REPORT #843

TAX SECTION

New York State Bar Association

REPORT ON SECTION 956A

August 1, 1995

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New York State Bar Association

August 4, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Code Section 956A

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to submit a report of the Tax Section's Committee on Foreign Activities of U.S. Taxpayers concerning various issues under Code Section 956A. The principal draftsperson of the report is Philip R. West, Co-Chair of the Committee.

As set forth in the report, some significant technical and substantive problems have emerged as taxpayers endeavor to comply with Section 956A. Some of these problems are inherent in the current statute and appear to require legislative change; others could be addressed administratively. We strongly urge, however, that these problems be addressed promptly, either by legislation or regulation, for the current situation is quite troublesome for taxpayers and the government alike.

The report includes comments on the definition of passive assets, on various aspects of the group rules, and on the appropriate scope of anti-avoidance rules. A summary of thirty-one of the principal recommendations of the report is set forth at pages 8-14. The report also expresses a fundamental concern that Section 956A, as currently formulated, can have unduly harsh applications to service businesses that require relatively little capital, to seasonal businesses, and to established businesses that have relatively low asset bases. The report urges that the Treasury and Congress not only address technical and interpretative problems under the current statute, but also consider ways to ameliorate the potentially inequitable application of Section 956A in such situations.

We would be happy to discuss this subject with you further, and we look forward to the opportunity to review specific proposals for legislative changes and administrative guidance.

Very truly yours,

Carolyn Joy Lee

Tax Report #843

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 956A

August 1, 1995

New York State Bar Association Tax Section

Report on Section 956A

I. INTRODUCTION.

This report, prepared by an ad hoc committee of the Committee on Foreign Activities of U.S. Taxpayers,[1] considers issues that arise under section 956A of the Internal Revenue Code.[2] The issues considered include both those that can be addressed administratively and those that, in our view, can be addressed only through legislative action.[3] Throughout the report, we attempt to distinguish between the two.

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1 The ad hoc committee consists of Michael Hirschfeld, Lisa A. Levy, Richard 0. Loengard, Jr., Pinchas Mendelson, David S. Miller, Kevin M. Rowe, and is chaired by Philip R. West. David S. Miller was the principal draftsperson of Parts I and III. Michael Hirschfeld was the principal draftsperson of Part IV and Lisa A. Levy was the principal draftsperson of Part V. Richard Loengard and Philip West made substantial contributions to all parts and Philip West coordinated the entire report. Helpful comments were received from Carolyn Joy Lee, Yaron Z. Reich, Richard L. Reinhold, Michael L. Schler and Steven C. Todrys.

2 All section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or to the Treasury regulations promulgated thereunder.

3 As discussed more fully below, all of these issues ideally would be incorporated in a comprehensive legislative package reforming the passive foreign investment company (“PFIC”) and subpart F areas. To assist in that effort, we are preparing a separate report on anti-deferral reform. However, to present our recommendations most expeditiously, we address herein both issues that can be dealt with administratively and those that can be dealt with only legislatively. We also address herein both issues that arise solely under section 956A and issues that arise under both section 956A and the PFIC rules, even though some of the recommendations found herein may appear in modified form in our report on anti-deferral reform, if such modification is appropriate given the different context in which that report is being drafted.

A. Background of Section 956A.

In 1993, as part of the Omnibus Budget Reconciliation Act, Congress enacted new section 956A[4] which, generally, taxes the United States shareholders of a controlled foreign corporation (a “CFC”) on the CFC's earnings and profits derived from active business operations to the extent those earnings and profits are reinvested in “excess passive assets” (i.e., the excess of the CFC's passive assets over 25 percent of its total assets). The purposes of section 956A are twofold: (i) to implement the policy behind deferral of foreign income in a manner less generous to taxpayers than that provided by pre-OBRA 93 law, and (ii) to provide a backstop to the accumulated earnings tax for CFCs by adding an objective test to determine a reasonable level of earnings that may be retained abroad.[5]

In short, Congress believed that the existing anti-deferral regimes (including those dealing with CFCs and PFICs) should be broadened. Congress determined that, although the accumulated earnings tax was designed to be a deterrent to Holdings of excess passive assets, the accumulated earnings tax is difficult to apply because it employs a subjective reasonableness test.[6]

[4] Omnibus Budget Reconciliation Act of 1993 (“OBRA 93”), Pub. L. No. 103-66, § 13231. As stated above, this report also discusses certain amendments to the PFIC rules which were contained in section 13231 of OBRA 93.

