paragraph, if you are a member of an eligible couple that is legally separated and/or living apart, we will deem unrecoverable from the other

person that part of your overpayment which he or she did not receive.

3. The authority citation for subpart N of part 416 is revised to read as follows:

**Authority:** Secs. 702(a)(5), 1631, and 1633 of the Social Security Act (42 U.S.C. 902(a)(5), 1383, and 1383b).

4. Section 416.1403 is amended by removing the word “and” at the end of paragraph (a)(16), removing the first period in paragraph (a)(17), removing “See” and adding “see” in its place in the parenthetical in paragraph (a)(17), removing the second period at the end of paragraph (a)(17) and adding a semicolon in its place, and adding new paragraphs (a)(18) and (19) to read as follows:

**§ 416.1403 Administrative actions that are not initial determinations.**

(a) \* \* \*

(18) Determining whether we will refer information about your overpayment to a consumer reporting agency (see §§ 416.590 and 422.305 of this chapter); and

(19) Determining whether we will refer your overpayment to the Department of the Treasury for collection by offset against Federal payments due you (see §§ 416.590 and 422.310 of this chapter).

\* \* \* \* \*

**PART 422—ORGANIZATION AND PROCEDURES**

5. The authority citation for subpart D of part 422 is revised to read as follows:

**Authority:** Secs. 204(f), 205(a), 702(a)(5), and 1631(b) of the Social Security Act (42 U.S.C. 404(f), 405(a), 902(a)(5), and 1383(b)); 31 U.S.C. 3711(e); 31 U.S.C. 3716.

6. Section 422.301(b) is amended by removing the words “title II” and by removing “§ 404.527” and adding “§§ 404.527 and 416.590” in its place.

7. Section 422.305 is amended by removing the reference to “title II” in the heading and in paragraph (a).

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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

[TD 8973]

**RIN 1545–AW09**

**Allocation of Loss With Respect to Stock and Other Personal Property**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations and removal of temporary regulations.

**SUMMARY:** This document contains final Tax Regulations which remove temporary regulations relating to the allocation of loss recognized on the disposition of stock and other personal property. The loss allocation regulations primarily will affect taxpayers that claim the foreign tax credit and that incur losses with respect to personal property and are necessary to modify existing guidance with respect to loss allocation.

**DATES:** *Effective dates:* These regulations are effective January 8, 2002.

*Applicability Dates:* For dates of applicability, see §§ 1.865–1(f) and 1.865–2(e).

**FOR FURTHER INFORMATION CONTACT:** David A. Juster, (202) 622–3850 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains amendments to 26 CFR part 1. On January 11, 1999, final regulations (TD 8805, 1999–1 C.B. 371, the 1999 final regulations) addressing the allocation of loss on the disposition of stock (§ 1.865–2) and amending the foreign tax credit passive limitation grouping rules under § 1.904–4(c) were published in the **Federal Register** (64 FR 1505), together with temporary regulations relating to the allocation of loss on the disposition of personal property other than stock (§ 1.865–1T) and providing a special matching rule with respect to the allocation of certain stock losses (§ 1.865–2T). A notice of proposed rulemaking (REG–106905–98) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (64 FR 1571). No public hearing was requested or held. One written comment responding to the notice of proposed rulemaking was received. After consideration of the comment, the regulations are finalized substantially as proposed, and the corresponding temporary regulations are removed. This Treasury decision also

contains minor clarifying amendments to § 1.865-2 of the 1999 final regulations. The revisions are discussed below.

### Explanation of Provisions

#### *Section 1.865-1: Loss With Respect to Personal Property Other Than Stock*

##### *Section 1.865-1(a): General Rules*

Taxpayers have inquired whether the regulations apply to section 166 bad debt deductions. Section 1.865-1 is intended to apply to all recognized losses with respect to personal property, unless otherwise excepted, whether or not the loss results from an actual sale or disposition. Although section 166 does not use the term *loss* in the context of describing worthless debts giving rise to a deduction under the statute, worthlessness deductions reflect economically sustained losses similar to losses described in section 165(g) with respect to worthless securities. Section 1.865-1(a)(1) of the final regulations clarifies that the loss allocation rules of § 1.865-1 apply to section 166 bad debt deductions, as well as losses on property that is marked-to-market (such as under section 475) and not excluded from the scope of these regulations (as are inventory property and certain derivative contracts).

