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January 16, 2007

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Temporary and Proposed Regulations Relating to Application of Separate Limitations to Dividends From Noncontrolled Section 902 Corporations

Dear Commissioner Everson:

Enclosed are comments concerning temporary and proposed regulations relating to applications of separate limitations to Dividends from noncontrolled section 902 corporations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

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EXECUTIVE SUMMARY

I. Application of Look-through

A. General Application of the Look-Through Rule

Regarding the reconstruction of look-through pools from non-lookthrough periods, we suggest that the Internal Revenue Service (“IRS”) consider creating an elective, simplified alternative for de minimis United States shareholders, for administrative convenience.

B. Substantiation of Underlying Earnings and Profits (“E&P”)

1. We recommend that the regulations, when finalized, provide an anti-abuse rule for situations in which a taxpayer deliberately fails to substantiate the characterization of earnings and profits (especially pre-2007 earnings and profits).

2. We recommend that the regulations provide a more detailed rule regarding situations in which a taxpayer is unable to substantiate the characterization of earnings and profits.

C. Treatment of Non-Look-Through Period Earnings and Taxes

1. We recommend clarification as to what constitutes “other relevant information” that may be used to characterize non-look-through pools absent election of the safe harbor. We also suggest clarification that taxpayers are required to determine the sub-characterization of earnings and profits, if relevant, for pre-2007 earnings and profits.

2. We recommend an anti-abuse rule regarding application of the safe harbor method of allocating earnings and taxes in non-look-through pools to separate categories where certain material changes have occurred since the years used to measure the safe harbor allocation.

3. We request guidance on the how the safe harbor election is to be made and the time frame for making such election.

4. We suggest that the IRS and the Department of Treasury exercise their regulatory authority under section 904(d)(4)(C)(i)(II) to limit foreign tax credits associated with distributions from earnings and profits accumulated before the foreign corporation became a controlled foreign corporation (“CFC”) or 10/50 corporation (i.e. before it had any United States shareholder), and/or before the taxpayer became a United States shareholder of the foreign corporation.

II. Transition from 10/50 Basket(s)

A. Carrybacks and Carryforwards of Excess Foreign Tax Credits

1. We recommend clarification that the principles of Treasury Regulation sections 1.904-2 and -3 continued to apply even before April 25, 2006. We further suggest that the IRS and Treasury update existing Treasury Regulation sections 1.904-2, 1.904-3, and 1.904(f) to reflect current statutory rules.

2. We recommend clarification that, if the taxpayer was no longer a qualifying shareholder as of the first year of the 10/50 corporation beginning after 2002, excess foreign taxes carried forward from pre-2003 years from the 10/50 baskets are carried forward pro rata to the baskets to which earnings or pre-1987 profits would have been assigned if they had been distributed in the last taxable year in which the taxpayer was a shareholder in such corporation, determined as if look-through had applied in that year.

B. Overall Foreign Losses (“OFL”) and Separate Limitation Losses (“SLL”)

We recommend that the OFL or SLL from other baskets, that would otherwise be recaptured from a 10/50 basket, be recaptured from the other baskets in the same proportions that dividends from the 10/50 corporation are assigned to such baskets.

III. Apportionment of Interest Expense

A. We request that the IRS and Treasury clarify the application of the interest expense apportionment rules to chains of 10/50 corporations and/or CFC’s in which different chain members have elected different interest apportionment methods.

B. Indirect Stock Ownership taken into account for Tax Book Value Method

Regarding the addition of “indirect” ownership to Temporary Regulation section 1.861-12T, we request discussion or clarification regarding the regulation’s use of a prospective date for a change labeled a clarification.

IV. Application of Section 904(g)

A. We request guidance on the application of section 904(g) to dividends of 10/50 corporations for 2003 through 2006.

B. We suggest that the rules of Regulation section 1.904-5(m)(5) (other than special rules for related person interest expense) should apply to section 1293 inclusions from 10/50 corporations.

V. Temporary Regulations under Section 964

A. Adoption of New Method of Accounting

1. We recommend that electing a method of accounting without consent under Temporary Regulation section 1.964-1T(c)(2) be allowed only for the first year for which such method is relevant for U.S. tax purposes and only if the foreign corporation has not previously elected a method of accounting.

2. We recommend clarification that changes in method of accounting or taxable year must comply with section 446 and the regulations thereunder.

B. Taxable Year Elections for CFCs

We recommend modification of Temporary Regulation section 1.964-1T(c)(2) to be consistent with current guidance, including existing rules regarding CFCs as prescribed by Revenue Procedure 63-7.

C. Simplifying Procedures for Single-Shareholder CFC's

We recommend permitting a CFC that is owned by a single United States shareholder to change its method of accounting by attaching Form 3115 to its tax return in lieu of the statement and written notice required by Temporary Treasury Regulation section 1.964-1T(c).

D. Section 481(a) Adjustment for Current E&P

We recommend clarifying that a foreign corporation is required to take a section 481(a) adjustment into account for purposes of computing E&P, and that such adjustment apply to current E&P, beginning in the year of change.

E. References to Expired Regulations

We request that the IRS and Treasury update the section 964 regulations' references to now-expired section 964 temporary regulations.

I. Background

As a result of the heightened investment in emerging markets and the requirements of local ownership, it seems that the number of 10/50 corporations is on the rise. As companies look at ways to grow their businesses and stay competitive, joint ventures are an increasingly attractive option. Absent a check-the-box election to treat a company as a partnership, many joint venture entities become 10/50 corporations. Accordingly, rules that ease compliance burdens and allow a U.S.-based multinational to utilize its foreign tax credits with respect to distributions from 10/50 corporations on a basis comparable with other direct investments will reduce distortions in U.S. companies' international investment decisions.

With regard to the temporary and proposed regulations, we understand the complex environment in which the IRS drafted these rules, and we appreciate the clarity that the regulations convey. The multiple statutory changes in the 10/50 corporation rules, combined with the sometimes conflicting policy objectives of clarity, efficiency, fairness, and administrability, create a significant regulatory challenge for the IRS. We feel that the proposed regulations provide a clear and comprehensive approach coordinating the application of the 10/50 look-through rules with other foreign tax credit rules.

Taxpayers are required to compute their foreign tax credit limitation separately for different categories of income. Such categories are generally known as "baskets." Prior to the Taxpayer Relief Act of 1997 (TRA '97)¹, there were at least nine baskets, including one for each 10/50 corporation from which a dividend was received. Under current section 904(d)(2)(E),² a noncontrolled section 902 corporation (10/50 corporation) is a foreign corporation in which a domestic corporation owns at least 10 percent but not more than 50 percent of the stock of such foreign corporation. A controlled foreign corporation (CFC), as defined in section 957, is not treated as a 10/50 corporation with respect to any distribution out of its E&P for periods during which it was a CFC.

Under the TRA '97 regime, the requirement that dividends from each 10/50 corporation represent a separate "basket" was eliminated. Instead, dividends paid by a 10/50 corporation from pre-2003 earnings and profits of all 10/50 corporations were assigned to a single 10/50 basket unless paid by a passive foreign investment company (PFIC). On the other hand, dividends paid from earnings that accumulated in post-2002 tax years were categorized according to the category of the underlying earnings from which the dividend was paid (*i.e.*, look-through treatment). The TRA '97 changes applied to taxable years beginning after 2002.

Congress made further changes to the 10/50 dividend rules with the enactment of the American Jobs Creation Act in 2004 (AJCA)³. Effective for tax years beginning after December 31, 2002, dividends from 10/50 corporations are eligible for look-through treatment without regard to whether their distributed earnings and profits (E&P) was accumulated before or after

¹ Public Law 105-34, 111 Stat. 788, 971 (1997).

² Unless otherwise indicated, all section references in these comments refer to the Internal Revenue Code of 1986, as amended, (the "Code") or the Treasury Regulations (the "Regulations"), as the context requires.

³ Public Law 108-357, 118 Stat. 1418 (October 22, 2004).

2003.⁴ In other words, the AJCA entirely eliminated the separate basket for dividends received from 10/50 corporations, including retroactive elimination of that basket for 2003 and 2004.

However, through the Gulf Zone Opportunity Act (GOZA),⁵ passed in 2005, Congress once again altered these rules and permitted taxpayers to elect to defer the effective date of the AJCA amendments until taxable years beginning after December 31, 2004. As a result, taxpayers could elect not to apply the AJCA's expanded look-through rules to dividends out of pre-2003 earnings. This election only applies to tax years beginning after December 31, 2002 but before January 1, 2005.

In an attempt to reflect the aforementioned changes made by AJCA and GOZA, new Temporary Regulations were issued on April 20, 2006, to address the look-through treatment of dividends from 10/50 corporations when calculating the foreign tax credit.⁶

The Temporary Regulations amend the regulations issued under section 861 to address the treatment of 10/50 corporation stock for interest allocation purposes. Temp. Reg. § 1.861-9T(f)(4). They state that a 10/50 corporation may elect the asset method or modified gross income method, and need not use the same method as its shareholders. They further provide that 10/50 stock is characterized as an asset, in the shareholder's hands, using the same interest allocation method that the 10/50 corporation uses to allocate its interest expense. In addition, the Temporary Regulations state that the interest allocation rules relating to "10 percent owned corporations" apply not only where an affiliated group owns 10 percent or more of the voting power of a corporation directly, but also where such ownership is indirect. Temp. Reg. § 1.861-12T(c)(2).