[5] See House Ways & Means Committee Print No. 103-11, 103d Cong., 1st Sess. 253-54 (May 18, 1993) (hereinafter, “House Report”).

[6] Id.

Therefore, Congress deemed that any foreign corporation whose passive assets exceed 25 percent of its total assets has retained an unreasonable amount of passive assets.[7] Accordingly, section 956A generally subjects each United States shareholder of such a CFC to tax on the shareholder's pro rata share of such "excess passive assets" to the extent of the shareholder's pro rata share of the CFC's untaxed undistributed earnings accumulated after September 30, 1993. Congress believed that this additional anti-deferral rule would not place CFCs at a competitive disadvantage to other foreign firms whose foreign shareholders are not subject to current tax on undistributed earnings.[8]

B. Challenges in Applying Section 956A.

Despite the apparently clear and relatively narrow[9] purpose of section 956A to reduce deferral opportunities and supplement the subjective analysis of the accumulated earnings tax with an objective standard for CFCs, the actual application of section 956A has brought to light a number of fundamental problem areas that either pose substantial interpretative challenges for Treasury and the Internal Revenue Service (collectively, the "Service"), or indicate a need for legislative

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[7] Public statements of Treasury officials indicate that the 25 percent threshold was designed to apply to companies organized in tax havens, including Ireland and Singapore, where Treasury determined that the average percentage of passive assets held by CFCs was "about 30 percent" and was designed not to apply to the average company organized outside tax havens where, on average, only "between 7 and 9 percent of companies' assets are passive." See John Turro, "Treasury Official Defends Foreign Passive Assets Proposal," Tax Notes Today (May 10, 1993), available in Lexis Fedtax file, 93 TNT 100-18.

[8] House Report at 254 & n. 62.

[9] The legislative history to section 956A specifically notes that Congress rejected (in both 1962 and 1993) an approach that would tax all the earnings and profits of all CFCs. See House Report at 253-54 and n. 62.

changes to the statute. These problem areas can be divided into four general categories.

First, section 956A carries with it the potential for a very substantial compliance cost on U.S. multinationals. The Service faces the challenge of prescribing rules that are consistent with the statutory language yet do not force U.S. taxpayers to incur unreasonable compliance costs to determine whether they are subject to section 956A and, if so, what their deemed inclusions are. For example, as discussed below, the statute requires CFCs to make quarterly determinations of the adjusted bases of all of their assets under U.S. tax principles. To impose a quarterly computation requirement, even though CFCs are not subject to U.S. income tax, may not have maintained the records that would permit them to determine the bases of all of their assets and, under pre-section 956A law, were not generally required to make these determinations with respect to their assets prior to a sale of those assets can be unreasonably burdensome.

Second, the scope of the provision will rest largely on the interpretation of the term "passive asset." The statute defines the term only by a cross-reference to the PFIC rules. These PFIC rules present unresolved interpretative issues, and taxpayers have had difficulty applying them in the absence of regulatory guidance.[10] This uncertainty, in turn, can chill legitimate business transactions for fear of the adverse tax consequences. Moreover, care must be taken to distinguish those assets held and used in active foreign businesses from passive assets used to defer federal income tax.

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[10] In this respect, the Service has taken a significant step forward by issuing proposed regulations that provide exceptions to the PFIC rules for foreign banks and securities dealers. See 50 Fed. Reg. 20922 (April 28, 1995). This Report does not address issues that may arise under those proposed regulations.