One commentator requested that the final regulations clarify the proper allocation of a loss from the disposition of a partnership interest. Treasury and the Service do not believe that a special rule is required. Instead, loss on the disposition of a partnership interest is subject to the general rule of § 1.865-1(a) that allocates loss to the class of gross income to which gain from the sale of such property would give rise in the seller's hands, i.e., on a reciprocal-to-gain basis.

##### *Section 1.865-1(b)(2): Contingent Payment Debt Instruments*

Section 1.865-1(b)(2), explaining the particular application of the reciprocal-to-gain loss allocation rule to contingent payment debt instruments, provides that loss on an instrument to which § 1.1275-4(b) applies is allocated and apportioned to the class of interest income to which the instrument would give rise. The final regulation adopts the rule of the temporary regulation, reworded to clarify the interaction of this section with § 1.1275-4(b)(9)(iv)(A).

##### *Section 1.865-1(c)(4): Unamortized Bond Premium*

Section 1.865-1(c)(4) provides an exception from the general reciprocal-to-gain rule with respect to unamortized bond premium. The final regulations

modify the text and add a new *Example 3* in § 1.865-1(e) to clarify that loss on a debt instrument is allocated against interest only to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer before the loss was recognized.

##### *Section 1.865-1(c)(6)(iii): Matching Rule*

For discussion of modifications to the matching rule in response to comments, see the discussion below in connection with the stock loss matching rule of § 1.865-2(b)(4)(iii).

##### *Section 1.865-1(f): Effective Dates*

The final regulations apply to losses recognized on or after January 8, 2002. A taxpayer may apply the regulations, however, to loss recognized in taxable years beginning on or after January 1, 1987, subject to certain conditions.

#### *Section 1.865-2: Loss With Respect to Stock*

##### *Section 1.865-2(a)(1): General Rules*

A sentence is added to § 1.865-2(a)(1) to clarify that the loss allocation rules of § 1.865-2 apply to loss on stock (other than inventory) that is marked-to-market (such as under section 475).

##### *Section 1.865-2(a)(3)(ii): Bona Fide Residents of Puerto Rico*

Under section 933, a U.S. citizen or resident alien that is a bona fide resident of Puerto Rico is generally exempt from U.S. tax with respect to Puerto Rican source income, but remains subject to U.S. tax with respect to income derived from other sources. Consistent with the general rule of the 1999 final regulations allocating losses against gains and taking account of the special source rule of section 865(g)(3), § 1.865-2(a)(3)(ii) provides that a loss recognized by a U.S. citizen or resident alien that is a bona fide resident of Puerto Rico with respect to stock of a corporation that is engaged in a trade or business within Puerto Rico shall be allocated to reduce foreign source income. The final regulation, however, did not specifically state whether the stock loss is allocated against Puerto Rican source income that is exempt from tax under section 933 or against all of the bona fide resident's foreign source income. Section 1.865-2(a)(3)(ii) is clarified to provide that if gain from the sale of such stock would be Puerto Rican source income that is exempt from tax under section 933, the loss with respect to such stock shall be allocated to Puerto Rican source income. Under section 933(1), a loss allocated to Puerto Rican source income that is excluded from gross income

under section 933 is not allowed as a deduction. See § 1.933-1(c).

##### *Sections 1.865-1(c)(6)(iii) and 1.865-2(b)(4)(iii): Matching Rule*

The temporary regulations provided that, to the extent a taxpayer recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock or other personal property, as the case may be, the loss shall be allocated and apportioned against such income. The preamble to the temporary regulations explained that this rule is intended to prevent taxpayers from avoiding the dividend recapture rule of § 1.865-2(b)(1) or from accelerating foreign source income and recognizing an offsetting U.S. loss.

