May 7, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224


Dear Commissioner Koskinen:

Enclosed please find comments requesting guidance under section 267(a)(3)(B) (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
    Robert Stack, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
    Danielle Rolfe, International Tax Counsel, Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
    Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jairo Cano, Paul Crispino, and Meg Hogan of the Committee on Foreign Activities of U.S. Taxpayers ("FAUST"). The Comments were reviewed by Joseph Calianno, Chair of FAUST, and Robert J. Peroni, Academic Vice-Chair of FAUST. The Comments were further reviewed by Reuven S. Avi-Yonah, on behalf of the Section's Committee on Government Submissions, by Alan I. Appel, the Section's Council Director for FAUST, and by Peter H. Blessing, the Section's Vice-Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 7, 2015
EXECUTIVE SUMMARY

Section 267(a)(2)\(^1\) imposes a general matching rule that seeks to ensure symmetry between the timing of deductions and the inclusion of corresponding income for transactions between related parties. The section precludes a deduction for amounts owed to related persons until the earlier of the period in which the item is paid or when the corresponding item of income is includable in the gross income of the recipient under its method of accounting.

Section 267(a)(3)(A) provides for regulatory authority to apply the matching principle of section 267(a)(2) to cases in which the recipient is a foreign person, such as a “controlled foreign corporation” within the meaning of section 957 (“CFC”) or a “passive foreign investment company” (“PFIC”) within the meaning of section 1297. The existing regulations effectively require taxpayers to apply the cash method of accounting with respect to the deduction of certain amounts owed to related foreign persons.\(^2\) Exceptions are provided for certain payments, including payments of otherwise deductible amounts to related foreign persons who include such payments in income as effectively connected income\(^3\) and payments to a CFC or PFIC.\(^4\) Under the latter exception, deductible payments made to a related CFC or PFIC are deductible when the corresponding amount is includable in the income of the CFC or PFIC under its method of accounting, even if the deduction occurs prior to the date of payment and prior to the date the corresponding amount is includable in the income of the recipient’s U.S. shareholder.\(^5\)

Congress believed that the failure of the existing regulations to condition the deductibility of the payment on the U.S. shareholder’s inclusion of the corresponding income could lead to material distortions in the matching of income and deductions in respect of amounts owed to related foreign corporations.\(^6\) Consequently, Congress enacted section 267(a)(3)(B)\(^7\) to limit the deductibility of items payable to a related CFC, or to a PFIC, until the earlier of payment or when an amount attributable to such item is includable in the income of a U.S. shareholder of such CFC or PFIC.\(^8\) In determining the portion of an item considered includable in a U.S. shareholder’s income, properly

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and to the Regulations promulgated thereunder.

\(^2\) Reg. § 1.267(a)-3(b)(1) (generally placing taxpayers on a cash method), (2) (amounts covered).

\(^3\) Reg. § 1.267(a)-3(c)(1).

\(^4\) Reg. § 1.267(a)-3(c)(4)(ii) (CFCs), (iii) (PFICs).

\(^5\) Id.

\(^6\) Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05), 406 (May 2005) (“Consequently, under the Treasury regulations, both the U.S. payors and U.S.-owned foreign payors may be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income. These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which could reduce a CFC’s income that would be currently taxable to its U.S. shareholders under subpart F.”) (hereinafter, “JCT Report”).


\(^8\) JCT Report, supra note 6, at 406.
allowable deductions and qualified deficits are not taken into account, i.e., a full
deduction is available for an amount accrued notwithstanding that the amount is reduced
by properly allocable deductions or a qualified deficit.\textsuperscript{9}

While section 267(a)(3)(B) is applicable to payments accrued on or after October
22, 2004, no regulations or other guidance have been issued.\textsuperscript{10} In the absence of
guidance reflecting the statutory changes, the application of the existing regulations,
which have not been withdrawn, is uncertain, and a number of fundamental issues
regarding the application of the new rules remain unresolved. For instance, difficult
conceptual issues arise from the interaction between section 267(a)(3)(B) and the foreign
tax credit and Subpart F look-through rules in CFC-to-CFC transactions. The lack of
guidance may be a trap for the unwary. It also may provide opportunities to achieve
results that are arguably outside of the intent of section 267(a)(3)(B) but consistent with
its statutory language and its apparent interaction with other U.S. international tax rules.
Accordingly, we respectfully request that the Department of the Treasury (“Treasury”)
and the Internal Revenue Service (the “Service”) publish guidance under section

Our principal suggestions regarding these matters may be summarized as follows:

(A) Payments between CFCs:

(1) Exempt payments between CFCs from the application of section

(2) If section 267(a)(3)(B) continues to apply to payments between CFCs,
clarify the interaction of section 267(a)(3)(B) and the foreign tax credit and
subpart F look-through rules in the manner described herein.

(3) Release suspended deductions on a pro rata basis when the U.S.
shareholder recognizes associated income.

(4) Reduce post-1986 undistributed earnings on a pro rata basis.

(B) Ordinary course exception:

(1) Adopt an ordinary course exception for items deductible under section
162.

(2) Adopt an eight and one-half month grace period for deducting accrued
amounts owed to CFCs prior to payment.