An overbroad interpretation of the term can have the dramatic consequence of subjecting U.S. taxpayers to tax (under section 956A or the PFIC rules) on earnings that cannot easily be repatriated. For example, as discussed below, because the Service has interpreted the statute to treat even a necessary amount of working capital as a passive asset, United States shareholders of a CFC with a low or no basis in its assets could be subject to current inclusions under section 956A regardless of whether the CFC can afford to distribute sufficient cash for its shareholders to pay the U.S. tax on undistributed earnings.

Third, section 956A compounds the complexities of the CFC rules. Included in the mandate of the statute are, for example, intricate rules for aggregating related CFCs into “CFC groups” and allocating the excess passive assets of some members of the group to other members. The Service thus has the daunting task of crafting rules consistent with the statutory language and anti-abuse purpose of section 956A that make sense of the statute.

Fourth, section 956A grants the Service broad anti-abuse authority. This authority challenges the Service to distinguish legitimate conduct that is consistent with the purpose of the statute from abusive conduct that is designed to defer U.S. tax on earnings invested in excess passive assets. At the same time, the Service's authority to attack abusive transactions must be balanced with the need of taxpayers and their advisors for sufficient guidance to reach judgments on the tax consequences of their activities and structures.

Although the regulatory authority under section 956A is broad,[11] it is not broad enough to resolve all of the statute's problems. We believe certain problems should be addressed through statutory changes, ideally as part of a comprehensive revision of all the anti-deferral rules, including especially the PFIC rules, from which a number of section 956A's critical terms were derived.[12] The Service can make considerable inroads in many of the problem areas through regulations and other guidance, and we strongly urge the Service to do so. In certain important respects, however, until legislative reform is accomplished, the Service will have a difficult job addressing the concerns expressed below in a manner that is sensitive both to the constraints of the current statutory language and to the appropriate impact of its regulations on both the PFIC rules and section 956A.

The comments that follow reflect these themes--compliance costs, appropriate scope, complexity, meaningful distinctions between valid tax planning and abuse prevention, and the extent of the Service's current regulatory authority. Because section 956A addresses a discrete abuse, but is capable of interpretations that will adversely affect a broad range of non-abusive situations, we urge the Service to use its authority and

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11 Section 956A (f) grants the Service the authority to “prescribe such regulations as may be necessary to carry out the purposes of this Section ....”

12 To assist Congress in this effort, we are preparing a report on anti-deferral reform. That report may take a different view on particular issues than the view expressed herein, where doing so is appropriate because of the differing contexts in which the issue arises. We note that there exists an alternative to choosing one or the other of two different views on a particular issue. It is possible that, even where the PFIC rules are incorporated in section 956A, those rules may be applied differently in the context of CFCs, given the different purposes behind the PFIC rules and section 956A. Whether the divergent ends of these two statutory regimes justify different interpretations in any particular case is a question that should be considered in drafting the regulations and in any legislative reform that is undertaken.

promptly issue comprehensive rules. We further urge that Congress promptly review the existing problems in the statute and enact appropriate reforms.[13]

II. SUMMARY OF RECOMMENDATIONS.

1. The requirement that excess passive assets be determined with reference to adjusted basis means that certain clearly active business, such as service businesses, will trigger inclusions under section 956A. We recommend several ameliorative measures, including a de minimis rule and a limited relaxation of the requirement that working capital be viewed as passive.

2. Quarterly adjusted basis computations can be impossible and will be burdensome. We recommend that the proposed regulations under section 964(a) be finalized, which would, in many cases, have the effect of allowing CFCs to determine inventory and depreciable asset basis in accordance with U.S. GAAP. We also recommend that, unless a CFC is otherwise required to determine its inventory cost more frequently, such cost should be calculated no more frequently than annually, with seasonal businesses being able to make the calculation during their active season. An alternative test based on book value, similar to that found in the FIRPTA regulations, should also be considered.

3. We do not disagree with the factual bases for Treasury's determination that marketing intangibles should not be capitalized. However, because a basis standard for computing excess passive assets can cause unintended results, Treasury might consider providing basis credit for same year advertising

[13] In many cases, the statutory changes we believe are needed to more reasonably apply section 956A are amendments that would remedy problems with the application of the statute that may not have been fully understood when the 1993 changes were enacted.

and promotional costs expended by a foreign corporation. While this might discriminate against firms that incur other kinds of marketing costs, it would provide partial relief and would avoid several of the problems identified by Treasury in its study of marketing intangibles.

