§ 1.902–1 provide definitions applicable for purposes of section 902 and §§ 1.902–1 and 1.902–2.

Paragraph (a)(1) defines a domestic shareholder that is eligible for the section 902 credit as a domestic corporation that owns directly at least 10 percent of the voting stock of a foreign corporation at the time it receives a dividend.

Revenue Ruling 71-141, 1971-1 C.B. 211, allows two 50 percent domestic corporate general partners of a domestic general partnership to claim a credit for taxes deemed paid under section 902 for foreign taxes paid by a foreign corporation in which the partnership owned 40 percent of the voting stock. The Internal Revenue Service is considering under what other circumstances a section 902 credit with respect to stock held by a partnership or other pass-through entity should flow through to a domestic corporation. The Service requests comments on whether the holding of Rev. Rul. 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, and beneficiaries of domestic or foreign trusts and estates or interest holders in other pass-through entities. The comments should address how the Service would administer any proposed expansion of the revenue ruling to allow deemed paid credits through other pass-through entities.

Paragraphs (a) (2) through (6) define the ownership requirements that must be met before foreign income taxes of a first-, second-, or third-tier foreign corporation will be deemed paid by an upper-tier foreign corporation or a domestic shareholder.

Paragraph (a)(7) defines foreign income taxes as those creditable under sections 901 and 903. Paragraph (a)(8) defines post-1986 foreign income taxes generally as foreign income taxes paid, accrued, or deemed paid for the current year and any foreign income taxes paid, accrued, or deemed paid in prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid on earnings previously distributed to or otherwise included in the income of a shareholder.

Paragraph (a)(9) defines post-1986 undistributed earnings generally as the amount of earnings and profits accumulated by a foreign corporation in taxable years beginning after December 31, 1986, determined as of the close of the taxable year in which a dividend is distributed. Post-1986 undistributed

earnings are not reduced by dividend distributions and deemed inclusions in the current year but are reduced by dividend distributions and deemed inclusions in prior post-1986 taxable years.

Paragraph (a)(10) defines pre-1987 accumulated profits as earnings and profits accumulated in taxable years beginning before January 1, 1987, and in later years if the special effective date of paragraph (a)(13) applies. Paragraph (a)(13) provides a special effective date applicable when the 10-percent ownership requirements of section 902(c)(3)(B) and paragraphs (a) (1) through (4) are first met with respect to a foreign corporation in a taxable year of the foreign corporation beginning after December 31, 1986. For post-1986 years prior to the first year in which the ownership requirements of section 902(c)(3)(B) are met, foreign taxes deemed paid must be computed under the rules of section 902 as in effect prior to the Tax Reform Act of 1986. See section 902(c)(6)

The proposed regulations specify that both post-1986 undistributed earnings and pre-1987 accumulated profits include a foreign corporation's entire earnings and profits. Further, for both post-1986 undistributed earnings and pre-1987 accumulated profits that are distributed in a taxable year beginning after December 31, 1986, the proposed regulations state that special allocations of accumulated profits and taxes to particular shareholders, whether required or permitted under foreign law or an agreement among the shareholders, will be disregarded. See paragraphs (a)(9)(iv) and (a)(10)(ii).

The intent of the proposed regulations is to reverse the Tax Court's decision in *Vulcan v. Commissioner*, 96 T.C. 410 (1991), affd. per curiam 959 F.2d 973 (11th Cir. 1992), for distributions in taxable years beginning after December 31, 1986, out of pre-1987 accumulated profits. In addition, the regulations are intended to make clear that the decision in *Vulcan* is not applicable to distributions out of post-1986 undistributed earnings.

In *Vulcan*, the Tax Court held that the term "accumulated profits" as used in the denominator of the section 902 deemed paid credit fraction prior to the Tax Reform Act of 1986 does not necessarily mean all of a foreign corporation's accumulated profits. The Tax Court concluded that the pre-1987 statute and regulations under section 902 were unclear and based its decision on what it viewed as the policy behind section 902. The pre-Tax Reform Act of 1986 version of section 902 described the creditable foreign tax as that levied

"on or with respect to the accumulated profits of the foreign corporation from which such dividends were paid." The Tax Court in *Vulcan* read this language as linking "accumulated profits" to the foreign tax paid by the subsidiary and, based in part on this reading, computed the section 902 credit using only the amount of accumulated profits on which the foreign tax was levied.

Contrary to the Tax Court's analysis, the term "accumulated profits" as used in pre-1987 section 902 generally is equated with, and determined in accordance with, United States tax principles relating to pre-tax earnings and profits. See United States v. Goodyear Tire and Rubber Company, 493 U.S. 132, 139 (1989). Earnings and profits are a measure of a corporation's ability to pay dividends. They generally are determined at the corporate level and include all income earned by the corporation, whether or not all or any portion of the income is subject to tax. The "on or with respect to" language on which the Tax Court focused simply reflects the annual nature of the section 902 credit calculation prior to 1986, and does not permit or require the computation of the deemed paid credit using less than all of the foreign corporation's accumulated profits.

The 1986 Act changes to section 902(a) eliminated the language the Tax Court relied on in Vulcan to link the taxes to be credited to the particular profits on which they were paid. See H.R. Rep. (Conf.) 841, 99th Cong., 2d Sess. II-589 (1986). As amended in 1986, section 902 simply defines the pool of creditable taxes as "any income, war profits, or excess profits taxes paid by the foreign corporation" to the foreign taxing authority. See section 902(c)(4). The proposed regulations make clear that Vulcan does not apply for years to which the pooling rules of new section 902 apply.

The proposed regulations would reverse *Vulcan* for distributions out of pre-1987 accumulated profits in post-1986 taxable years. The *Vulcan* reversal for distributions out of pre-1987 accumulated profits thus will have a continuing impact in post-1986 years. The Internal Revenue Service published this position in Rev. Rul. 87–14, 1987–1 C.B. 181. Thus, taxpayers had notice of the rule prior to the issuance of these proposed regulations.

Paragraph (a)(10)(iii) provides that foreign income taxes of a particular year with pre-1987 accumulated profits must be reduced by the amount of foreign income taxes deemed paid on a distribution or inclusion out of pre-1987 accumulated profits of that year. Foreign income taxes paid or accrued on or with