The Temporary Regulations also amend the regulations under section 904 to provide rules for carrybacks from post-2002 years (after the 10/50 basket disappears) to pre-2003 years when such basket exists, and vice versa. Essentially, look-through characterization applies to foreign taxes that are so carried over. The regulations also provide special rules for taxpayers who cease to be United States shareholders of the foreign corporation before the foreign taxes are carried forward. In addition, the Temporary Regulations provide guidance for the recapture of overall foreign losses and separate limitation losses that would otherwise be recaptured from the former 10/50 basket, or would otherwise lead to recharacterization of income as belonging in the former 10/50 basket. See Temp. Reg. § 1.904(f)-12T(g).

The Temporary Regulations further provide guidance as to the application of look-through treatment to dividends paid by a 10/50 corporation, including rules for reconstructing the characterization of earnings and profits accumulated before the application of the look-through rules, and a safe harbor for such reconstruction. Temp. Reg. § 1.904-7T(f). In addition, the Preamble states that the IRS and Treasury decline to exercise their regulatory authority to address distributions from earnings and profits accumulated before a foreign corporation became

⁴ See section 904(d)(4)(C)(iv). Congress did, however, grant regulatory authority to address distributions of E&P accrued in periods before the taxpayer acquired the relevant stock. See section 904(d)(4)(C)(i)(II).

⁵ Public Law 109-135, 119 Stat. 2577 (December 22, 2005).

⁶ See T.D. 9260; 2006-23 I.R.B.1001, 71 FR 24516. The text of the Temporary Regulations also serves as the text of the proposed regulations.

a CFC or 10/50 corporation, or before the taxpayer became a United States shareholder of such corporation.

The Temporary Regulations also provide that taxpayers may elect to defer application of the new regulatory rules relating to 10/50 corporations until taxable years beginning after January 1, 2005. Temp. Reg. § 1.904-7T(f)(9).

Lastly, the Temporary Regulations provide rules regarding elections of accounting methods and taxable years by CFC's and 10/50 corporations. See Temp. Reg. § 1.964-1T(c).

II. Application of Look-Through

a) General Application of the Look-Through Rule

We think that the Temporary Regulations provide a clear and comprehensive approach for coordinating the application of the 10/50 look through rule with the rest of the U.S. foreign tax credit system. However, we are concerned that in some cases, where the U.S. shareholder has a relatively small ownership interest, the administrative burden on both the taxpayer and the IRS pertaining to the calculation of foreign tax credits in connection with dividends from 10/50 corporations remains quite high. The process of obtaining and analyzing multiple years of historical financial data to ascertain the exact portion of distributions that relate to specific categories of income can be challenging, particularly where distributions relate to earnings from historical periods (for example, those during which the taxpayer did not own the 10/50 corporation). The reconstruction and safe harbor methods provided in the Temporary Regulations reduce those difficulties for non-look-through periods. Also, for post-2006 years, characterization may become considerably easier as section 904(d)(1) is reduced to only two foreign tax credit baskets. However, we think that calculating and characterizing a 10/50 corporation's look-through pools may remain quite difficult for minority shareholders in the future, for current earnings and foreign tax pools (to which the special reconstruction and safe harbor methods created for non-look-through pools do not apply).

Therefore, we suggest that the IRS consider a simplified alternative for United States shareholders who own a minimal interest in a 10/50 corporation, using a safe harbor approach. If basket characterization remains difficult for smaller shareholders after 2006, a safe harbor for de minimis shareholders might refer to the gross revenue of each 10/50 corporation for an abbreviated period to categorize the entire dividend. For example, one method might be to treat the distribution as from separate categories of income in proportion to the gross revenue of the 10/50 corporation for the latest 3 years. This type of information could be more easily pulled from the latest statutory accounts of the foreign entity. This rule could include an anti-abuse provision that prevents use of this particular safe harbor if there has been a material change in the 10/50 corporation's operations, assets, or structure over the last three years. Another example might treat the distribution as from a single category if more than 90 percent of the 10/50 corporation's gross revenue for the latest 3 years originated from that category, with a similar anti-abuse provision. In both of these examples, the safe harbor could be elective. We believe that this type of approach would allow more certainty to taxpayers and reduce administrative burdens. Limiting the safe harbor to de minimis holdings, for example, to domestic shareholders

who own 15 percent or less of a 10/50 corporation (after application of attribution rules) could limit abuse potential. The simplifying rules might also appropriately be limited to situations in which the domestic shareholder is claiming less than a specified amount of credits with respect to taxes of the 10/50 corporation for the current year or a combination of the current year and the preceding three years.

b) Substantiation of Underlying E&P

Section 904(d)(4)(C)(ii) delegates to the Commissioner the authority to classify as “passive income” the underlying E&P distributed by the 10/50 corporation if the taxpayer cannot substantiate the look-through treatment for FTC limitation purposes. Temporary Regulation section 1.904-5T(c)(4)(iii) provides in pertinent part that “[a] dividend distributed by a noncontrolled section 902 corporation shall be treated as passive income if the look-through characterization of such dividend is not substantiated to the satisfaction of the Commissioner....” Consistent with the general theme of the Code and legislative history, the burden of proof is on the taxpayer to substantiate the classification of the underlying E&P.⁷

Some taxpayers may misuse the regulatory provision with regard to pre-2007 income by intentionally failing the substantiation requirement in order to classify the income as passive (and therefore eligible for the high-tax kick-out to the general category).⁸ We note that the potential for abuse decreases starting in 2007, when most taxpayers will have only two foreign tax credit baskets.⁹ We recommend that the regulations, when finalized, provide an anti-abuse rule for situations in which the taxpayer deliberately fails to substantiate. An anti-abuse rule could provide that, if the Commissioner finds that the taxpayer has willfully failed to substantiate in an attempt to circumvent the Code and regulations, then the earnings and associated taxes are placed in a separate sub-basket to prevent cross-crediting. Alternatively, the regulations could apply rules similar to the rules of section 907.

We further recommend that the IRS and Treasury create a rule for situations in which the taxpayer is unable to substantiate. The Temporary Regulation clearly satisfies the direction and intent of the statute pertaining to the reclassification of unsubstantiated income as passive. However, this rule potentially creates uncertainty when a taxpayer is unable to ascertain the category of the underlying E&P from historical data. In such a case, the rule does not allow the taxpayer to voluntarily characterize the amount as passive. The discretion is only with the Commissioner. We are not clear as to why the rule for inadequate substantiation for look-through characterization of a current dividend provides for automatic passive characterization,¹⁰ while the rule for inadequate substantiation for look-through characterization of non-look-through pools provides that the amounts are treated as passive only if the IRS is unable to re-

⁷ See H.R. Conf. Rep. No. 755, 108th Cong. 2d Sess. at 386 n.222 (2004) (“If the Treasury Secretary determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 corporation to the proper foreign tax credit limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes”).

⁸ For purposes of the high tax kick-out, the regulations do not distinguish between income treated as passive by reason of lack of substantiation and income treated as passive for other reasons. The Preamble confirms that this lack of differentiation is intentional.

⁹ Some taxpayers will also have baskets created outside of 904(d), such as 901(j) income.

¹⁰ Temp. Reg. § 1.904-5T(c)(4)(iii).

characterize them based on reasonably available information.¹¹ The different phrasing of the two rules implies a different meaning, even if none was intended. We recommend that the two rules be conformed, and that both use the latter formulation – *i.e.* that the regulations clarify that, in applying look-through rules to a dividend under section 1.904-5T(c)(4)(iii), the Commissioner may characterize the dividend based on reasonably available information if the taxpayer fails to substantiate the characterization.

c) Allocation and Apportionment of Expenses of a 10/50 Corporation

The Temporary Regulations apportion expenses of a 10/50 corporation by applying the same five-step process by which expenses of a controlled foreign corporation are apportioned, except that the third and fourth steps, the special rule for related party interest expense, are not applicable.¹²

We generally agree with this three-step apportionment process, and in particular with the Temporary Regulations' apportionment of related party interest expense of a 10/50 corporation differently from that of a controlled foreign corporation. The Temporary Regulations apportion related party interest expense of a 10/50 corporation based on either its assets or gross income, which is identical to the manner by which unrelated party interest expense is apportioned.¹³ By contrast, related party interest paid by a controlled foreign corporation is subject to a special rule, which first apportions that interest expense directly to any passive foreign personal holding company income earned by the controlled foreign corporation.