4. For purposes of computing the passive assets of a CFC, the basis of its assets is increased by 300 percent of the annual payments for certain intangible property. Consideration should be given to whether this overstates the basis of active assets in the case of a lump sum or prepaid royalty.

5. The interaction of the 300 percent rule and the requirement of quarterly computations may understate the basis of active assets. We recommend that, even though computations may be made quarterly, credit should be given in each quarter for all payments made during the taxable year.

6. We recommend that the basis of a leased asset at the beginning of each year be equal to the present value of the future rental payments, discounted at the applicable federal rate ("AFR") prevailing at the time the lease was entered into. We also recommend that consideration be given to expanding the leased asset rule to apply to leased real property.

7. We propose a narrow safe harbor for working capital. Assets reasonably necessary for the operation of a predominantly active business within a 12 month period and invested in a bank account or in securities with a term of no more than 90 days should be excluded from the definition of passive asset if the aggregate amount of gross income from such working capital over the taxable year does not exceed 5 percent of the otherwise active gross income of the CFC in such year.

8. We recommend that section 956A contain an exception for start-up and changing businesses, similar to those provided in the PFIC context.

9. An exception to the passive asset definition should be provided in the case of an extraordinary capital infusion that is subject to a commitment to produce an asset that will give rise to nonpassive income, provided the infusion is reasonably expected to be expended within a reasonable period after receipt.

10. CFCs should be afforded an election to compute their passive assets with reference to their basis in the stock of foreign corporations that are not CFCs, where the 25 percent look-through rule of section 1296(c) would otherwise require that such CFCs look through to the assets of such foreign corporations.

11. Gain from the sale of stock in a 25 percent owned foreign corporation should be treated as passive or nonpassive in proportion to the character of the assets or, if elected, the income of the foreign corporation.

12. We recommend that the regulations incorporate the rule characterizing related party interest income of a CFC as passive to the extent of the passive income of the payor.

13. The regulations should adopt a grouping mile regarding aggregation of the activities of related entities to determine whether the income of a foreign corporation is passive or active.

14. For purposes of section 956A, a pure conduit approach should be adopted for partnership interests owned by

CFCs. Rules consistent with those recommended above for basis determinations in the case of 25 percent-owned foreign corporations that are not CFCs should apply to partnerships as well.

15. The exclusion from the definition of passive asset for United States property (within the meaning of section 956) is too broad and allows abusive transactions.

16. The regulations should clarify that depreciable property is treated as passive only to the extent that the trade or business in which it is used produces passive income.

17. Under section 956A (d), all of the assets of a member of a CFC group are included in the computation of the group's excess passive assets, even if less than all of the equity of the member is owned by the group. Congress should consider allocating to the CFC group only a pro rata share of the assets of a partially owned foreign corporation.

18. Where both the group rules and the 25 percent look-through rule apply, the same assets (both passive and non-passive) may be counted twice in the excess passive asset calculation -- once by the CFC group and again by any 25 percent owner in proportion to its interest. We recommend several alternative approaches to avoid such double counting.

19. In cases in which the group rules apply, unlike cases in which they do not, excess passive assets can be used more than once to cause income inclusions, so that total inclusions exceed the amount of excess passive assets. We offer several options for addressing this anomaly.

20. Earnings and profits deficits among members of a CFC group do not count for purposes of determining inclusions under section 956A. We believe that Congress should consider ameliorating this rule's perhaps unintended results.

21. Under the group rules, assets may be allocated to a CFC group to cause income inclusions to a United States shareholder with no ownership interest in the foreign corporation from which the assets are allocated. We recommend an approach under which the members of a CFC group with respect to a given United States shareholder would consist only of those corporations in which the shareholder has a direct or indirect interest.

22. We recommend that the regulations make clear that the constructive ownership rules of section 958(b) do not apply for purposes of the group rules.