\textsuperscript{9} Id. at 406-07.
\textsuperscript{10} Commentators have requested such guidance. See, e.g., ABA Section of Taxation, Comments on Notice
Meeting with Treasury Office of Tax Policy Officials, BNA Tax Core (February 21, 2007).
This comment letter does not address two issues that implicate policy concerns beyond section 267(a)(3)(B). If requested, we would be happy to address each of these issues in a separate comment letter. First, this comment letter does not address the definition of a “payment” for purposes of section 267(a)(3)(B). Second, this comment letter does not address whether section 267(a)(3)(B) applies to payments made to a partnership.


12 Read literally, section 267(a)(3)(B) applies only to payments made to a CFC or a PFIC, and not payments made to a partnership. This conclusion relies on treating a partnership as an entity and not as an aggregate of its partners, which could include CFCs and PFICs. We believe that the Commissioner could invoke the abuse of entity treatment rule of Reg. § 1.701-2(e) to require that section 267(a)(3)(B) be applied on an aggregate basis. It is less clear, however, whether taxpayers could take the position that section 267(a)(3)(B) applies on an aggregate basis. While taxpayers may be able to reference existing regulations, such as Reg. § 1.267(b)-1(b)(1) and Temp. Reg. § 1.267(a)-2T(c) Q&A3, to treat a partnership as an aggregate for purposes of section 267(a)(3)(B), some practitioners have cast doubt on the continued validity of these regulations. See, e.g., Douglas A. Kahn, Sales Between a Partnership and Non-Partners, 136 Tax Notes 827 (Aug. 13, 2012).
DISCUSSION

A. Payments Between CFCs

(1) Section 267(a)(3)(B) and the Foreign Tax Credit and Subpart F Look-Through Rules

a. Section 267(a)(3)(B) and the foreign tax credit look-through rules of section 904(d)(3)

Section 904(d) requires foreign source income to be placed in the passive or general category (or basket) for purposes of determining the limitation on the foreign tax credit (“FTC”) under section 904(a). For this purpose, a U.S. shareholder, within the meaning of section 951(b), characterizes dividends, interests, rents and royalties received from a CFC by reference to the character of the item in the hands of the CFC payor, i.e., on a “look-through” basis. For example, if a U.S. shareholder receives interest income from a CFC and the CFC’s corresponding interest expense is properly allocable against income in the general category, the U.S. shareholder characterizes the interest income as income in the general category. As discussed in paragraph (b) below, similar rules apply to the characterization of subpart F income under section 951(a)(1)(A) and qualified electing fund (“QEF”) income under section 1293. Regulations extend the look-through rules to payments between CFCs.

Applying section 267(a)(3)(B) in the context of transactions between CFCs presents challenges for the proper application of the look-through rules because the determination of the category of the recipient’s income is based on the FTC category to which the payor’s deduction is properly allocable. If applied to transactions between CFCs, the deferred

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13 I.R.C. § 904(d)(3). See also Reg. § 1.904-5.
14 I.R.C. § 904(d)(3)(A), (C); Reg. § 1.904-5(c)(2).
15 I.R.C. § 904(d)(3)(B); Reg. § 1.904-5(c)(1).
16 I.R.C. § 904(d)(2)(B)(ii) (treated QEF income generally as passive income), (d)(2)(E)(ii) (look-through treatment for QEF income to the extent the PFIC is a non-controlled section 902 corporation with respect to the U.S. shareholder), (d)(3)(H) (look-through treatment for QEF income of a PFIC that is also a CFC for which the taxpayer is a U.S. shareholder within the meaning of section 951(b)); Reg. § 1.904-5(j)(1). In the case of a PFIC, the statutory look-through rule of section 904(d)(3)(H) for QEF income of a PFIC that is also a CFC is unlikely to have any application in light of the CFC-PFIC overlap rule of section 1297(d)(1). Under section 1297(d)(1), a foreign corporation is not treated as a PFIC as to the shareholder during the periods in which it is a CFC and the shareholder is a U.S. shareholder within the meaning of section 951(b).
17 Reg. § 1.904-5(i).
deduction under section 267(a)(3)(B) may distort the relationship between the category of the payor’s deduction and the category of the recipient’s inclusion.\textsuperscript{18}

Thus, if a borrowing CFC’s deduction for interest expense is deferred under section 267(a)(3)(B), it is not clear how the recipient CFC should categorize its interest income for FTC purposes. Under one approach, if the borrowing CFC’s deferred deduction would have been properly allocable to general basket income were it deductible, the recipient CFC might categorize its income as general basket under the look-through rule. In light of section 267(a)(3)(B), however, it is not clear that this is the appropriate conclusion because there would, in fact, be no item of income to which a deduction of the expense would relate, at least not in the current year. As section 267(a)(3)(B) has no application to the recipient CFC’s income inclusion, however, the recipient CFC must categorize its income notwithstanding the uncertainty arising from the application of section 267(a)(3)(B) to the payor’s deduction. The recipient CFC might categorize its income as general basket, either on the theory that the expense did not reduce passive income of the payor CFC or because the payor CFC would have applied the expense deduction against its general basket income in the absence of section 267(a)(3)(B). What happens, however, if in the year the payor CFC deducts the expense, its income is entirely passive basket income? The expense deduction, released pursuant to section 267(a)(3)(B), then would reduce the passive income of the payor CFC, notwithstanding that the recipient CFC had characterized the income as general category income in the year of receipt.\textsuperscript{19}

A second alternative would take a similar approach to categorizing the income inclusion (e.g., if the payor CFC would have allocated its interest expense against general category income in the year of accrual if it had been deducted in such year, the recipient would treat the income as falling into the general category). Under the second alternative, however, the expense deduction would be deemed applied against that same category of income of the payor CFC in the year the item is paid (or at the time there is an inclusion at the level of the U.S. shareholder of the recipient), regardless of the composition of passive or general category income of the payor in such year.

