

as if \$100 of income were recognized from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, \$50 is treated as foreign source income and \$50 as U.S. source income. Assume further that on a separate entity basis, S would have \$37.50 of foreign source income and \$37.50 of U.S. source income, and that all of B's \$25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have \$62.50 of combined foreign source income and \$37.50 of U.S. source income. Accordingly, under single entity treatment, \$12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to recharacterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that \$7.50 of S's foreign source income is redetermined to be U.S. source and \$5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

(b) *Intercompany sale with independent factory price.* The facts are the same as in paragraph (a) of this *Example 14*, except that an independent factory price exists for the sale by S to B such that \$70 of S's \$75 of income is attributable to the production function. Assume that on a single entity basis, \$70 is treated as U.S. source income (because of the existence of the independent factory price) and \$30 is treated as foreign source income. Assume that on a separate entity basis, \$70 of S's income would be treated as U.S. source, \$5 of S's income would be treated as foreign source income, and all of B's \$25 income would be treated as foreign source income. Because the results are the same on a single entity basis and a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(c) *Sale of property reflecting intercompany services or intangibles.* S earns \$10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90 profit, with title passing in Country Y. Under the matching rule, S's \$10 income and B's \$90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis \$50 is treated as foreign source income and \$50 is treated as U.S. source

income. Assume that on a separate entity basis, S would have \$10 of U.S. source income, and B would have \$45 of foreign source income and \$45 of U.S. source income. Accordingly, under single entity treatment, \$5 of income that would be treated as U.S. source income on a separate entity basis is redetermined to be foreign source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$5 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. (If instead of performing services, S licensed an intangible to B and earned \$10 that would be treated as U.S. source income on a separate entity basis, the results would be the same.)

*Example 15. Section 1248. (a) Facts.* On January 1 of Year 1, S forms FT, a wholly owned foreign subsidiary, with a \$10 contribution. During Years 1 through 3, FT has earnings and profits of \$40. None of the earnings and profits is taxed as subpart F income under section 951, and FT distributes no dividends to S during this period. On January 1 of Year 4, S sells its FT stock to B for \$50. While B owns FT, FT has a deficit in earnings and profits of \$10. On July 1 of Year 6, B sells its FT stock for \$70 to X, an unrelated foreign corporation.

(b) *Timing.* S's \$40 of intercompany gain is taken into account in Year 6 to reflect the difference between B's \$20 of gain taken into account and the \$60 recomputed gain.

(c) *Attributes.* Under the matching rule, the attributes of S's intercompany gain and B's corresponding gain are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is \$60 of gain and the portion which is characterized as a dividend under section 1248 is determined on the basis of FT's \$30 of earnings and profits at the time of the sale of FT to X (the sum of FT's \$40 of earnings and profits while held by S and FT's \$10 deficit in earnings and profits while held by B). Therefore, \$30 of the \$60 gain is treated as a dividend under section 1248. The remaining \$30 is treated as capital gain. On a separate entity basis, all of S's \$40 gain would be treated as a dividend under section 1248 and all of B's \$20 gain would be treated as capital gain. Thus, as a result of the single entity determination, \$10 that would be treated as a dividend under section 1248 on a separate entity basis is redetermined to be capital gain. Under paragraph (c)(4)(ii) of this section, this redetermined attribute must be allocated between S's intercompany item and B's corresponding item by using a reasonable method. On a separate entity basis, only S would have any amount treated as a dividend under section 1248 available for redetermination. Accordingly, \$10 of S's income is redetermined to be not subject to section 1248, with the result that \$30 of S's intercompany gain is treated as a dividend and the remaining \$10 is treated as capital gain. All of B's corresponding gain is treated as capital gain, as it would be on a separate entity basis.

(d) *B has loss.* The facts are the same as in paragraph (a) of this *Example 15*, except that FT has no earnings and profits or deficit in earnings and profits while B owns FT, and B sells the FT stock to X for \$40. On a single entity basis, there is \$30 of gain, and section 1248 is applied on the basis of FT's \$40 earnings and profits at the time of the sale of FT to X. Under section 1248, the amount treated as a dividend is limited to \$30 (the amount of the gain). On a separate entity basis, S's entire \$40 gain would be treated as a dividend under section 1248, and B's \$10 loss would be a capital loss. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control. Accordingly, \$10 of S's gain must be redetermined to be capital gain. B's \$10 loss remains a capital loss. (If, however, S sold FT to B at a loss and B sold FT to X at a gain, it may be unreasonable for the attributes of B's corresponding gain to control S's offsetting intercompany loss. If B's attributes were to control, for example, the group could possibly claim a larger foreign tax credit than would be available if S and B were divisions of a single corporation.)

(d) *Acceleration rule.* S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) *S's items*—(i) *Timing.* S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved—

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction).

(ii) *Attributes.* The attributes of S's intercompany items taken into account