23. We recommend that, if the regulations adopt anti-avoidance rules that would apply if “one of the principal purposes” of a transaction was avoidance of section 956A, the regulations provide sufficient examples to establish reasonable safe harbors. Moreover, the regulations should make clear that they do not apply merely because a consequence of a transaction is the reduction of a potential inclusion under section 956A.

24. We recommend that, with respect to divisive tax-free reorganizations, rebuttable presumptions, such as those found in the regulations under section 954, be applied to offer guidance on whether the requisite anti-avoidance purpose will be found to exist. The regulations should also make clear that they do not affect the status of reorganizations for purposes other than section 956A.

25. We recommend that acquisitive tax-free reorganizations generally be respected, even if a principal purpose of the transaction is the avoidance of section 956A.

26. The regulations should respect, for purposes of measuring excess passive assets, intercompany asset sales and taxable reorganizations among related parties that are undertaken for valid non-tax business reasons.

27. The sale or contribution of active assets to a CFC or CFC group should not be viewed as abusive and should be respected for purposes of determining the excess passive assets of a CFC or CFC group.

28. Transactions that reduce inclusions under section 956A but actually decontrol a CFC generally should not be viewed as avoidance transactions for purposes of section 956A.

29. Consistent with the apparent Congressional intent that deficits should not be taken into account for purposes of applying the group rules, the regulations might appropriately provide that a combination of a profitable and an unprofitable CFC in a CFC group, in transactions described in section 381(a), will be disregarded for purposes of section 956A to the extent of previously accumulated losses.

30. As long as the “cream-rises-to-the-top” rule continues to apply in the context of section 956A, intra-group loans should not be viewed as abusive.

31. The regulations should be retroactive only insofar as they implement conclusions that are clearly articulated in the legislative history.

III. DETERMINING A CFC'S "TOTAL ASSETS" AND "PASSIVE ASSETS".

Section 956A is triggered only if a CFC (or CFC group) has "excess passive assets," and section 956A (a) causes United States shareholders to be subject to deemed inclusions only to the extent of such excess passive assets. Under section 956A(c), a CFC has excess passive assets to the extent the average of the CFC's "passive assets" held at the end of each quarter of the taxable year exceeds 25 percent of the average of the CFC's "total assets" held at the end of each such quarter.

A. Determining "Total Assets".

1. Use of Adjusted Basis. Prior to OBRA 93, assets for purposes of the PFIC rules were measured by reference to fair market value, but a foreign corporation could instead elect to use adjusted tax basis.[14] Congress determined, however, that use of fair market value was a "source of complexity and administrative burden for taxpayers" and "an enforcement problem for the Internal Revenue Service,"[15] but that adjusted basis would be "highly appropriate to the task of measuring the earnings of a controlled foreign corporation that is invested in excess passive assets."[16] Accordingly, Congress prohibited CFCs

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14 Section 1296(a) (flush language), prior to amendment by § 13231(d)(1) of OBRA 93.

15 House Report at 255; S. Rep't No. 103-36, 103d Cong., 1st Sess. 324 (June 1993) (hereinafter, "Senate Report").

16 House Report at 255; see also. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 638 (August 4, 1993) (hereinafter, "Conference Report").

from using fair market value to determine the amount of their passive and total assets.[17] New section 956A requires CFCs to determine the adjusted tax bases of all of their assets quarterly under the U.S. tax principles for determining earnings and profits in order to determine whether, and to what extent, they have excess passive assets.[18]

The Senate did recognize that the use of adjusted basis to determine a CFC's total assets and passive assets could cause certain “active” CFCs to be subject to section 956A or the PFIC provisions under certain circumstances that would be inappropriate (e.g., if they incurred expenditures in connection with their active business that give rise to valuable assets but under federal tax principles are currently deductible and therefore do not produce tax basis).[19] To address these situations, Congress modified section 1297 (which is cross-referenced in section 956A) to provide that (i) rental payments for tangible personal property under a lease with a term of at least 12 months produce an asset whose adjusted basis will, under regulations, be the unamortized portion of the present value of the rental payments, determined under section 1274 principles,[20] (ii) research or experimental expenditures (within the meaning of section 174) paid by the foreign corporation in the current or two preceding taxable years give rise to adjusted basis equal to

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[17] See Senate Report 329 n.6 (“the bill offers no option to measure assets by fair market value.”).