\textsuperscript{18} Commentators have raised this concern and discussed alternatives. See Harter and Lee, \textit{supra} note 11, at 20-21.

\textsuperscript{19} Regulations could mandate this result, i.e., the expense deduction would be deemed applied against general category income of the payor CFC in the year the item is paid (or at the time there is an inclusion at the level of the U.S. shareholder of the recipient), regardless of the composition of passive or general category income of the payor in such year. The interest allocation regulations provide rules for the treatment of interest deductions suspended under sections 163(d) and 469. Reg. § 1.861-9T(c)(3), (4) (in the year a deduction becomes allowable, the interest expense is subject to apportionment as though it were incurred in the taxable year in which the expense is deducted). As discussed herein, it is not clear whether a similar rule should apply to interest expense suspended under section 267(a)(3)(B).
A third alternative would be to determine the FTC category of the recipient’s income without regard to the look-through rule, as section 267(a)(3)(B) precludes the necessary relationship that underlies its application. In this case, the recipient CFC would determine the category of its income under the general rules, i.e., the income would fall in the passive category if it is of a kind which would be foreign person holding company income.20

b. Section 267(a)(3)(B) and Subpart F

Similar to its effect on the FTC look-through rule, section 267(a)(3)(B) could lead to unintended consequences when applied in the context of the subpart F look-through rule. Under both the same country exception of section 954(c)(3), and the look-through rule of section 954(c)(6),21 as interpreted in Notice 2007-9, a recipient CFC generally treats income received from a related person as subpart F income if the associated expense reduces subpart F income of the payor CFC or creates or increases a qualified deficit under section 952(c).22 If, in the year an expense accrues, the payor CFC has only income that does not qualify as subpart F income (or if the expense otherwise would not be allocated against subpart F income), the accrued income would not be subpart F income to the recipient CFC if the expense were otherwise deductible by the payor. Section 267(a)(3)(B)’s suspension of the deduction, however, raises substantial uncertainty on how to allocate and apportion the expense for purposes of determining the recipient’s treatment of such item. As is the case with section 904, one approach that a taxpayer might take is that, because section 267(a)(3)(B) has no applicability to the recipient CFC, the recipient would not have subpart F income even if the payor CFC later reduces subpart F income with the deferred expense in the year the expense is paid or when the associated income is includable in the income of the U.S. shareholder of the recipient.

A second approach would be to categorize the income by reference to the manner in which it would have been categorized when accrued if it had been deductible then, and to reference that same categorization when categorizing the deduction when paid.

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21 Application of this look-through provision was extended through December 31, 2014. It is currently not certain whether it will be extended again, although it has been extended numerous times in the past and we expect it will be extended once again.
22 I.R.C. § 954(c)(3)(B) (same country exception not applicable to the extent interest, rent or royalty payments reduce the payor’s subpart F income or creates or increases a qualified deficit), (c)(6) (subpart F look-through rule; for purposes of section 954(c), dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as subpart F income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor effectively connected income). See also Notice 2007-9, 2007-5 I.R.B. 401 (generally adopting for purposes of section 954(c)(6) allocation rules similar to those of the same country exception).
Under a third approach, the recipient CFC would be required to recharacterize its previous inclusion based on the allocation and apportionment of the payor’s expense in the year the deduction is allowed. This last approach presumably would require the taxpayer to keep open its original return so that a retroactive change could be made to the recipient’s treatment in the event its original filing position turns out to be incorrect in light of the allocation and apportionment of the payor’s expense in the year of deduction.

Applying section 267(a)(3)(B) to transactions between CFCs could distort the earnings and profits of the payor CFC even though there would not be immediate U.S. tax consequences to either the CFC payor or the CFC payee based on the operation of the same country exception and subpart F look-through rule.\(^ \text{23} \) For example, assume that CFC-1 has $100 of non-subpart F income and accrues a royalty expense of $80 payable to CFC-2 and that the same country exception or subpart F look-through rule applies to such income. In this case, the royalty received by CFC-2 would not be subpart F income because it would be attributable to CFC-1’s non-subpart F income. If section 267(a)(3)(B) were to apply, CFC-1 would not be permitted to deduct the expense until it pays the expense or the U.S. shareholder of CFC-2 recognizes the associated income. The result would be a temporary increase in CFC-1’s earnings and profits, which could prove beneficial to the U.S. shareholder of CFC-1 depending on the facts and circumstances.

In cases in which there are immediate U.S. tax consequences, applying section 267(a)(3)(b) would not be needed to ensure that the payor’s deduction matches the recipient’s income. If CFC-1 were to earn $100 of subpart F income, e.g., foreign base company sales income, and accrued a royalty payment of $80 to CFC-2, section 267(a)(3)(B) would not be needed to ensure a matching of deduction and inclusion. In this circumstance, CFC-1 would have (prior to relevant deductions) $20 of potential subpart F income and CFC-2 would have $80 of subpart F income attributable to the royalty received from CFC-1. The two CFCs would report subpart F income in the appropriate amounts. In this case, like the previous deferral case, section 267(a)(3)(B) would be unnecessary because there would be a match between the deduction at the payor CFC and inclusion at the U.S. shareholder of the recipient CFC.

c. Section 267(a)(3)(B) should not apply to payments between CFCs

We suggest that Treasury and the Service exercise regulatory authority\(^ \text{24} \) to exempt payments between CFCs from the application of section 267(a)(3)(B), leaving the section applicable to payments to PFICS and payments by U.S. persons to CFCs. While section 267(a)(3)(B) was intended to address Congressional concerns about the potential for material distortions if U.S., CFC, and PFIC payors could deduct accrued expenses without the U.S.