One commentator characterized the rule as overly broad and the examples as unrealistic. The commentator recommended that the matching rule be eliminated from the final regulations or revised to target identified abuses more narrowly.

Taking these considerations into account, §§ 1.865-1(c)(6)(iii) and 1.865-2(b)(4)(iii) are modified to provide that the matching rule will only apply if a taxpayer engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss. As an anti-abuse rule, the matching rule targets transactions that are designed to produce an artificial or accelerated recognition of income that directly results in the creation of a corresponding built-in loss. The step-down preferred transactions described in *Examples 4* and *5* of § 1.865-2T(b)(4)(iv) are transactions of this type; however, because those transactions are now expressly addressed by regulations at § 1.7701(l)-3, the final regulations omit *Examples 4* and *5*. In addition, *Example 6* of § 1.865-2T(b)(4)(iv) is revised and redesignated as *Example 6* of paragraph (b)(1)(iv) of § 1.865-2 to illustrate an amendment to the definition of the recapture period in § 1.865-2(d)(3) discussed below.

Section 1.865-2(b)(4)(iii) is also revised to clarify the interaction of the matching rule and the exceptions to the dividend recapture rule for de minimis or passive dividends. In the temporary regulations, the matching rule applied to amounts that otherwise were exempted from the dividend recapture rule under the passive or de minimis exceptions only if the taxpayer held the stock with a principal purpose of producing foreign source income and corresponding loss. Because the final regulations revise the matching rule to

incorporate a principal purpose test in all instances, the specific requirement of a principal purpose to apply the matching rule to de minimis or passive dividends is no longer necessary.

#### *Section 1.865-2(d)(3): Recapture Period*

The dividend recapture period set forth in § 1.865-2(d)(3) is revised to provide that the 24-month period ends on the date on which a taxpayer recognizes a loss with respect to stock. In addition, in connection with the revisions to the matching rule discussed above, the definition of the recapture period in § 1.865-2(d)(3) is expanded to provide that the recapture period is extended if the assets of the corporation are converted to low-risk investments with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. As noted above, *Example 6* of § 1.865-2T(b)(4)(iv) has been redesignated as *Example 6* of § 1.865-2(b)(1)(iv) and revised to illustrate the operation of this change to the definition of the recapture period. Finally, § 1.865-2(d)(3) is revised to clarify that the dividend recapture rule applies to a dividend paid after the date a loss is recognized, if the loss is incurred after the dividend was declared (i.e., when the stock is sold ex-dividend).

#### *Section 1.865-2(e): Effective Dates*

The final regulations retain the January 11, 1999 effective date of the identical provisions of the temporary regulations and provide that the amendments made by the final regulations apply to losses recognized on or after January 8, 2002. A taxpayer may apply the regulations, however, to loss recognized in any taxable year beginning on or after January 1, 1987, subject to certain conditions.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. A final regulatory flexibility analysis under 5 U.S.C. 604 has been prepared for the portion of this Treasury decision with respect to regulations issued under section 865 of the Internal Revenue Code. This analysis is set forth below.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Small Business Administration for comment on its impact on small business.

#### **Regulatory Flexibility Analysis**

It has been determined that a final regulatory flexibility analysis is required under 5 U.S.C. 604 with respect to this Treasury decision issued under section 865 of the Internal Revenue Code. These regulations will affect small entities such as small businesses but not other small entities, such as local government or tax exempt organizations, which do not pay taxes. The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap or conflict with these regulations. The final regulations address the allocation of loss with respect to stock and other personal property. These regulations are necessary primarily for the proper computation of the foreign tax credit limitation under section 904 of the Internal Revenue Code. With respect to U.S. resident taxpayers, the regulations generally allocate losses against U.S. source income. Generally, this allocation simplifies the computation of the foreign tax credit limitation. None of the significant alternatives considered in drafting the regulations would have significantly altered the economic impact of the regulations on small entities. There are no alternative rules that are less burdensome to small entities but that accomplish the purposes of the statute.