[18] Section 956A (a)(1) and (c).

[19] Senate Report at 324-25; Conference Report at 641-42.

[20] See section 1297(d)(2). Exceptions apply if the lessor is related to the lessee (within the meaning of section 954(d)(3)), or the principal purpose of the lease was to avoid section 956A or the PFIC provisions. Section 1297(d)(3). Comments regarding section 1297(d)(2) are contained in Part III.A.6., below.

the payments,[21] and (iii) royalty payments made by the foreign corporation for the use of intangible property in connection with the active conduct of its trade or business give rise to adjusted basis in an amount equal to 3 times the amount of the payments made during the taxable year.[22]

However, there are other cases in which the use of adjusted basis can cause an active CFC to be subject to section 956A and the PFIC rules.

> Example (1). A U.S. person owns all of the stock of a foreign subsidiary engaged in a real estate brokerage business. The fair market value of the business is $1 million, but the value is almost entirely attributable to goodwill and going concern value. (Assume the subsidiary leases its offices, and its only assets are office furniture and working capital. Also assume that the business needs cash to provide for marketing activities and to provide a cushion to deal with an uneven stream of brokerage income, or that cash is accumulated in a pool from which year-end bonuses can be paid to individual brokers.) Although the subsidiary's income may be nearly 100% “active” service income, its working capital will be a passive asset under Notice 88-22,[23] and even a modest amount of working capital may exceed 25% or even 50% of the adjusted basis of its office furniture.

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21 Section 1297(e)(1). Comments regarding section 1297(e)(1) are provided in Part III.A.5., below.

22 Section 1297(e)(2). This rule is subject to the same exceptions contained in section 1297(d)(3). See note 20, above. Comments regarding section 1297(e)(2) are made in Part III.A.5., below. In addition, the legislative history to section 956A requested the Treasury to undertake to recommend whether such basis credit should be given for marketing expenditures. Our comments regarding Treasury's recommendations are contained in Part III.A.3, below.

23 1988-1 C.B. 489. We comment on the working capital rule in Part III.B.1., below.

Accordingly, the U.S. shareholder will be subject to inclusions under Section 956A or the PFIC rules on its undistributed earnings.

We do not believe that Congress intended, by modifying the measure of a CFC's assets, to cause such active service CFCs (or any established CFC that has a low basis in valuable, long-held business assets but a high basis in relatively small passive assets) to become subject to the PFIC rules and section 956A.[24] We believe that the Service could take one of several steps (consistent with the statutory prohibition on periodic fair market valuations) to ameliorate this problem. As discussed below in Part III.B.1, all or a portion of a CFC's working capital could be excluded from the definition of passive asset. This would help the CFC in Example (1), although the extent to which it would help other CFCs would depend on the breadth of the exclusion. Alternatively, the Service could provide a meaningful exception from section 956A and the PFIC rules for CFCs with de minimis amounts of passive income.[25]

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[24] We note that the effect of the new adjusted basis test for CFCs is that U.S. portfolio investors (i.e., those persons owning less than 10 percent of the voting stock) in foreign companies that expect the active assets of their investment to appreciate relative to its passive assets will benefit under the PFIC rules by investing in foreign corporations that are not CFCs because these companies still retain the more favorable fair market value test. Of course, such foreign corporations may be compelled to apply the basis test if other U.S. investors that own 10 percent or more of the voting stock of the company (i.e., United States shareholders) come to own more than 50 percent of the foreign company and it becomes a CFC. We also note that a basis-based asset test has the effect of treating identical businesses differently, depending upon whether they have a high or low basis in business or passive assets. Thus, for example, the CFC that recently purchased a business and thus has a high basis in active assets is afforded a tax advantage over the CFC which developed the identical business itself and has little remaining basis in the business.