\(^{23}\) I.R.C. §§ 954(c)(3) and (c)(6), respectively.

shareholder of the related CFC or PFIC recipient including a corresponding amount in income, because it fails to take into account the look-through rules applicable to section 904(d) categories of income and to subpart F income, it creates its own material distortion and appears to be unnecessary for the purposes Congress had in mind. In addition, it creates unnecessary complexity and traps for the unwary in determining the earnings and profits of CFCs, including in respect of global treasury centers.\(^{25}\)

Further, in the absence of applicable guidance, section 267(a)(3)(B) would appear to grant taxpayers significant flexibility in the use of deductions against subpart F income, permitting a shift of subpart F income among related CFCs. Assume that CFC-1 earns $100 of subpart F income, accrues but does not pay passive interest expense of $10 to CFC-2, and has other expenses of $90. In the absence of guidance, taxpayers may argue that CFC-1’s interest expense accrual in respect of its payable to CFC-2 should not reduce its subpart F income because there is no reduction in CFC-1’s subpart F income until the expense is actually paid.\(^{26}\) Therefore, the interest income accrued by CFC-2 may benefit from the same country exception in the year of accrual, and arguably CFC-2 would not have subpart F income until the expense is paid by CFC-1. Thus, rather than CFC-2 earning subpart F income, CFC-1 would have subpart F income. When CFC-1 pays the expense in a subsequent year, it is not clear whether the expense would retain its character as a subpart F-related expense or whether its character would depend on the mix of CFC-1’s income in the year of payment.\(^{27}\)

\(^{25}\) Global treasury centers act as intermediaries in funding affiliates. The application of section 267(a)(3)(B) to such companies results in the duplication of earnings and profits because the treasury center is required to include in income interest on its long positions, but it is unable to deduct currently the associated interest expense on its short positions even if its counterparty is required to include that interest in income. Further, unjustified complexity is injected into the determination of CFCs, as not only must records be kept on a cash and an accrual basis but also it is necessary to filter normal intercompany netting to determine whether it actually results in “payment” being made.

\(^{26}\) As other commentators have noted, there is some circularity involved in applying section 267(a)(3)(B) in the context of the subpart F and FTC look-through rules. See, e.g., Harter and Lee, supra note 11, at 22 (noting circularity of analysis). Section 267(a)(3)(B) would delay a deduction unless the payee would derive subpart F income, but whether the payee would derive subpart F income can depend on how the deduction is allocated. (Consider that the subpart F ordering rules of Reg. § 1.954-1(c)(1)(i)(C) would have the effect of allocating passive category subpart F income first to CFC-2, prior to other subpart F income or other income.) Thus, the rules must be applied together rather than sequentially.

\(^{27}\) In the absence of applicable guidance, section 267(a)(3)(B) would appear to grant taxpayers significant flexibility in the use of deductions against subpart F income, regardless of how the recipient CFC treats the associated income item. This potential mismatch could provide an unintended benefit to U.S. shareholders. For example, without applicable guidance, it is not clear that the Service could prevent the release of deductions suspended under section 267(a)(3)(B) against subpart F income arising in a subsequent year, even if the payor CFC had accrued the expense against non-subpart F income and the recipient CFC had treated the associated income as eligible for deferral under the same country exception or subpart F look-through rule in the year of accrual. Ironically, as noted previously, Congress enacted section 267(a)(3)(B) to change the results under the existing regulations, which permit deductions prior to payment, because the existing regulations could allow
Exempting payments between CFCs should not recreate the same concerns that prompted Congress to enact section 267(a)(3)(B) in the first instance. If CFC-2 earns income from a related payor CFC-1 attributable to effectively connected income of CFC-1, CFC 1’s deduction is already subject to the matching rule of section 267(a)(2).\(^\text{28}\) If CFC-1 allocates the accrued expense against income deferred from current tax, there is no reason to defer its deduction until payment is made, or until the U.S. shareholder has an inclusion in respect of such amount, because there will be a proper matching with CFC-2, which also would have deferral in respect of the accrued amount. In other words, if both the payor and the recipient are deferring the payments from current U.S. tax, there is no reason to apply section 267(a)(3)(B). On the other hand, if the payor CFC allocates the accrued expense against subpart F income, section 267(a)(3)(B) should have no application because the recipient CFC should have subpart F income.\(^\text{29}\)

We understand that the effect of accruing deductible payments for earnings and profits purposes without payment may under certain circumstances permit planning in respect of earnings and profits. Nevertheless, even leaving aside that this is not an issue that section 267(a)(3)(B) was intended to address, we do not believe that the opportunity for planning would be significant, and that the potential for abuse is easily outweighed by the reduction in complexity and in the distortion associated with having duplicated earnings and profits in the CFC group.