For a controlled foreign corporation's related party interest, this special rule is necessary because the lending domestic shareholder or controlled foreign corporation characterizes the interest income received, for foreign tax credit purposes, on a look-through basis based on the underlying income of the paying controlled foreign corporation.¹⁴

The special rule is not necessary for 10/50 corporations because, although dividends paid by a 10/50 corporation are eligible for look-through treatment, related party interest paid by a 10/50 corporation is not. Rather, interest paid by a 10/50 corporation is generally passive income to the recipient. Therefore, related party interest paid by a 10/50 corporation does not need to be apportioned directly to passive foreign personal holding company income in order to

¹¹ Temp. Reg. § 1.904-7T(f)(4)(iii).

¹² See Temp. Reg. § 1.904-5T(c)(2)(iii), cross-referencing the rules of section 1.904-5(c)(2)(iv) through (c)(4)(ii).

¹³ See Temp. Reg. § 1.904-5T(c)(2)(iii).

¹⁴ See section 904(d)(3)(A), (C). Congress has expressed its concern that, without the special rule, a U.S. taxpayer with excess credits in the general limitation basket would have an incentive to transfer passive assets offshore by lending to a controlled foreign corporation with an active business. H.R. Rep. No. 99-841, at II-578 (Conference Report, Tax Reform Act of 1986). The controlled foreign corporation could then invest those amounts in passive assets itself. In that case, neither the interest income earned by the U.S. taxpayer nor the income of the controlled foreign corporation is likely to be subject to a significant tax. In the case of the U.S. taxpayer, most of its interest income would be allocable to general limitation income of the controlled foreign corporation, and what began as passive income would have been transformed into general limitation income and could have been used to help the taxpayer claim credits for foreign taxes on other, unrelated general limitation income. By first apportioning the controlled foreign corporation's related party interest expense directly to its passive income, the special rule reduces this incentive to move passive assets offshore because the related party interest income is now passive limitation income in the hands of the recipient, to the extent of the payer's passive income. See Reg. § 1.904-5(c)(2)(i).

protect the United States' ability to tax the passive income of its residents, as was the case with the related party interest of a controlled foreign corporation.

Nevertheless, the Temporary Regulations' ratable allocation of 10/50 related party interest is likely to have the effect of converting active income to passive income, thereby discouraging related party loans to a 10/50 corporation. For example, if a U.S. taxpayer loans an amount to its 10/50 corporation which earns active and passive income, the U.S. taxpayer's interest income will be passive limitation income and the expense will be apportioned to active and passive income ratably, reducing the amount of the 10/50 corporation's earnings eligible for general basket characterization on distribution. Although this result potentially impacts taxpayers negatively, it is probably justifiable based on Congress' clear intent that 10/50 interest income not be subject to look-through and the longstanding principle that interest expense be apportioned on a fungible basis.

d) Treatment of Non-Look-Through Period Earnings and Taxes

1. In General

We commend the IRS for developing administrative rules for applying look-through treatment to distributions of earnings and profits arising in non-look-through periods. While the reconstruction and safe harbor methods of creating the opening balance of the look-through pools are welcome, we have several recommendations.

2. Reconstruction Method

The Temporary Regulations generally provide that undistributed earnings and foreign taxes for pre-2003 years after a 10/50 corporation first had a corporate shareholder meeting the requirements of section 902(a) (non-look-through pools) must be reconstructed for each such year.¹⁵ Such reconstructed earnings and taxes become the opening balances of the post-1986 undistributed earnings and post-1986 foreign income tax pools for the first post-2002 year of the 10/50 corporation. The earnings and taxes are then treated, for post-2002 years, as if they had originally been eligible for look-through treatment when the earnings were accumulated, or the taxes were accrued, paid, or deemed paid. Similar rules apply for CFCs, for earnings and taxes arising in pre-2003 years in which the CFC was a 10/50 corporation.¹⁶ Analogous rules also apply to earnings accumulated, and taxes paid or accrued, in years before a foreign corporation first became a 10/50 corporation or CFC.¹⁷

We recognize, as do the IRS and Treasury, that reconstruction of a 10/50 corporation's earnings and taxes for old years may be quite difficult, especially for periods before the particular taxpayer became a shareholder.¹⁸ Therefore, we commend the government's

¹⁵ Temp. Reg. § 1.904-7T(f)(2).

¹⁶ Temp. Reg. § 1.904-7T(f)(3).

¹⁷ Temp. Reg. § 1.904-7T(f)(6).

¹⁸ T.D. 9260 ("The IRS and the Treasury Department recognize that shareholders may face difficulties in reconstructing historical accumulated earnings and taxes accounts of a 10/50 corporation on a look-through basis, because noncontrolling shareholders may have difficulty obtaining detailed records for prior periods from the 10/50 corporation.").

statement, in the Temporary Regulation's Preamble, that "the IRS and the Treasury Department anticipate that a reasonable approximation of the amounts properly included in the look-through pools, based on available records obtained through reasonable, good-faith efforts by the taxpayer, will adequately substantiate the reconstruction required by the statute."¹⁹ We also commend the creation of a safe harbor that grants greater certainty to taxpayers, because the practical application of the "reasonable approximation," "available records," and "reasonable, good faith efforts" standards cited above (on audit and potentially in court) is not necessarily predictable.

A shareholder is required (unless it elects the safe harbor) to characterize the non-look-through pools based on "reasonably available books and records and other relevant information."²⁰ Clarification of what constitutes other relevant information would be helpful. The existing examples do not provide guidance on this question, beyond a reference to "information used to characterize [foreign subsidiary's] stock for purposes of apportioning [parent's] interest expense. . . ." ²¹ In the absence of further clarification, taxpayers likely would rely on the safe harbor in lieu of reconstructing the look-through pools.

In addition, although not entirely clear from the Temporary Regulations, we presume taxpayers are required to determine the sub-characterization of earnings and taxes if otherwise relevant. We recommend clarification of this point. For example, if a 10/50 corporation conducts a financing business but doesn't itself qualify as a financial services entity within the meaning of section 1.904-4(e)(3)(i), a shareholder using the reconstruction method would need to determine what portion of the non-look-through earnings qualify as active financing income as defined in section 1.904-4(e)(1)(i). Such a determination would be necessary in order to determine whether the income would be placed in the financial services basket upon distribution to an upper-tier financial services entity. This particular issue, and several others, will disappear in 2007 with the reduction to two section 904(d)(1) baskets, but multiple section 904(d)(1) baskets remain important for the application of the Temporary Regulations to 2003-2006 earnings and foreign taxes.

3. Safe Harbor

The Temporary Regulations provide a safe harbor under which a taxpayer may allocate earnings and taxes in the non-look-through pools to separate categories (for post-2002 years' post-1986 look-through pools) in the same percentages as the taxpayer allocated the foreign corporation's stock for interest allocation purposes for the first taxable year after 2002 (or for 2003 and 2004 if the taxpayer used the modified gross income method).²² While the safe harbor provides a simple and administrable method for characterizing non-look-through pools, distortions are possible, as acknowledged in the Temporary Regulations. To minimize potential distortions arising from the use of the modified gross income method to allocate the foreign corporation's interest expense, the Temporary Regulations require such a corporation's shareholder to use an average of the foreign corporation's modified gross income ratios for the

¹⁹ T.D. 9260, see also Temp. Reg. § 1.904-7T(f)(4) ("the taxpayer shall make a reasonable, good-faith effort").

²⁰ Temp. Reg. § 1.904-7T(f)(4)(i).

²¹ Temp. Reg. § 1.904-7T(f)(4)(iv), Example 1.

²² Temp. Reg. § 1.904-7T(f)(4)(ii).

2003 and 2004 taxable years (rather than using the 2003 ratios alone) if the shareholder elects the safe harbor.

Other potential distortions, however, are not addressed in the Temporary Regulations. For example, there could be instances in which a material change in the foreign corporation's operations (or asset composition) would distort the characterization of the non-look-through earnings and taxes under the safe harbor. This could work to the taxpayer's benefit or detriment, especially if the taxpayer lacks sufficient documentation to substantiate the non-look-through pools without the safe harbor. Conditioning the use of the safe harbor on the lack of any material change in the foreign corporation's operations or structure from the non-look-through period would reduce the likelihood of a distortion.

Therefore, we recommend an anti-abuse rule that 1) prevents the safe harbor from applying where the taxpayer's percentage allocation of the foreign corporation's stock among separate limitation categories for interest expense allocation purposes has materially changed since 2003 (or the average of 2003 and 2004, if the modified gross income method is elected), taking into account the shift to two section 904(d)(1) baskets after 2006; and/or 2) prevents the safe harbor from applying where the composition of the foreign corporation's operations, assets, or income have materially changed since 2003 (or 2004) so as to create material distortions in the application of the safe harbor. A minority of those who participated in preparing these comments, in contrast, recommend against conditioning the use of the safe harbor, reasoning that such a condition would decrease the simplicity benefits of the safe harbor. Others felt that the potential for abuse outweighed the simplicity benefits, and that the benefits of certainty and administrability would remain even if the safe harbor were limited by such an anti-abuse rule.