#### **Drafting Information**

Various personnel from the Office of Associate Chief Counsel (International) within the Office of Chief Counsel, the IRS and Treasury Department participated in developing these regulations.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 is amended by removing the entries for “1.865-1T” and “1.865-2T”, revising the entry for “1.865-2”, and adding entries in numerical order to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

Section 1.861-8 also issued under 26 U.S.C. 882(c). \* \* \*

Section 1.865-1 also issued under 26 U.S.C. 863(a) and 865(j)(1).

Section 1.865-2 also issued under 26 U.S.C. 863(a) and 865(j)(1). \* \* \*

**Par. 2.** Section 1.861-8 is amended by:

1. Revising paragraphs (e)(7)(iii) and (e)(8).

2. Removing the authority citation at the end of the section.

The revisions read as follows:

#### **§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.**

\* \* \* \* \*

(e) \* \* \*

(7) \* \* \*

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§ 1.865-1 and 1.865-2 for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

\* \* \* \* \*

**Par. 3.** Section 1.861-8T is amended as follows:

1. Paragraphs (e)(1) and (e)(3) through (e)(11) are revised.

2. Paragraph (h) is amended by removing the last sentence of the concluding text.

3. The authority citation at the end of the section is removed.

The revisions read as follows:

#### **§ 1.861-8T Computation of taxable income from sources within the United States and for other sources and activities (temporary).**

\* \* \* \* \*

(e) \* \* \*

(1) [Reserved]. For further guidance, see § 1.861-8(e)(1).

\* \* \* \* \*

(3) through (11) [Reserved]. For further guidance, see § 1.861-8(e)(3) through (e)(11).

\* \* \* \* \*

**Par. 4.** Section 1.865-1 is added to read as follows:

#### **§ 1.865-1 Loss with respect to personal property other than stock.**

(a) *General rules for allocation of loss—(1) Allocation against gain.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. For purposes of this section, loss includes bad debt deductions under section 166 and loss on property that is

marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale or worthlessness of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904-4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904-4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership.* A partner's distributive share of loss

recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application—*(1) *Depreciable property.* In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument.* Loss described in the last sentence of § 1.1275-4(b)(9)(iv)(A) that is recognized with respect to a contingent payment debt instrument to which § 1.1275-4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions—*(1) *Foreign currency and certain financial instruments.* This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory.* This section does not apply to loss recognized with respect to property described in section 1221(a)(1).

(3) *Interest equivalents and trade receivables.* Loss subject to § 1.861-9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of § 1.861-9T and not under the rules of this section.

(4) *Unamortized bond premium.* If a taxpayer recognizing loss with respect to a bond (within the meaning of § 1.171-1(b)) did not amortize bond premium to the full extent permitted by section 171 and the regulations thereunder, then, to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer, loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the

statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest.* Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§ 1.61-7(d) and 1.446-2(e).

(6) *Anti-abuse rules—*(i) *Transactions involving built-in losses.* If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after

application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to personal property (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. For an example illustrating a similar rule with respect to stock loss, see § 1.865-2(b)(4)(iv) *Example 3*.

(d) *Definitions*—(1) *Contingent payment debt instrument.* A contingent payment debt instrument is any debt instrument that is subject to § 1.1275-4.

(2) *Depreciable personal property.* Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in § 1.861-8.* See § 1.861-8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

(e) *Examples.* The application of this section may be illustrated by the following examples:

*Example 1.* On January 1, 2000, A, a domestic corporation, purchases for \$1,000 a machine that produces widgets, which A sells in the United States and throughout the world. Throughout A's holding period, the machine is located and used in Country X. During A's holding period, A incurs depreciation deductions of \$400 with respect to the machine. Under § 1.861-8, A allocates and apportions depreciation deductions of \$250 against foreign source general limitation income and \$150 against U.S. source income. On December 12, 2002, A sells the machine for \$100 and recognizes a loss of \$500. Because the machine was used predominantly outside the United States, under sections 865(c)(1)(B) and 865(c)(3)(B)(ii) gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire \$500 loss is allocated against foreign source general limitation income.