\textbf{(2) Clarify the Interaction of Section 267(a)(3)(B) and the FTC and Subpart F Look-Through Rules}

We understand that, in light of the statutory language, excluding payments between CFCs from section 267(a)(3)(B) might not be considered feasible. If Treasury and the Service continue to apply section 267(a)(3)(B) to payments between CFCs, we suggest that Treasury and the Service exercise regulatory authority clarifying the interaction of section 267(a)(3)(B) and the FTC and subpart F look-through rules. Such guidance could, for example, exclude transactions\(^\text{30}\) that result in the potential for manipulation of the look-through rules. For deductions to be used, “in the case of a U.S.-owned foreign payor, to reduce earnings and profits which could reduce a CFC’s income that would be currently taxable to its U.S. shareholders under subpart F.” JCT Report, \textit{supra} note 6, at 406.

\(^\text{28}\)\text{Reg. § 1.267(a)-3(c)(1).}
\(^\text{29}\)\text{If the recipient CFC’s income is attributable to subpart F income of the related payor CFC, generally neither the same country exception nor the look-through rule should apply, although the existence of section 267(a)(3)(B) may change this result. See note 26, \textit{supra}.}
\(^\text{30}\)\text{I.R.C. § 267(a)(3)(B)(ii) permits exclusion of transactions from the scope of section 267(a)(3)(B)(i). It is not clear whether the general grant of authority under section 7805(a) to provide for all needful rules and regulations would permit Treasury and the Service to modify the provisions of section 267(a)(3)(B) other than by way of
instance, we suggest that for purposes of the FTC look-through rule, the payor CFC determine, hypothetically, against which income its expense would have been allocated in the year of accrual, notwithstanding the deferral of the deduction, and that such manner of allocation be binding in the year of deductibility. Consequently, if the payor CFC had general basket income to which the expense relates in the year of accrual, in the year the payor CFC pays the expense (or in which the U.S. shareholder includes in income the associated recipient CFC’s income), the deduction would be allocated against general basket income in the year of payment, regardless of whether the payor CFC has such income in that year.

Similarly, with respect to the subpart F look-through rule, if the payor CFC would have allocated its expense deduction against non-subpart F income in the year of accrual, that characterization would apply in the year of payment (or, if earlier, in the year in which the U.S. shareholder includes the associated income in its income). While in certain cases this may provide taxpayers with a benefit, as, in the absence of sufficient non-subpart F income of the CFC payor in the year of payment (or CFC recipient shareholder inclusion), the deduction could reduce subpart F income of the CFC payor in such year, the opposite situation could as easily arise. In any event, under the earnings and profits limitation rule of section 952(c)(1)(A), the reduction of the subpart F income should create a subpart F recapture account under section 952(c)(2). In other words, the CFC’s future non-subpart F earnings and profits, if any, would be recharacterized as earnings and profits attributable to subpart F income in order to ensure the taxation of that income in future years. This alternative would appear to be superior to a recharacterization approach, as discussed above, in which the recipient’s treatment would be subject to recharacterization based on the allocation and apportionment of the expense in the year the deduction becomes allowable.

(3) Release Suspended Deductions on a Pro Rata Basis When the U.S. Shareholder Recognizes Associated Income.

A deduction suspended under section 267(a)(3)(B) because of non-payment (or lack of inclusion of the related CFC’s income by the U.S. shareholder) is unsuspended at the earlier of its payment or when the U.S. shareholder includes in income an amount determined in respect of the related CFC’s income. In the latter case, an inclusion could occur if the related CFC acquires an investment in U.S. property or makes a distribution of non-previously taxed

excluding transactions from its scope. Cf. I.R.C. § 904(d)(6)(B) (authorizing regulations to prevent the manipulation of the character of income the effect of which is to avoid the purposes of section 904(d)).

31 While a subpart F recapture account at the level of the payor CFC would not recapture the previously deferred income of the recipient CFC, it could result in a recapture of the payor CFC’s deduction against subpart F in a later year, assuming that the recipient CFC generates non-subpart F earnings and profits in a later year.

32 See Harter and Lee, supra note 11, at 22 (noting the need to implement a complex look-back rule to account for instances where certain accrued payments are deducted). Treasury and the Service also may consider promulgating an anti-abuse rule that would apply if a payor’s (or a controlling shareholder’s) principal purpose of deferring a payment is to manipulate the category or nature of the recipient CFC’s income.
earnings and profits to its shareholder. In the case of an income inclusion at the U.S. shareholder level, it is not clear how taxpayers are to determine how and when an inclusion is attributable to a previously suspended deduction, especially when the foreign corporation has accrued expenses arising prior to the effective date of section 267(a)(3)(B).

Assume, for example, that in year 1, accrual basis CFC-1 borrows from related accrual basis CFC-2 and incurs $100 of otherwise deductible interest expense. If CFC-1’s income is deferred from U.S. tax, CFC-1 does not pay the year 1 accrued interest, and CFC-2’s income accrued in respect of the interest is not otherwise subject to U.S. tax in the hands of its U.S. shareholder, section 267(a)(3)(B) would suspend CFC-1’s deduction of its accrued interest expense against its earnings and profits. In year 2, CFC-1 does not pay the interest, but CFC-2 makes an investment in U.S. property that subjects $50 of its $500 of post-1986 undistributed earnings to U.S. taxation in the hands of its U.S. shareholder. In this case, what portion, if any, of CFC-1’s suspended interest deduction is released against CFC-1’s post-1986 undistributed earnings?