We also request guidance on how the safe harbor election is to be made and the time frame for making such an election. We note that the Temporary Regulations contain no deadline for the election, which implies that taxpayers could elect the safe harbor retroactively, on an amended return, or even during an audit. We think these are acceptable results.

e) Deficit Accumulated In Non-look-through Period

We agree with the Temporary Regulations' treatment of deficits accumulated in a non-look-through period.²³ It is sensible to allocate a deficit in the same manner that positive earnings would be allocated. For shareholders not electing the safe harbor, clarification that one or more separate categories could have positive earnings, while one or more separate categories could have a greater deficit, would be helpful. Thus, for example, if a foreign corporation had a \$100 deficit accumulated in its non-look-through period, the deficit could consist of a \$200 deficit in the general category and \$100 earnings in the shipping category.

f) Pre-acquisition or Pre-10/50-Status E&P

Pursuant to section 904(d)(4)(C)(i)(II), the Treasury and the IRS have the authority to "prescribe regulations regarding the treatment of distributions out of earnings and profits for

²³ Temp. Reg. § 1.904-7T(f)(5).

periods before the taxpayer's acquisition of the stock to which the distributions relate." Treasury and the IRS have declined to exercise this regulatory authority.²⁴

The Preamble notes that such distributions may occur in two situations: 1) out of earnings accumulated before a foreign corporation became a 10/50 corporation or CFC, *i.e.* before the foreign corporation had any qualifying U.S. shareholders (pre-status earnings), or 2) from earnings accumulated by a 10/50 corporation or CFC before the specific shareholder acquired its stock (pre-acquisition earnings). There are also situations in which an existing qualifying shareholder acquires additional stock, for example when a 10 percent domestic shareholder of a 10/50 corporation acquires an additional 80 percent, potentially entitling the shareholder to claim credits for 90 percent of the historic foreign taxes in the corporation's foreign income tax pools.

In the absence of any rule to the contrary, the Temporary Regulations by their terms apply look-through treatment to dividends from both pre-acquisition and pre-status E&P of 10/50 corporations, starting with dividends paid in 2003. We believe the extension of look-through treatment to pre-acquisition and pre-status earnings provides certain taxpayers with the ability to claim credits for foreign taxes for which they do not bear the economic cost and regarding which they have suffered no double taxation. This rule may encourage tax-motivated acquisitions of foreign corporations with attractive foreign tax and earnings pools. This incentive exists not only for 10/50 corporations, but for CFCs. Distributions of pre-CFC-status earnings are currently treated as dividends from a 10/50 corporation,²⁵ but such treatment no longer limits cross-crediting because such deemed-10/50 dividends are no longer isolated in a separate basket.

There is no affirmative policy reason to allow credits for foreign taxes on pre-status earnings and profits, and no good to be accomplished from such allowance. The foreign tax credit was intended to lessen the undue influence of double taxation of the taxpayer on business decisions, so that taxpayers would neither be prevented from doing business offshore, nor encouraged to attempt evasion of the U.S. tax net.²⁶ In the case of foreign taxes on pre-status earnings, no U.S. taxpayer was subject to any incentive or influence when the foreign taxes were

²⁴ T.D. 9260.

²⁵ Reg. § 1.904-4(g)(3).

²⁶ See *Burnet v. Chicago Portrait Co.*, 285 U.S. 1 (1932), *American Chicle Co. v. United States*, 316 U.S. 450 (1942). Before the enactment of the foreign tax credit in 1918, the Chair of the House Ways and Means Committee stated in a floor discussion that-

[The foreign tax credit] is not only a just provision, but a very wise one. It is wise from the standpoint of the commerce of the United States, of the expansion of business of the United States. * * * We would discourage men from going out after commerce and business in different countries or residing for such purposes in different countries if we maintained this double taxation. They would take their corporations that are American corporations and reorganize them, getting their charters in foreign countries, if we did not do this, and we might not be able to tax their income and profits at all. Another thing: if we did not do that, a man would become a citizen of another country instead of retaining his citizenship here in order to escape the large and double taxation imposed.

Mr. Kitchin, discussion on the floor of the House of Representatives, 56 Cong. Rec. App. 677-678, reprinted in J.S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws 1938-1861*, at 928 (1938).

imposed, because no U.S. shareholder was present when the taxes were paid or accrued. No unfair economic result is averted by awarding the foreign tax credits to the new U.S. shareholder. In addition, those earnings were entirely outside the U.S.'s tax jurisdiction when they were subjected to foreign tax.

The U.S. taxpayer may, however, be encouraged to purchase foreign corporations that have foreign tax pools. The fact that foreign taxes and associated U.S. foreign tax credits will encourage foreign rather than U.S. investment, and the diversion of funds from non-tax-driven business activities, is antithetical to the purpose of the foreign tax credit.²⁷ Furthermore, the separation of foreign tax credits (which are allocated to one person) from the associated income (belonging to another person) conflicts with the IRS and Treasury's recent policy emphasis on allocating foreign tax credits to the person who owns the associated income, as articulated in recent proposed regulations issued under section 901. See REG-124152-06, Prop. Reg. § 1.901-2(f).

The availability of a foreign tax credit for foreign taxes on pre-status earnings and profits is likely to change taxpayer behavior even in acquisitions that are undertaken for non-tax business reasons. For instance, U.S. taxpayers acquiring 80 percent or more of a foreign corporation generally make a section 338 election in order to preclude residual U.S. tax on distributions of pre-acquisition earnings. Prior to the Temporary Regulations, the pre-acquisition earnings and taxes would have been allocated to a separate category.²⁸ If that category had excess creditable taxes, the taxpayer could not have used the excess taxes to reduce residual U.S. tax on other foreign source income. Thus, choosing not to make a section 338 election generally had downside risk and no upside potential.

Under the Temporary Regulations, however, taxpayers will rethink whether to make a section 338 election. If a potential target has excess creditable taxes in its pre-acquisition tax pool, the U.S. shareholder would be able to direct distributions of the earnings and excess creditable taxes in order to claim the excess credits against U.S. tax on other foreign source income in the same category. Granting excess credits in this case is unwarranted. It is likely the shareholder's purchase price would have been net of the target's previously paid or accrued creditable taxes, so that the new shareholder does not bear the cost of previous years' foreign taxes. Thus, granting the use of the excess credit promotes trafficking in foreign tax credits.

The majority of those who participated in preparing these comments believe that extending look-through treatment to distributions out of pre-status earnings and profits (E&P profits accumulated before the 10/50 corporation or CFC had any qualifying U.S. shareholders, and before it became a 10/50 corporation or CFC) is inappropriate, given the resulting incentives to make foreign rather than U.S. investments, the lack of double taxation of the domestic shareholder claiming the credits, and the considerable potential for abuse. A minority thinks that

²⁷ The encouragement of foreign rather than U.S. investment results from the fact that the U.S. shareholder avoids the economic burden of the foreign taxes, so that the U.S. foreign tax credits are an affirmative benefit that is not offset by the countervailing cost of the foreign taxes. Because the foreign taxes have been paid and accrued in the past, on pre-status and/or pre-acquisition earnings and profits, the purchase price should reflect the current value of earnings and profits (post-foreign taxes), and the cost of the foreign taxes is thus not borne by the new shareholder.

²⁸ Section 904(d)(1)(E) (repealed); Reg. § 1.904-4(g)(3) (relating to distributions of E&P accumulated before CFC status).

the abuse potential is tempered by the taxpayer's difficulty in obtaining adequate records regarding pre-status, pre-acquisition earnings and taxes. The majority thinks that substantial numbers of foreign corporations are likely to have sufficient records to reconstruct the non-look-through pools. Taxpayers can also meet that hurdle by using the safe harbor, which uses relatively recent records. Alternatively, taxpayers willing to accept passive characterization (or expecting the high tax kick-out from passive income) need not make any effort to substantiate the characterization of the earnings and taxes. In light of this, and the absence of any risk of double taxation, the majority of those who participated in preparing these comments think that granting the shareholder excess credits is inconsistent with the purposes underlying the foreign tax credit.

Regarding pre-acquisition²⁹ (as opposed to pre-status) earnings and profits, a majority feels that look-through treatment is inappropriate for the same reasons listed above. Look-through treatment for post-status, pre-acquisition E&P is, however, slightly less objectionable than in the case of pre-status E&P because there is at least one 10 percent U.S. shareholder of the foreign corporation at the time the foreign taxes are paid or accrued and because administrative convenience is served by applying the same basket treatment to all U.S. shareholders of the corporation. A minority thinks that look-through treatment for pre-acquisition earnings is acceptable as a means of reducing administrative complexity and avoiding distinctions between similarly situated taxpayers depending on when they acquired the foreign corporation's stock. The majority thinks that taxpayers who became qualifying shareholders before and after the 10/50 corporation accumulated earnings and paid or accrued the foreign tax on those earnings are not similarly situated with regard to the foreign taxes.

