Internal Revenue Service, Treasury § 1.861–8T

(ii) Exempt income and exempt asset defined—(A) In general. For purposes of this section, the term exempt income means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term exempt asset means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) Certain stock and dividends. The term ‘exempt income’ includes the portion of the dividends that are deductible under—

1. Section 243(a)(1) or (2) (relating to the dividends received deduction),

2. Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder’s share of such dividends. See §1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rules set forth in §1.861–10(c), and in the apportionment of other expenses under the consolidation rules set forth in §1.861–14T.

(iii) Income that is not considered tax exempt. The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer including a foreign sales corporation (FSC) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of §1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) Prior years. For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by §1.861–13T, see §1.861–8(d)(2) (Revised as of April 1, 1986).

Allocation and apportionment of certain deductions. (1) [Reserved]. For further guidance, see §1.861–8(e)(1).

2. Interest. The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§1.861–9T through §1.861–13T.

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

(f) Miscellaneous matters—(1) Operative sections. (i) [Reserved]

(ii) Separate limitations to the foreign tax credit. Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each