Many provisions of the Code require some convention to determine the ordering of allocations. Recently, for example, Treasury and the Service addressed the question of what portion of an FTC suspended pursuant to section 909 should be released when related income is included in a U.S. shareholder’s income. Initially, Treasury and the Service permitted taxpayers to apply a “last in, first out” or “LIFO” convention for releasing section 909 suspended FTCs. After further reflection on this methodology, Treasury and the Service precluded the use of LIFO and required taxpayers to apply a pro rata convention to reflect suspended FTCs in both the Temporary and Final Regulations. Treasury and Service officials explained that a LIFO convention could provide taxpayers with the ability to not only release previously suspended foreign tax credits but also a portion of the CFC’s pre-existing section 902 foreign tax credit pool. The government viewed such a concentration of FTCs against related income to be inappropriate (essentially providing a mismatch of earnings and credits).

While an inclusion also could occur pursuant to the subpart F rules under section 951(a)(1)(A) or, in the case of a pedigreed PFIC, pursuant to the QEF rules of section 1293, these inclusions likely would occur in the year of accrual and section 267(a)(3)(B) would not have suspended the payor’s deduction.

As time has continued to pass since the enactment of section 267(a)(3)(B), the likelihood of having accrued expenses attributable to periods prior to the enactment of the section has been reduced.


See also Parillo, Treasury, IRS Officials Address FTC Splitter Notice, Sunsetting Regs, 129 Tax Notes 1182 (Dec. 13, 2010) (Quoting government officials as saying that “There are many reasons to think that pro rata is going to be the only workable going-forward rule, so people should not assume that the related income first-out rule will apply” and “going forward, we have concerns about providing an alternative rule” that would permit related income to release both suspended credits and unsuspended credits in the section 902 undistributed earnings pool.), Doc 2010-26227, 2010 TNT 237-6.
Section 267(a)(3)(B) provides taxpayers with the ability to control when a suspended deduction is released, e.g., by making a payment of an otherwise suspended expense. In light of this control, taxpayers could time the release of a suspended deduction in a year in which the deduction would provide an FTC benefit.\(^{38}\) For instance, the payor CFC 1 could pay the suspended expense, or the recipient CFC 2 could make an investment in U.S. property or a distribution that triggers an income inclusion for its U.S. shareholder, in each case releasing the suspended expense against current year non-Previously taxed earnings. As CFC 1’s existing foreign tax pool would not be reduced, even though the current year non-Previously taxed earnings would be,\(^{39}\) if the payor CFC can control the amount of its income for a taxable year by, e.g., receiving a dividend from a subsidiary in a controlled amount, CFC 1’s U.S. shareholder would benefit from the use of the suspended expense in the current year to concentrate CFC 1’s FTCs to use against other foreign source income.\(^{40}\)

While the ability to benefit from FTCs exists in the context of both section 909 and section 267(a)(3)(B), the decision to preclude a LIFO methodology for purposes of section 909 should not be conclusive of the allocation methodology chosen for purposes of section 267(a)(3)(B). In the context of section 909, related income is associated with particular foreign taxes, and Treasury and the Service believed it was inappropriate to permit related income to provide taxpayers with access to additional FTCs residing in the FTC pool. In the context of section 267(a)(3)(B), however, the payee CFC’s income is associated with a reduction in the payor CFC’s earnings and profits and does not provide access to additional FTCs for taxes that would not have been deemed paid in the absence of a suspension under section 267(a)(3)(B).

Notwithstanding this difference, however, we suggest that Treasury and the Service adopt a pro rata methodology for releasing previously deferred deductions when the U.S. shareholder of the recipient CFC recognizes income associated with a deferred deduction, as it has done for purposes of section 909. Accordingly, a deduction suspended under section 267(a)(3)(B) would be released on a pro rata basis as the U.S. shareholder recognizes the related CFC’s post-1986 undistributed earnings (assuming the related income inclusion arises

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\(^{38}\) Such control over the timing of deductions is reminiscent of the so-called rhythm method Congress intended to eliminate through the enactment of the FTC pooling rules in section 902. See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), 869 (May 4, 1987).

\(^{39}\) The Service has stated that an FTC pool should be reduced when post-1986 undistributed earnings are otherwise removed under section 312(a). AM 2013-006 (September 30, 2013), Doc 2013-25467, 2013 TNT 213-17. The rationale for this position has no application to the reduction in post-1986 undistributed earnings that arises pursuant to section 267(a)(3)(B) when deductions are released. Suspended deductions are pre-existing expenses that otherwise would have been taken into account in the current year calculation of earnings and profits but for section 267(a)(3)(B)’s suspension. The release of the suspended amount should not be viewed as an "other reduction" that reduces the related FTC pool.

\(^{40}\) Note that section 960(c) could preclude the taxpayer’s ability to concentrate FTCs in cases in which it applies.
prior to the payor CFC’s payment of the associated expense). While either a LIFO or first-in, first-out (“FIFO”) methodology also could be chosen, a pro rata methodology is appropriate and fair because there is no demonstrably clear way to distinguish section 267(a)(3)(B) associated income from other income when both reside in the same post-1986 undistributed earnings pool. In addition, a pro rata approach is less susceptible to manipulation than either a LIFO or FIFO approach.