We suggest that the IRS and Treasury consider options for addressing distributions of pre-status and pre-acquisition earnings, pursuant to the statutory grant of regulatory authority.³⁰ The Preamble states that look-through treatment is more appropriate than passive category characterization in these circumstances. No mention is made of creating a separate category for pre-acquisition earnings. While the trend has been away from multiple categories – indeed there will be only two categories listed in section 904(d)(1) for taxable years beginning after December 31, 2006³¹ – we believe section 904(d)(4)(C)(i)(II) provides the IRS with sufficient authority to retain a separate category for pre-acquisition earnings. We suggest that reasonable, useful solutions to lessen the potential for abuse and reduce cross-crediting include the following:

1. a new separate limitation category for earnings and profits accumulated before each foreign corporation had any domestic shareholder who met the ownership requirements of

²⁹ Pre-acquisition earnings and profits, as used here, means E&P accumulated by a 10/50 corporation or CFC before the specific shareholder acquired its stock, but after the corporation had at least one shareholder meeting the ownership requirements of section 902(a).

³⁰ For example, the IRS and Treasury have differentiated between E&P accumulated before any U.S. shareholder and post-U.S.-shareholder E&P in the recently proposed section 1248 regulations, and similar principles might be used in the foreign tax credit context. See Prop. Reg. § .1248-8(b)(2).

³¹ Notwithstanding the existence of two general categories, active and passive, effective for taxable years beginning after December 31, 2006, there will still be instances of separate categories in specific cases. See, e.g., section 865(h)(1)(B) (separate category for foreign creditable taxes imposed on gains that would otherwise be sourced in the United States).

section 902(a) (or one such new basket for such earnings from all foreign corporations). This alternative is similar to previous treatment of pre-status earnings of CFCs,³² and would eliminate the concern raised in the Preamble regarding “administrative complexities associated with maintaining multiple sets of look-through pools starting on different dates for different U.S. shareholders,”³³ because the pre-status date would be the same for all shareholders.

2. a new separate limitation category for earnings and profits accumulated before the taxpayer met the ownership requirements of section 902(a) with respect to each foreign corporation (or one such new basket for such earnings from all foreign corporations, which would allow more cross-crediting and planning opportunities). This alternative reflects the policy behind the foreign tax credit, which is to reduce double taxation of the taxpayer (not to grant the taxpayer a credit for taxes on others’ previously earned income).

We agree with the IRS and Treasury that passive treatment of pre-acquisition or pre-status earnings and foreign taxes is not a good option: the foreign taxes would have been creditable, cross-crediting within the passive basket would have been allowed, or the taxes could have been “kicked out” to the general basket. Further, passive treatment would not be an undesirable result for all taxpayers. For pre-2007 years, passive income is a consistently, predictably bad result mostly for financial services corporations, for whom the high-tax-kick-out to the general category is often not a helpful remedy.

If the IRS and Treasury continue not to exercise their regulatory authority on this issue, we recommend that the IRS monitor the claiming of credits with respect to pre-acquisition and pre-status earnings and take appropriate action to combat abuse as the need arises.

III. Transition from 10/50 basket(s)

a) Carrybacks and Carryforwards of Excess Foreign Taxes

The Temporary Regulations contain a new section 1.904-2T(a), which essentially restates the introductory paragraph of the existing 1.904-2 regulations. The newly issued section explains that existing sections 1.904-2 and -3 of the regulations do not reflect many subsequently enacted statutory amendments, and states that the principles of those sections nonetheless continue to apply, “modified so as to take into account the effect of statutory amendments.”³⁴ This new regulatory language takes effect on April 25, 2006 (the general effective date for the regulations package), in the absence of a more specific effective date. We agree that the principles of sections 1.904-2 and -3 should continue to apply. However, we suggest that the IRS and Treasury clarify that the principles of these regulations continued to apply even before April 25, 2006. Further, we suggest that the IRS and Treasury update the existing section 1.904-2 and -3 regulations (and the section 1.904(f) regulations, which are also outdated) to reflect the current statutory rules.

³² See Reg. § 1.904-4(g)(3).

³³ T.D. 9260.

³⁴ Temp. Reg. § 1.904-2T(a).

The Temporary Regulations provide, consistently with section 904(d)(4)(C)(iv), that excess foreign taxes carried forward from pre-2003 years from the 10/50 baskets are carried forward to the baskets to which the underlying dividends would have been assigned if the dividends had been eligible for look-through when paid.³⁵ For these purposes, the application of look-through treatment to the dividends is determined under either the reconstruction or safe harbor method. The regulations further state that if the taxpayer was no longer a qualifying shareholder as of the first taxable year of the 10/50 corporation beginning after 2002, any excess taxes carried forward are allocated among baskets “in the same percentages as the earnings in the noncontrolled section 902 corporation’s non-look-through pool or pre-1987 accumulated profits would have been assigned had they been distributed in the last taxable year in which the taxpayer was a domestic shareholder in such corporation.”³⁶ We assume that the IRS and Treasury meant to refer to the separate categories to which such earnings would have been assigned if look-through had applied on the date of such deemed distribution in the last taxable year in which the taxpayer was a domestic shareholder. However, the regulatory language literally refers to the category to which earnings would have been assigned, presumably under pre-2003 law. Because the rule applies only to taxpayers who ceased to be domestic shareholders before 2003, a distribution of such earnings would have been assigned to the separate category for dividends from the specific 10/50 corporation, because such distribution would have occurred before 2003. We assume that this is not the intended result.³⁷ We think a clarification is required.

We generally agree that the carryback rule in the Temporary Regulations provides a reasonable result. The regulations state that excess foreign taxes carried back to pre-2003 years will not be traced to the pre-2003 10/50 basket for the relevant 10/50 corporation, but instead will be carried back to the same baskets to which the relevant post-2002 10/50 dividends are assigned under look-through principles. This rule should only apply, practically speaking, for carrybacks to 2001 and 2002, and we agree that the rule eliminates substantial complexity.

b) Overall Foreign Losses and Separate Limitation Losses

The Temporary Regulations provide that if a taxpayer has an overall foreign loss (OFL) or separate limitation loss (SLL) in a 10/50 basket and the OFL or SLL is to be recaptured in post-2002 years, the OFL or SLL will be recaptured from the other baskets pro rata based on the baskets to which the taxpayer properly attributes the 10/50’s stock under the Temporary Regulations for purposes of interest expense apportionment for the first post-2002 year.³⁸ The Preamble explains that the interest expense apportionment ratios, rather than ratios of the reconstructed non-look-through pools, were used because the former are consistent with the “forward-looking” quality of the OFL and SLL rules. A rule that recaptures the OFL or SLL

³⁵ Temp. Reg. § 1.904-2T(h)(1).

³⁶ Temp. Reg. § 1.904-2T(h)(1).

³⁷ The Preamble states that, with respect to such a former shareholder, “§ 1.904-2T(h)(1) provides that the excess taxes are assigned pro rata to the separate categories to which the foreign corporation’s pre-2003 earnings would have been assigned had they been distributed in the last year that the taxpayer was a qualifying shareholder.” T.D. 9260. (Emphasis added.) The reference to multiple categories with respect to a single 10/50 corporation makes it seem that the Temporary Regulations intended to look-through to the multiple separate categories to which the 10/50 corporation’s earnings should be allocated under look-through principles.

³⁸ Temp. Reg. § 1.904(f)-12T(g)(1). A similar rule applies for SLL’s in other baskets that previously offset income in a 10/50 basket. See Temp. Reg. § 1.904(f)-12T(g)(2). Our comments apply equally to such rule.

from the other baskets in the same proportions that post-OFL or SLL dividends from the 10/50 corporation are assigned to such other baskets would be more consistent with other provisions of the Temporary Regulations that generally take the approach of following the consequences that would have applied if look-through had always been in effect.³⁹ We also note that, rather than avoiding the reconstructed non-look-through pool result, the regulations essentially give all taxpayers the same result (for this purpose) as using the safe harbor method of reconstructing the non-look-through pools. We further question whether tying the OFL or SLL to 2002 interest expense allocation is “forward-looking.”

c) High Tax Kick-Out Grouping Rules

The Temporary Regulations generally apply to dividends from 10/50 corporations the same high-tax kick-out grouping rule that currently applies to dividends and section 951(a) inclusions from CFCs: the high-tax kick-out, including its grouping rules, applies separately to the dividends from each 10/50 corporation.⁴⁰ As the Preamble notes, no distinctions are made, for purposes of applying the high-tax kick-out grouping rules, between 10/50 corporation dividend income that is treated as passive by reason of the look-through rule and such income treated as passive by reason of inadequate substantiation.⁴¹ Thus, income treated as passive by reason of inadequate substantiation could make it more or less likely that other dividend income from the same 10/50 corporation will be moved from the passive to the general basket. However, the converse is also true: separating the two types of passive income for purposes of applying the high-tax kick-out could make it more or less likely that either of the two types is “kicked-out” to the general basket. We think the approach in the Temporary Regulations is reasonable.