*Example 2.* On January 1, 2002, A, a domestic corporation, loans \$2,000 to N, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to § 1.1275-4(b). During 2002 through 2004, A accrues and receives interest income of \$630, \$150 of which is foreign source general limitation income and \$480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to § 1.1275-4(b)(6) in 2002 through 2004. On January 1, 2005, A disposes of the debt instrument and recognizes a \$770 loss. Under § 1.1275-4(b)(8)(ii), \$630 of the loss is treated as ordinary loss and \$140 is treated as capital loss. Assume that \$140 of interest income earned in 2005 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under § 1.1275-4(b)(9)(iv), \$150 of the ordinary loss is allocated against foreign source general limitation income and \$480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the \$140 capital loss is allocated against foreign source passive income.

*Example 3.* (i) On January 1, 2003, A, a domestic corporation, purchases for \$1,200 a taxable bond maturing on December 31, 2008, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Interest payments for 2003 and 2004 are timely made. A does not elect to amortize its bond premium under section 171 and the regulations thereunder, which would have permitted A to offset the \$100 of interest income by \$28.72 of bond premium in 2003, and by \$30.42 in 2004. On January 1, 2005, A sells the bond and recognizes a \$100 loss. Under paragraph (c)(4) of this section, \$59.14 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining \$40.86 of the loss is allocated against U.S. source income.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that A made the election to amortize its bond premium effective for taxable year 2004 (see § 1.171-4(c)). Under paragraph (c)(4) of this section, \$28.72 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining \$71.28 of the loss is allocated against U.S. source income.

*Example 4.* On January 1, 2002, A, a domestic corporation, purchases for \$1,000 a bond maturing December 31, 2014, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 2002 and 2006, A accrues and receives foreign source interest income of \$500 with respect to the bond. On January 1, 2007, A sells the bond and recognizes a \$500 loss. Under paragraph (a)(1) of this section, the \$500 loss is allocated against U.S. source income.

*Example 5.* On January 1, 2002, A, a domestic corporation on the accrual method of accounting, purchases for \$1,000 a bond maturing December 31, 2012, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 2002, after A has accrued \$44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. A sells the bond (including the accrued interest) for \$20. Assuming that A properly accrued \$44 of interest income, A treats the \$20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a \$1,000 loss with respect to the bond principal and a \$24 loss with respect to the accrued interest. See § 1.61-7(d). Under paragraph (a)(1) of this section, the \$1,000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the \$24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section is applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (f), 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.

(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 for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; 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.

(3) *Examples.* See § 1.865-2(e)(3) for examples illustrating an applicability date provision similar to the applicability date provided in this paragraph (f).

#### § 1.865-1T [Removed]

**Par. 5.** Section 1.865-1T is removed.

**Par. 6.** Section 1.865-2 is amended by:

1. Adding a sentence after the first sentence of paragraph (a)(1).
2. Adding two sentences at the end of paragraph (a)(3)(ii).
3. Adding *Example 6* to paragraph (b)(1)(iv).

4. Revising paragraph (b)(4)(iii).  
 5. Adding *Example 3* to paragraph (b)(4)(iv).  
 6. Revising paragraphs (d)(3), (e)(1), and (e)(2)(i).

The revisions and additions read as follows:

**§ 1.865-2 Loss with respect to stock.**

(a)(1) \* \* \* For purposes of this section, loss includes loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. \* \* \*

\* \* \* \* \*

(3) \* \* \*

(ii) \* \* \* If gain from a sale of such stock would give rise to income exempt from tax under section 933, the loss with respect to such stock shall be allocated to amounts that are excluded from gross income under section 933(1) and therefore shall not be allowed as a deduction from gross income. See section 933(1) and § 1.933-1(c).