(4) Reduce Post-1986 Undistributed Earnings on a Pro Rata Basis

As noted previously, in determining the portion of an item considered includable in a U.S. shareholder’s income, properly allocable deductions and qualified deficits are not taken into account, and so are not considered to reduce the amount of the related inclusion. In describing the methodology to determine how much of the amount accrued, if any, is currently includable in the income of a U.S. person under the relevant inclusion rules, the legislative history references the principles of section 954(b)(5) to determine properly allocable deductions.41

The examples in the legislative history describe situations involving current year subpart F income, losses in separate income categories and the overall earnings and profits limitation rule of section 952(c)(1)(A). The examples do not address how to allocate expenses against non-subpart F related income that becomes part of post-1986 undistributed earnings and is only later included in the income of the U.S. shareholder. The only reference is to the “principles of section 954(b)(5),” but it is not clear how to apply those principles to deductions that reduce post-1986 undistributed earnings, such as reductions under section 312(a) that do not, in and of themselves, result in an income inclusion.42 If a reduction of post-1986 undistributed earnings were treated as an item that arises from a separate category of income which is not properly allocable to the related income, the payor CFC would not be entitled to a full deduction for the associated expense until payment of that expense.

We suggest that Treasury and the Service clarify the application of the principles of section 954(b)(5) when post-1986 undistributed earnings are reduced and a portion of those earnings represents an amount of associated income in respect of a section 267(a)(3)(B) suspended deduction. For example, assume that CFC-1 has $100 of non-subpart F income and accrues a royalty expense of $80 payable to CFC-2 and that the same country exception or subpart F look-through rule applies to such income at CFC-2. In this case, the royalty received by CFC-2 would not be subpart F income because it would be attributable to CFC-1’s non-subpart F income. Assume, in a subsequent year, CFC-2’s post-1986 undistributed

42 While post-1986 undistributed earnings may reside in separate categories for purposes of section 904, the earnings are not subpart F income and the application of the principles of section 954(b)(5) to such earnings is not clear.
earnings, which includes the $80 of related earnings and $120 of other earnings, is reduced by $50 pursuant to section 312(a) other than by reason of a dividend distribution, and CFC-2 later distributes the remaining $150 of earnings and profits to its U.S. shareholder. In this case, would CFC-1 be entitled to release $30, $60 or $80 of the deferred deduction?43

If the $50 reduction in post-1986 accumulated earnings is not definitely related to income in respect of a section 267(a)(3)(B) suspended deduction, we suggest that Treasury and the Service consider reducing all categories of post-1986 undistributed earnings on a pro rata basis. For this purpose, the portion of the post-1986 undistributed earnings related to a section 267(a)(3)(B) suspended deduction would be treated as a category of income separate from the remaining post-1986 undistributed earnings for purposes of applying the principles of section 954(b)(5). A substantially similar pro rata methodology has been adopted in the section 909 Regulations for allocating a reduction in earnings and profits between related income and other income when the post-1986 undistributed earnings pool includes both categories of earnings and profits.44 We suggest that this approach also be adopted for allocating a reduction in earnings and profits between section 267(a)(3)(B) associated income and other income. In the absence of tracing expenses to particular categories of earnings and profits, a pro rata methodology is appropriate and fair because there is no demonstrably clear way to distinguish section 267(a)(3)(B) associated income from other income when both reside in the same post-1986 undistributed earnings pool.

B. Issues Related to an Ordinary Course Exception under Section 267(a)(3)(B)(ii)

(1) Adopt an Ordinary Course Exception for Items Deductible under Section 162

Section 267(a)(3)(B)(ii) provides authority to except from the application of the section 267(a)(3)(B)(i) matching rule any transaction which is entered into in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the accrued amount is paid within eight and one-half months after accrual or within such other period as the regulations may prescribe. To date, no regulations or other guidance have been issued under this provision.

43 If the entire $50 reduction to post-1986 undistributed earnings were applied against the $80 of related earnings, CFC-1 would release $30 of the deferred deduction as a result of the inclusion of income by its U.S. shareholder. If the entire $50 reduction to post-1986 undistributed earnings were applied against the other post-1986 undistributed earnings, CFC-1 would release $80 of the deferred deduction. If the entire $50 reduction to post-1986 earnings were applied against all such earnings on a pro rata basis, with $20 applied to the related earnings (80/200 times 50), CFC-1 would release $60 of the deferred deduction.

44 Reg. § 1.909-6(d)(3). This methodology was originally adopted in section 4.06(b)(3) of Notice 2010-92, supra. Thus, for example, for purposes of section 909, a reduction in a covered person’s earnings and profits that results from a payment on stock that is not treated as a dividend, such as a distribution subject to section 312(n)(7), will reduce related income and other income on a pro rata basis.
Guidance is needed on the application of section 267(a)(3)(B) to transactions arising in the ordinary course of business between CFCs, and between CFCs and their U.S. shareholders.\(^{45}\) Under the statute and the current regulations, to the extent that an item owed is a foreign source active business expense which would not be subpart F income or effectively connected income of the payee CFC, the expenses may not be deducted by the U.S. shareholder or payor CFC until paid or the payee CFC income is included in the U.S. shareholder’s gross income for the period (e.g., as a dividend). Thus, for example, in the case of amounts incurred by a U.S. corporate shareholder in the ordinary course of its business with its CFCs (or amounts incurred between CFCs), a temporary distortion of income, as determined under the U.S. shareholder’s regular method of accounting, may result in an ongoing overstatement of the shareholder’s income (or a CFC’s earnings and profits) in an amount equal to the deferred expense.\(^{46}\) In the absence of guidance, taxpayers face uncertainty in computing the amount of current year earnings when they expect to pay the associated expenses in the year following accrual, e.g., within eight and one-half months after accrual.