IV. Apportionment of Interest Expense

The Temporary Regulations make three changes to the interest expense apportionment rules of Temporary Regulation sections 1.861-9T through -12T. We generally agree with each of these changes.

a) Treatment of Tiers Electing Different Methods

The Temporary Regulations permit a 10/50 corporation, for purposes of determining its earnings and profits, to apportion its interest expense based on either the asset method or the gross income method.⁴² Either the majority domestic corporate shareholders⁴³ or the 10/50

³⁹ See, e.g., Temp. Reg. § 1.904-2T(h)(1), (2) (carryovers of excess foreign taxes from 10/50 baskets), Temp. Reg. § 1.904-7T(f)(2), (3) (characterization of non-look-through pools as if look-through had applied).

⁴⁰ Temp. Reg. 1.904-4T(c)(4).

⁴¹ Cf. H.R. Conf. Rep. No. 755, 108th Cong., 2nd Sess. at 386 n. 222 (2004) (“the high-tax income rules [should] apply appropriately to dividends treated as passive category income because of inadequate substantiation”).

⁴² Temp. Reg. § 1.861-9T(f)(4)(i).

⁴³ Temp. Reg. § 1.861-9T(f)(4)(ii). The majority domestic corporate shareholders generally mean those domestic corporations that meet the section 902(a) ownership requirements for the 10/50 corporation (or a first-tier foreign corporation in the same qualified group) and that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all the voting stock of the 10/50 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or a relevant first tier foreign corporation). See Temp. Reg. § 1.964-1T(c)(5)(ii).

corporation itself can make the election. Unlike a controlled foreign corporation, a 10/50 corporation can elect the modified gross income method even if its United States shareholders have elected the fair market value method.⁴⁴

The Temporary Regulations also characterize the taxpayer's adjusted basis in the shares of a 10/50 corporation as an asset in the various separate categories on a look-through basis, taking into account either the underlying assets or income of the 10/50 corporation, depending on the 10/50 corporation's method of allocating its interest expense.⁴⁵ The regulations formerly treated stock in each 10/50 corporation as an asset generating income in a separate 10/50 category. The new rule applies for taxable years ending after the first day of the first taxable year of the 10/50 corporation beginning after December 31, 2002.⁴⁶ Therefore, if the 10/50 corporation is a calendar year taxpayer, then the taxpayer will be permitted look-through for the 10/50 corporation for the taxpayer's first taxable year ending after January 1, 2003.

We recommend that the IRS provide clarification, in the form of regulatory text or examples, regarding the application of different interest expense apportionment methods in the same chain of corporations. For example, assume U.S. shareholder owns a portion of 10/50 corporation A, which owns part of 10/50 corporation B. Under the Temporary Regulations, A could elect the asset method while B elects the modified gross income method, or vice versa, regardless of the method elected by the U.S. shareholder. Before the Temporary Regulations were issued, mismatches between interest allocation methods of tiered corporations were rare because a chain of controlled foreign corporations generally all had to use the same method in apportioning interest expense.⁴⁷ However, even before the Temporary Regulations, the same issues could have arisen for some CFC chains: theoretically, a second tier CFC could have elected a different interest expense apportionment method than its first tier CFC shareholder, if the two CFC's had different controlling United States shareholders. The fact pattern of various chain members electing different interest expense allocation methods is expected to occur more often in the 10/50 context because 10/50 corporations are permitted to elect a different method than their upper tier foreign shareholders and United States shareholders. Under the Temporary Regulations, we can expect to see chains of 10/50 corporations using different methods, and mixed chains containing both CFC's and 10/50 corporations who have elected different methods of interest expense allocation. Therefore, we recommend that the IRS provide guidance on the appropriate mechanics of applying the interest expense allocation rules to tiers whose members elect different methods.

The current regulations provide a rule for "tiering up" the income of tiers of corporations on the modified gross income method.⁴⁸ Those regulations state that the lowest tier's interest expense is allocated based on its income, and its gross income reduced by such allocated interest expense is then treated as gross income of the next higher tier. These steps are then essentially repeated, moving up the tiers. We suggest that this regulation be amended to state that the lowest tier's interest expense is allocated according to the interest allocation method that such lowest tier has chosen (rather than according to its gross income).

⁴⁴ Temp. Reg. § 1.861-9T(f)(4)(i).

⁴⁵ Temp. Reg. § 1.861-12T(c)(4)(i).

⁴⁶ Temp. Reg. § 1.861-12T(c)(4)(iii).

⁴⁷ Temp. Reg. § 1.861-9T(f)(3)(iii).

⁴⁸ Temp. Reg. § 1.861-9T(j)(2).

If an upper tier instead uses the asset method (and therefore is characterizing the lower tier's stock), the Temporary Regulations require the upper tier to characterize the lower tier 10/50 corporation's stock "using the same method that the noncontrolled section 902 [10/50] corporation uses to apportion its interest expense."⁴⁹

We suggest that the rules should work as follows. Assume the following facts: CFC A owns a portion of 10/50 corporation B; B has equal amounts of general and passive assets; and B's modified gross income is 60 percent general and 40 percent passive. B has a total 100 of income and 80 of interest expense.

If A uses the asset method and B uses the modified gross income method, A would treat the B stock as an asset that is 60% general, 40% passive. If, instead, A elects the modified gross income method and B elects the asset method, A would take into account its pro rata share of B's income, after that income is characterized based on B's assets. Thus, when a higher-tier member of a section 902(b) qualified group owns an interest in one or more lower-tier 10/50 corporations, and the higher-tier member has elected the modified gross income method, then the higher-tier member's share of the lower-tier 10/50 corporation's modified gross income should tier up, under the principles of Treasury Regulation section 1.861-9T(j)(2) (when amended as recommended above), with the lowest tier's interest expense allocated according to the lowest tier's allocation method. The lower-tier member's income should tier up in these circumstances, even if the lower-tier 10/50 corporation has elected the asset method.

In the example above, if both A and B have elected the modified gross income method, A would take into account its share of B's gross income based on the principles of Treasury Regulation section 1.861-9T(j)(2), modified as suggested above. Given the facts above, B's allocation results in 12 of general income and 8 of passive income, both of which A takes into account for purposes of A's allocation.

On the other hand, if A has elected the modified gross income method, but B has elected the asset method, then a proportionate amount of B's income still should tier up to A. B should allocate its interest expense based on the asset method. Under the facts above, such allocation leaves B with 20 of general income and zero passive income. That 20 and zero should then move up to A for purposes of A's interest expense allocation. This method results in A's treating B's 20 of net income, for A's interest allocation purposes, the same way that such 20 would be presumably be treated under the look-through rules if distributed from B to A as a dividend.

b) Indirect Stock Ownership taken into account for Tax Book Value Method

Temp. Reg. § 1.861-12T requires a taxpayer, for purposes of apportioning interest expense under the tax book value method, to increase its basis in the shares of a 10 percent owned corporation by the corporation's earnings and profits attributable to such stock, and reduce such basis by deficits in earnings and profits attributable to such stock. Before the

⁴⁹ Temp. Reg. § 1.861-9T(f)(4)(iii) (applying to characterization of 10/50 corporation's stock by its United States shareholder or member of the same qualified group), compare Temp. Reg. § 1.861-9T(f)(3)(iv) (similar rule for CFC stock). See also Temp. Reg. § 1.861-12T(c)(4) (stock in a 10/50 corporation is characterized in the hands of its domestic shareholders using the asset or gross income method, depending on the method used by the 10/50 corporation to apportion its interest expense).

issuance of these Temporary Regulations, Reg. § 1.861-12T(c)(2) stated that a taxpayer must make such a basis adjustment only if it owned the 10 percent corporation “directly.” The Temporary Regulations amend section 1.861-12T(c)(2) to state that a taxpayer must adjust its basis in a 10 percent owned corporation whether the taxpayer owns the corporation “either directly or, for taxable years beginning after April 25, 2006, indirectly through a partnership or other pass-through entity.”⁵⁰ Therefore, the Temporary Regulations, in effect, view the pass through entity as an aggregate and treat the taxpayer as directly owning the proportionate amount of shares it owns through a pass through entity for purposes of adjusting the basis of the taxpayer’s shares by reference to the underlying earnings of the corporation. We note that this change is not limited to 10/50 corporations, or even to foreign corporations.

The Preamble to the Temporary Regulations describes this amendment as a clarification, yet the amendment is effective on a prospective basis only.⁵¹

We agree with the drafters’ decision to add “indirect” ownership to the regulation provision, because this is a sound policy result and provides a clear rule. However, some members, taking the view that the amendment merely clarifies existing law, would urge removal of the prospective effective date because they believe the prospective effective date conflicts with the Temporary Regulations’ description of the change as a “clarification”. Another group agrees that the amendment clarified existing law, and also thinks that a prospective effective date is appropriate because the “directly” language did cause some degree of uncertainty as to the meaning of -12T(c)(2) before it was amended. Finally, a third group of members considers the amendment as a change of law and would therefore recommend deleting the reference to clarification from the preamble when the regulations are finalized.

We ask that the IRS and Treasury provide some discussion as to the need for a prospective effective date, when the change is otherwise considered to be only a clarification. Without that discussion, the prospective date appears to conflict with the characterization of the change as a clarification. We are aware of a number of arguments both in favor of and against a basis adjustment in these circumstances, but the Preamble does little to resolve that debate and instead unhelpfully provides ammunition to both sides of the argument.