[25] Cf. Section 954(b)(3).

2. Simplification of Adjusted Basis Determinations. We recommend that the Service finalize the proposed regulations under section 964(a). These regulations generally permit CFCs, for earnings and profits purposes, to limit inventory cost capitalization to that required under U.S. generally accepted accounting principles ("GAAP") and to use GAAP to compute depreciation.[26] These regulations would have the effect in many cases of permitting inventory and depreciable asset basis determinations to be made in accordance with GAAP.[27] As the Service recognized in the Preamble to those proposed regulations,[28] eliminating the required book-to-tax adjustments would greatly simplify the computation of adjusted basis.[29]

We also believe that determining the adjusted tax basis of inventory on a quarterly basis can be an extremely burdensome exercise because, for example, the uniform capitalization rules require a determination of direct and indirect costs and an

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26 See proposed Treasury regulation section 1.964-1(c) These regulations also provide that, where a section 338 election is made by an acquiror with respect to a foreign target, the adjusted basis of such target's assets is determined in accordance with the regulation under that section. Proposed Treasury regulation section 1.964-1(c)(1)(iii)(D).

27 An exception is provided where U.S. tax accounting principles would yield depreciable basis that is materially different from that which would result under GAAP. See proposed Treasury regulation section 1.964-1(c) (1) (iii) (D).

28 See 57 Fed. Reg. 29,246 (July 1, 1992).

29 The Service has broadly interpreted its regulatory authority under section 964(a) to permit the use of financial accounting for computing a CFC's earnings and profits with respect to depreciable property where the result would not be materially different from tax accounting. See proposed Treasury Regulation section 1.964-1(c)(1). Section 956A (f) offers the Service even broader regulatory authority. We believe that section 956A (f) grants the Service sufficient authority to adopt this recommendation. The following recommendation may, however, require legislation.

allocation of those costs to the inventory.[30] Direct and indirect cost calculations to determine tax basis are not normally made for inventory on a quarterly basis. Therefore, we also recommend that the adjusted bases of inventory be permitted to be computed on an annual basis (rather than quarterly), unless the CFC would otherwise be required for regulatory or other purposes to compute the tax (or, if the proposed regulations under section 964 are finalized, financial accounting) basis of its inventory more frequently, or unless such annual reporting would provide materially different results than quarterly computations.[31] This could be implemented by requiring basis to be determined by averaging beginning-of-year and year-end bases. Absent unusual circumstances, one should be able to assume that the average of beginning-of-year and year-end basis is the basis at each quarter-end.

Seasonal businesses arguably should have even broader relief. A seasonal business that each year invests its $100 capital in passive assets for three quarters and buys inventory for its fourth quarter, the only quarter in which it can reasonably expect significant business, arguably is not the type of corporation at which section 956A was aimed. Therefore, such a business should be able to make the passive asset determination during its active business quarter. Of course, to prevent abuse, the Service should circumscribe the class of corporations that will be entitled to this relief, requiring a showing of substantial activity in a business that truly is seasonal.

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30 See generally section 263A.

31 To prevent abuse the taxpayer should have the burden of proving the absence of materially different results. We believe that this would be a lesser burden than proving the actual basis of inventory each quarter, except in certain cases, such as seasonal businesses.

Another option would be to incorporate in the regulations an alternative test similar to that available under section 897. In the FIRPTA area, the statute and regulations provide that a corporation is a U.S. real property holding corporation ("USRPHC") if, in general, the fair market value of its United States Real Property Interests ("USRPIs") equals or exceeds 50 percent of the fair market value of its worldwide real property and its other assets used or held for use in a trade or business ("Worldwide Assets").[32] Under an alternative test, however, the regulations provide that a corporation will be presumed not to be a USRPHC if the total book value of its USRPIs is 25 percent or less of the book value of its Worldwide Assets, with book value being defined as the value at which an item is carried on the financial accounting records of the entity, if such value is computed in accordance with generally accepted accounting principles applied in the United States.[33] This kind of presumption is a helpful approach to reducing the burdens of compliance in cases where it is highly likely the corporation will not cross the statutory threshold. In the section 956A context, such a rule might allow U.S. shareholders to presume that a foreign corporation has no excess passive assets if its passive assets constitute, for example, 10 percent or less of its total assets, with the determination based on U.S. GAAP books.[34]

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[32] Section 897(c)(2); Treasury regulations section 1.897- 2(b)(1).