The AJCA legislative history provides that under regulations, transactions may be exempt from section 267(a)(3)(B)(i) if they satisfy two requirements: (1) they are entered into by the payor in the ordinary course of a trade or business in which the payor is predominantly engaged; and (2) payment of the accrued amounts occurs shortly after its accrual.\(^{47}\) In respect of these two requirements, while we recognize Treasury and the Service may be reluctant to provide standards on when a transaction is entered into in the ordinary course of a trade or business in which the payor is predominantly engaged,\(^{48}\) we suggest that Treasury and the Service clarify that any payment qualifying as an ordinary and necessary business expense under section 162 be considered made in the ordinary course of business for purposes of section 267(a)(3)(B)(ii).

\(^{45}\) The rule also applies to all amounts owed to PFICS; however, the focus of this discussion is on section 267(a)(3)(B)’s application to CFCs.

\(^{46}\) Commentators have discussed such distortions that may arise under section 267(a)(3)(B). See William H. Quealy and Diana A. Melnyk, Proposal to Adopt a Recurring Item Standard for the Deduction of Liabilities Owed to Foreign Persons under Section 267(a)(3)(B), Taxation Procedure & Litigation Committees of the Taxation Sections of the State Bar of California and the Los Angeles County Bar Association (May 18, 2009) ("LA Bar Report") 2009 TNT 103-50. Other negative effects of the application of section 267(a)(3)(B) to transactions among related parties include: (1) U.S. corporations being placed at an economic disadvantage relative to foreign owned domestic corporations who are generally not subject to the matching rule; and (2) the rule’s potential interference with the ability of U.S. shareholders to adjust expenses in CFC transactions under section 482. Id.

\(^{47}\) JCT Report, supra note 6, at 407.

\(^{48}\) In this regard, we believe the reference to “predominantly engaged” references the extent or significance of the payor’s activities and not whether any one activity constitutes its predominant business.
(2) Adopt an Eight and One-half Month Grace Period for Deducting Accrued Amounts Owed to CFCs Prior to Payment

In determining whether a payment occurs shortly after accrual, the statute indicates that a payment within eight and one-half months after accrual should be considered a short period, although regulations could prescribe another period. Because the recurring item exception to the economic performance rules of section 461(h)(3) also has an eight and one-half month rule (presumably the basis for the reference in section 267(a)(3)(B)(ii)), we suggest that guidance under section 267(a)(3)(B)(ii) adopt that time frame for purposes of section 267(a)(3)(B). Taxpayers and the Service are already familiar with this time frame and its operation, and incorporating this time frame would be administratively efficient.

As a result of adopting the grace period of the recurring item exception for purposes of section 267(a)(3)(B), a U.S. shareholder could deduct, prior to payment, all qualifying expenses that had been accrued but not paid to its CFC (and a payor CFC could similarly deduct all qualifying expenses that had been accrued but not paid to a sister CFC) where the U.S. shareholder (or CFC) and the related entity are both accrual basis taxpayers, to the extent their U.S. taxable years overlap, and payment of the liability occurs on or before the earlier

50 Section 461(h)(3) provides an exception to the economic performance rules for certain recurring items. Where the exception applies, a liability is treated as incurred in the taxable year in which the all events test is met even though economic performance has yet to occur. For the exception to apply, all of the following conditions must be met: (i) the all events test (determined without regard to economic performance), is met with respect to the item during the taxable year; (ii) economic performance with respect to the item occurs within the shorter of a reasonable period after the close of such taxable year or eight and one-half months after the close of such taxable year; (iii) the item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the all events test is met; and (iv) either (A) the item is not a material item or (B) the accrual of the item in the year in which the all events test is met results in a more proper match of the item against the income to which it relates than would result from accuring the item for the taxable year in which economic performance occurs. See also Reg. § 1.461-5(b)(1).
51 Treasury and the Service also may consider adopting a shorter grace period, such as 90 days, for trade receivables arising in the ordinary course of business among affiliates. See Reg. § 1.482-2(a)(1)(iii)(B) (interest-free period for certain intercompany trade receivables arising in the ordinary course of business).
52 Our recommendation is that only the time frame of section 461(h)(3) be adopted and not the other components of the recurring item exception. In light of our suggestion that the section 267(a)(3)(B)(ii) exception apply to all section 162 expenses, we would not recommend adopting the recurring item standard generally because that standard could narrow the universe of expenses subject to the exception. Additionally, we would not recommend the adoption of a section 461(h)(3) matching principle because distortions could occur under that rule where there are payments for services between CFCs. Generally, the recurring item exception does not apply to services because economic performance for services occurs in the year the services are performed. Where the services are performed by the end of year one, for example, distortions may occur under a matching rule requiring that payment occur by October 15th of year two. Additionally, for similar reasons, we would not recommend the adoption of the section 461(h)(3) materiality component.
53 Note that a CFC may have a fiscal year end, beginning one-month earlier than the majority U.S. shareholder year, pursuant to section 898(c)(2).
of the filing of a timely (including extensions) original return for the year or within eight and one half months after the close of the payor’s taxable year. Consequently, where the requirements are met, a U.S. shareholder or CFC payor would be able to deduct, in advance of payment, the full amount of any accrued expense incurred in the ordinary course of business and owed to a related CFC even though not treated as subpart F income or as effectively connected income by the payee.

We appreciate your consideration of these comments.