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(iv) \* \* \*

*Example 6.* (i) On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for \$1,000. On March 1, 1998, *P* causes *N* to sell its operating assets, distribute a \$400 general limitation dividend to *P*, and invest its remaining \$600 in short-term government securities. *P* converted the *N* assets into low-risk investments with a principal purpose of holding the *N* stock without significant risk of loss until the recapture period expired. *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) Pursuant to paragraph (d)(3) of this section, the recapture period is increased by the period in which *N*'s assets were held as low-risk investments because *P* caused *N*'s assets to be converted into and held as low-risk investments with a principal purpose of enabling *P* to hold the *N* stock without significant risk of loss. Accordingly, under paragraph (b)(1)(i) of this section the \$400 loss is allocated against foreign source general limitation income.

\* \* \* \* \*

(4) \* \* \*

(iii) *Matching rule.* If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to stock (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the

extent of the recognized foreign source income. This paragraph (b)(4)(iii) applies to any portion of a loss that is not allocated under paragraph (b)(1)(i) of this section (dividend recapture rule), including a loss in excess of the dividend recapture amount and a loss that is related to a dividend recapture amount described in paragraph (b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) of this section.

(iv) *Examples.* \* \* \*

*Example 3.* (i) *Facts.* On January 1, 2002, *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, 2002, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2003. These contracts are prepaid by the dance studio customers on December 31, 2002, and *R* recognizes foreign source taxable income of \$500 from the prepayments (*R*'s only income in 2002). *P* takes into income its \$450 distributive share of partnership taxable income. On January 1, 2003, *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, 2003, *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, 2003, *P* sells *S* to an unrelated party for \$1050 and recognizes a \$300 loss.

(ii) *Loss allocation.* *P* recognized foreign source income for tax purposes before the income had economically accrued, and the accelerated recognition of income increased *P*'s basis in *R* without increasing its value by a corresponding amount, which resulted in the creation of a built-in loss with respect to the *S* stock. Under paragraph (b)(4)(iii) of this section the \$300 loss is allocated against foreign source income if *P* had a principal purpose of recognizing foreign source income and corresponding loss.

\* \* \* \* \*

(d) \* \* \*

(3) *Recapture period.* A recapture period is the 24-month period ending on the date on which a taxpayer recognized a loss with respect to stock. For example, if a taxpayer recognizes a loss on March 15, 2002, the recapture period begins on and includes March 16, 2000, and ends on and includes March 15, 2002. A recapture period is increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against

risk of loss (or are converted into and held as low-risk investments) with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. In the case of a loss recognized after a dividend is paid, the recapture period is extended through the date on which the dividend is paid.

\* \* \* \* \*

(e) *Effective date*—(1) *In general.* This section is applicable to loss recognized on or after January 11, 1999, except that paragraphs (a)(3)(ii), (b)(1)(iv) *Example 6*, (b)(4)(iii), (b)(4)(iv) *Example 3*, and (d)(3) of this section are applicable to loss recognized on or after January 8, 2002. 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.

(2) \* \* \*

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

\* \* \* \* \*

**§ 1.865-2T [Removed]**

**Par. 7.** Section 1.865-2T is removed.

**§ 1.904-4 [Amended]**

**Par. 8.** In § 1.904-4, paragraph (c)(2)(ii)(A), remove the language "1.865-1T through 1.865-2T" at the end of the first sentence and add "1.865-1 and 1.865-2" in its place.

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

Approved: December 19, 2001.

**Mark Weinberger,**

*Assistant Secretary of the Treasury.*

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**DEPARTMENT OF THE TREASURY**

**31 CFR Part 103**

[FinCEN Issuance 2001-2]

**Financial Crimes Enforcement Network; Bank Secrecy Act Regulations—Issuance Concerning the Requirement that Money Transmitters and Money Order and Traveler's Check Issuers, Sellers, and Redeemers Report Suspicious Transactions; Effective Date and Reporting Form**

**AGENCY:** Financial Crimes Enforcement Network ("FinCEN"), Treasury.