VI. Application of Section 904(g) to Interest, Dividends, and Section 1293 Inclusions from 10/50 Corporations

Section 904(g) re-sources, for purposes of the section 904 foreign tax credit limitation, certain types of income from United States-owned foreign corporations as United States sourced where it would otherwise be foreign sourced income.⁵² A United States-owned foreign corporation is any foreign corporation that is owned more than 50 percent (by vote or value) by United States persons, whether or not those U.S. persons each own at least 10 percent of the voting power in the corporation (i.e. are “United States shareholders” under section 951(b)).⁵³

⁵⁰ See Temp. Reg. § 1.861-12T(c)(2)(i).

⁵¹ Id.

⁵² Section 904(g), as in effect for 2006, will be redesignated as section 904(h), effective for taxable years beginning after 2006. These comments continue to refer to the section as “section 904(g),” because the designation will not take effect until 2007.

⁵³ Section 904(g)(6).

While this definition includes CFCs, certain 10/50 corporations, and other foreign corporations in which United States persons owned at least 50 percent of the corporation's stock, the original regulations that were issued under section 904(g) only addressed the application of this section to CFCs.⁵⁴ Newly issued Temporary Treasury Regulation section 1.904-5T(m) essentially applies the rules of those original regulations (other than special rules of related person interest expense) to interest and dividends from 10/50 corporations that are United States-owned foreign corporations.

The Preamble to the Temporary Regulations indicates that the change is intended to “clarify that the rules for re-sourcing interest and dividends also apply to a 10/50 corporation that meets the definition of a United States-owned foreign corporation.”⁵⁵ Given that the current final regulations on section 904(g) refer only to CFCs, and that the preamble to those regulations specifically states that such regulations do not apply to any United States-owned foreign corporations other than CFCs, the addition of 10/50 corporations to the scope of those rules would appear to be a change rather than a mere clarification. However, the Preamble to the Temporary Regulations also limits the application of this change in position to amounts paid by a 10/50 corporation in taxable years of such company beginning after April 25, 2006. This prospective effective date presumably curbs any confusion with regard to the retroactive application of these rules to 10/50 corporation.

We note that, unlike the statutory provision of look-through treatment for 10/50 corporations' dividends, and unlike the new regulations for reconstructing look-through pools,⁵⁶ this expansion of the section 904(g) regulatory rules does not apply retroactively to taxable years beginning after 2002 (or after 2004, for taxpayers electing to apply TRA '97 rules regarding the single 10/50 basket for 2003 and 2004). We request that the preamble accompanying the final version of these regulations not refer to the application of the section 904(g) regulations to 10/50 corporations as a clarification, and that the IRS and Treasury provide guidance on the appropriate treatment of dividends from 10/50 corporations under section 904(g) for 2003 through 2006. For example, what would be the IRS position regarding a taxpayer that received a dividend from a 10/50 corporation in 2005 and applied section 904(g) to that dividend using a method other than the rules of Treasury Regulation section 1.904-5(m)? We suggest that the IRS and Treasury consider making section 1.904-5T(m) retroactive to 2003 (or 2005, for taxpayers electing to apply TRA '97 statutory rules for 2003 and 2004), to match the retroactive effective date of the statutory changes to look-through for 10/50 corporations and of the section 1.904-7T rules for reconstructing non-lookthrough pools.

In addition, the Temporary Regulations do not address the application of section 904(g) to section 1293(a) inclusions from a 10/50 corporation. This could result in varying interpretations of the proper method by which these inclusions should be re-sourced under section 904(g). Taxpayers could potentially use various reasonable methods of attributing the underlying PFIC income to U.S. sources for such purposes. Because the statutory language of

⁵⁴ See Reg. § 1.904-5(m). The preamble to the original section 1.904-5(m) stated that the regulation “provides rules for the application of section 904(g) to income of a CFC” and that “the application of section 904(g) to income of United States-owned foreign corporations other than CFCs is not addressed in these rules.” T.D. 8214.

⁵⁵ T.D. 9260.

⁵⁶ Temp. Reg. § 1.904-7T(f)(10) (effective date).

section 904(g) applies exactly the same rule to section 1293 inclusions and section 951(a) inclusions,⁵⁷ we think it would be reasonable and helpful for the regulations to provide that for purposes of applying section 904(g) to section 1293 inclusions from a 10/50 corporation, taxpayers must apply rules similar to the rules for applying section 904(g) to subpart F inclusions. Specifically, we suggest that the rules of section 1.904-5(m)(5) (other than the special rules for related person interest expense which are incorporated in that section by cross-reference to section 1.904-5(m)(4)(ii)) should apply to section 1293 inclusions from 10/50 corporations.

VII. Temporary Regulations under Section 964

a) Background

The Temporary Regulations include regulations issued under section 964. In particular, Temporary Treasury Regulation sections 1.964-1T(c)(2) and (3) add rules allowing the majority domestic corporate shareholders of a 10/50 corporation to make an election, adopt a method of accounting or taxable year, or change a method of accounting or taxable year on behalf of the 10/50 corporation. Further, these regulations modify the rules related to adoption or change of a method of accounting or taxable year by a CFC.

b) Adoption of a New Method of Accounting

New Temporary Regulation section 1.964-1T(c)(2) provides, in part, that-

For the first taxable year of a foreign corporation beginning after April 25, 2006, in which a foreign corporation is a controlled foreign corporation (as defined in section 957 or 953) or a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)), any method of accounting or taxable year allowable under this section may be adopted, and any election allowable under this section may be made, by such foreign corporation or on its behalf notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year.

As currently drafted, section 1.964-1T(c)(2) appears to be quite broad in application. In particular, this regulatory provision seems to provide that for the first taxable year after April 25, 2006, any CFC or section 10/50 corporation may adopt any method of accounting or taxable year allowable under section 964 notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is otherwise required by the Code or regulations to be made in a prior taxable year.

Application of this regulatory provision in this manner appears to be inconsistent with section 446 and the regulations thereunder because it suggests that taxpayers may change a method of accounting without the prior consent of the Commissioner. Section 446(a) provides that taxable income shall be computed under the method of accounting under which the taxpayer

⁵⁷ See section 904(g)(2).

regularly computes its income in keeping its books. In general, taxpayers may adopt any permissible method of accounting when filing their first tax return.⁵⁸ Section 446(e) provides that a taxpayer may not change its method of accounting unless the Commissioner consents to such change. Commissioner consent is required because virtually any material change in the method of reporting income or deduction will result in a distortion of taxable income.⁵⁹

The apparent inconsistency between the new regulatory provision and section 446 is surprising because other provisions of the regulations under section 964 incorporate the rules of section 446. In particular, section 1.964-1(c)(1) provides that the tax accounting standards to be applied in making the tax adjustments required by section 1.964-1(a)(3) include accounting methods, and section 1.964-1(c)(1)(i) provides that the method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

New Temporary Regulation section 1.964-1T(c)(2) is remarkably similar in language to former section 1.964-1(c)(2), which it replaces. In relevant part, former section 1.964-1(c)(2) provides:

Adoption of method – For the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation . . . there may be adopted or made by such corporation or on its behalf any method of accounting or election allowable under this section notwithstanding that, in previous years, its earnings and profits were computed, or its books or financial statements prepared, on a different basis and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. . . .

Because the subpart F rules first took effect in 1963,⁶⁰ former section 1.964-1(c)(2) effectively allowed foreign corporations to elect a method of accounting for the first year for which that method was relevant for U.S. tax purposes. We believe that the IRS may well have intended to draft a similar rule, that is, a rule for adopting methods of accounting the first time E&P becomes relevant and for adopting taxable years the first time that choice becomes relevant. If that is the case, we recommend that section 1.964-1T(c)(2) be revised to state that electing a method of accounting without consent will be allowed under such section only for the first year for which such a method is relevant for U.S. tax purposes and only if the foreign corporation has not previously elected a method of accounting. We recommend that the IRS and Treasury further make clear that any other changes in methods of accounting or taxable years must be made pursuant to section 446 and the regulations thereunder. Alternatively, the IRS and Treasury may consider limiting the new regulatory provision to 10/50 corporations and to corporations that first become CFCs after April 25, 2006 (and were not 10/50 corporations in earlier years).

⁵⁸ See Reg. §1.446-1(e)(1). Rev. Rul. 90-38 provides that the use of a proper method of accounting on a single return, or an improper method on two consecutive tax returns, constitutes the adoption of an accounting method.

⁵⁹ See Commissioner v. O. Liquidating Co., 292 F.2d 225, 230 (3d Cir. 1961), cert. denied, 368 US 898 (1961).

⁶⁰ See P.L. 87-834 (Revenue Act of 1962), § 12(a) (Subpart F applies to taxable years of foreign corporations beginning after December 31, 1962, and taxable years of United States shareholders with or within which such taxable years of foreign corporations end.).

c) Taxable Year Elections for CFCs

As noted above, Temporary Regulation section 1.964-1T(c)(2) expands the guidance under section 964 to provide rules for changing taxable years in the context of determining the E&P of a foreign corporation. Previously, the regulations under section 964 only dealt with adopting and changing accounting methods as distinguished from accounting periods.

Although section 1.964-1T(c)(2) refers taxpayers to section 898 for rules regarding the taxable year of a specified foreign corporation as defined in section 898(b),⁶¹ this section does not refer to the general rules under section 441 and 442 relating to taxable years and changes thereto. Further, a CFC that is not a specified corporation (or that qualifies for an exception) is not subject to the section 898 conformity rules. Rather, Revenue Procedure 63-7,⁶² as clarified by Revenue Procedure 75-54,⁶³ provides rules for determining the taxable year of foreign corporations (including CFCs), in general.⁶⁴

A CFC adopts a taxable year with the filing of its first Form 5471 (or 1120-F, if applicable).⁶⁵ Accordingly, once adopted, a CFC that is not subject to section 898 must comply with section 442 and the regulations thereunder when changing its taxable year. However, as currently drafted, Temporary Regulation section 1.964-1T(c)(2) could be interpreted to permit a CFC (other than those CFCs subject to section 898) to adopt any taxable year for the first taxable year after April 25, 2006, notwithstanding that the CFC had previously adopted a different taxable year. Such a result would contradict the existing rules related to CFCs as prescribed by of Revenue Procedure 63-7. Accordingly, we recommend that section 1.964-1T(c)(2) be modified to be consistent with current guidance.

d) Simplifying the Procedures where CFC is 100 Percent owned by One U.S. Shareholder

We recommend that Temporary Regulation sections 1.964-1T(c)(3)(i) and (ii) be modified to permit a CFC that is 100 percent owned by a U.S. shareholder to change its method of accounting by attaching a copy of Form 3115 (and/or the consent agreement, as applicable) in lieu of the statement and written notice required by section 1.964-1T(c)(3).

New Temporary Regulation section 1.964-1T(c)(3) provides guidance on the procedures that must be followed by a foreign company's controlling domestic shareholders in order to effectuate an election, or adopt or change a method of accounting or taxable year. In general,

⁶¹ See Reg. §1.441-1(b)(2)(K) (certain taxpayers must use the particular taxable year that is required under the Internal Revenue Code and the regulations thereunder. For example, in the case of a specified foreign corporation, the taxable year is determined under section 898(c)(1)(A)).

⁶² 1963-1 C.B. 485.

⁶³ 1975-1 C.B. 595.

⁶⁴ According to Rule 1 of Rev. Proc. 63-7, the taxable year of a CFC shall be determined under section 441, and the regulations thereunder. Further, Rule 4 of Rev. Proc. 63-7, as clarified by Rev. Proc. 75-54, provides, in part, that a taxable year of a CFC that has been established or adopted in accordance with Proc. 63-7, may be changed only with the prior approval of the Commissioner in accordance with section 442, and by treating a foreign corporation that is not subject to United States income tax as though it were a taxpayer within the meaning of section 7701(a)(14).

⁶⁵ See Yoder, 926-2nd T.M., Subpart F-General.

section 1.964-1T(c)(3)(i) provides that as well as following the requirements of sections 442 and 446, the controlling domestic shareholders must file a statement described in section 1.964-1T(c)(3)(ii), and provide written notice required by section 1.964-1T(c)(3)(iii), in the time and manner prescribed therein.

We recommend modifying section 1.964-1T(c)(3)(i) and (ii) to provide that if a CFC is 100 percent owned by one United States shareholder and that shareholder changes a method of accounting for an item of income or deduction, the shareholder may file the original Form 3115 with its tax return in lieu of filing an additional statement or notice. Additional filings should be unnecessary where there are no other shareholders to notify.⁶⁶ Modifying the rules in this manner would provide clear administrable rules and eliminate redundant filing requirements in these circumstances.

e) Section 481(a) Adjustment for Current E&P

To the extent a change in method of accounting requires a code section 481(a) adjustment, we recommend that the regulations under section 964 clarify that a foreign corporation is required to take a section 481(a) adjustment into account for purposes of computing E&P.⁶⁷ Further, we also recommend that the section 481(a) adjustment be taken into account in current E&P, beginning in the year of change.

In general, the regulations under section 964 appear to provide that the general rules applicable to domestic corporations apply in the context of changing a method which is to be taken into account in the computation of E&P.⁶⁸ Expired temporary regulations under section 964, issued in 1990, also referred to taking a section 481 adjustment into account.⁶⁹ In particular, expired section 1.964-1T(g)(5) provides that-

Adjustments to the appropriate separate category (as defined in § 1.904-5(a)(1)) of earnings and profits and income of the controlled foreign corporation shall be required using the principles of section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any such election or adoption.

⁶⁶ See Notice 89-91 (filings by the controlling United States shareholder are intended to notify the IRS and minority shareholders).

⁶⁷ In particular, Temporary Regulation section 1.964-1T(c)(2) provides, in part, that “[a]ny allowable methods adopted or elections made shall be reflected in the computation of the foreign corporation’s earnings and profits for such taxable year, prior taxable years, and (unless the Commissioner consents to a change) subsequent taxable years.” If our recommendation above is adopted and section 1.964-1T(c)(2) only applies to situations relating to the first time that computing E&P becomes relevant, the approach identified in the Temporary Regulations is appropriate. However, if section 1.964-1T(c)(2) instead was intended to provide a mechanism to allow any CFC or 10/50 corporation to change a method of accounting notwithstanding that it had previously adopted a method of accounting, this approach seems to circumvent the requirements of section 481. If the latter was intended, we recommend that the regulations under section 964 clarify that a section 481 adjustment should be taken into account in current E&P, consistent with the current domestic guidance.

⁶⁸ See Reg. §1.964-1(c).

⁶⁹ T.D. 8283.

Presumably such a reference to making an adjustment according to the principles of section 481 means that adjustments should be taken into account beginning in the year of change, consistent with domestic rules. The IRS has noted there is no specific guidance on how to implement the section 481(a) adjustment at the CFC level,⁷⁰ but has stated in a Field Service Advice that a change in method of accounting that required a positive section 481(a) adjustment was properly taken into account at the CFC level over a four-year period.⁷¹ The IRS cited section 1.964-1T(g)(5) to support its conclusion, noting that section 481 adjustments were required to prevent duplication or omission that would otherwise result from adoption or election of a tax accounting method.

Thus, without specific guidance to the contrary, it would appear that if a CFC is implementing a method change and taking a section 481(a) adjustment into account, the applicable domestic rules apply.⁷² Consistent with these procedural rules, we recommend that to the extent the section 481(a) adjustment applies, the adjustment should be taken into account in determining current E&P for the same period as the adjustment is taken into account for purposes of computing taxable income.

Further support for such a recommendation may be drawn from guidance in the domestic context. For example, Revenue Procedure 79-47⁷³ sets forth the effect on E&P of section 481(a) adjustments resulting from a change in method of accounting. This revenue procedure provides that “when computing its earnings and profits (current and accumulated) available for the payment of dividends, the taxpayer shall follow its new method for reporting taxable income and shall take the section 481(a) adjustment into account (whether positive or negative) over the same period as it does for purposes of computing taxable income.”⁷⁴

We recommend that, to the extent the section 481(a) adjustment is applicable, the regulations under section 964 should clarify that the adjustment should be taken into account in current E&P beginning with the year of change, consistent with the current domestic guidance in Revenue Procedure 2002-19. Given the lack of binding authority on how to apply a section 481(a) adjustment to a foreign corporation’s E&P, the best approach appears to be to follow domestic principles.

⁷⁰ See 1998 FSA Lexis 448.

⁷¹ *Id.*

⁷² Sections 1.481-1(c)(2) and (3) generally provide that if a change in method of accounting is voluntary (*i.e.*, initiated by the taxpayer), or involuntary (*i.e.*, not initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is usually taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. However, both provisions refer to sections 1.446-1(e)(3) and 1.481-4, which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. Under Revenue Procedure 97-27 and Revenue Procedure 2002-9, the Commissioner has exercised discretion to allow taxpayers to take section 481(a) adjustments into account over different periods. For example, Rev. Proc. 2002-19 provides that in the case of changes in methods of accounting that result in a negative section 481(a) adjustment, the entire amount of the adjustment should be taken into account in the year of change. For net positive adjustments, Revenue Procedure 2002-19 requires that the amount of the adjustment be taken into account prospectively for four taxable years beginning with the year of change.

⁷³ 1979-2 C.B. 528.

⁷⁴ See also PLR 8047012 (the appropriate portion of the adjustment required under section 481(a) should be reflected in current E&P for each taxable year of the adjustment period).

f) References to Expired Regulations

We also note that the Temporary Regulations regarding section 964 refer to previous, now expired,⁷⁵ section 964 temporary regulations. We request that the IRS and Treasury either remove these references or incorporate the language of the relevant expired provisions into the Temporary Regulations or other current regulations.

⁷⁵ Section 7805(e) provides that any temporary regulations issued after November 20, 1988, expire within three years after their date of issuance.