[33] See Treasury regulation section 1.897-2(b)(2). We acknowledge that such a presumption may be most necessary where the shareholder owns a small percentage of stock. Such a rule may still be justifiable, however, in cases where 10% United States shareholders are grappling with the compliance burdens of Section 956A.

[34] A GAAP book presumption may even more closely achieve the results contemplated by a statute, like section 956A, requiring basis determinations, than a statute, like FIRPTA, requiring determinations based on the fair market value of real property. Conversely, non-CFCs making determinations under section 1296(a)(2) look to value, so that application of the presumption to such corporations could create significantly different results.

3. Basis Increase for Certain Marketing Expenditures. The legislative history to section 956A requested that the Treasury Department study whether CFCs should get “basis credit” for marketing expenditures for purposes of section 956A or the PFIC rules.[35] In December 1994, Treasury issued the results of its study and “strongly” recommended that no basis credit be given to CFCs for marketing expenditures, largely because of (i) the difficulties of (x) identifying the marketing expenditures that would create an asset and (y) measuring the useful life of such an asset, and (ii) because Treasury found that, on average across industries, such an asset would have a useful life of under one year and therefore basis credit would be less compelling than for research and experimental expenditures.[36]

We have not undertaken an independent study on the subject of marketing expenditures. Based on Treasury's description of the literature cited in its report, we do not disagree with the factual bases for Treasury's conclusions. Specifically, we agree that it would be difficult to determine whether a specific marketing expenditure would have a useful life in excess of one year. However, as discussed elsewhere in this report, the use of adjusted basis rather than fair market value to measure a CFC's total and active assets can cause certain active CFCs to be subject to section 956A and the PFIC rules. While we recommend other measures to ameliorate this consequence, permitting basis credit for current year advertising and

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[35] Conference Report at 642.

[36] See Department of the Treasury, “Report to the Congress on Adjusting the Excess Passive Assets Rules and the Passive Foreign Investment Company Rules to Account For Marketing Intangibles”(dated November 22, 1994; issued December 29, 1994), reprinted in B. N.A., Daily Tax Report L-59 (December 30, 1994). Industry average useful lives were viewed as the most administratively feasible way to implement any basis rule for marketing intangibles that was enacted.

promotional expenses would also help distinguish active operating businesses from passive investment vehicles, without presenting several of the problems identified by Treasury in its study. Therefore, we recommend that Congress and the Service consider this option.[37]

4. Basis Credit for Lump-Sum Royalty Payments. Section 1297(e)(2) provides basis credit to CFCs making royalty payments equal to 300 percent of such payment if the intangibles are used in the active conduct of a trade or business. If this method were applied to a lump sum (or prepaid) royalty payment for the use of intangibles over several years, it could be viewed as overstating a CFC's adjusted basis in its assets for the year in which the payment is made, and understating it for later years.

An alternative that would adjust the lump sum payment to correspond to the statute's approach would be to provide an annual basis credit in the case of a lump sum royalty payment equal to 300 percent of the payment made on a hypothetical self-amortizing installment obligation (i) issued for the amount of the lump-sum payment, (ii) with a maturity equal to the term of the license,[38] and (iii) providing for interest equal to the AFR determined under section 1274(d) principles.[39]

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[37] As noted in the Treasury study, marketing expenditures are only one example of expenditures that enhance goodwill. Even our recommendation would not help those who enhance goodwill through, for example, the provision of additional services.

[38] A reasonable limit, such as fifteen years, might be provided in the case of a license that has a term greater than fifteen years. cf. section 197 (providing for fifteen year amortization period for certain intangibles). This would allow the installment obligation paradigm to be used with a perpetual license. The present value of payments on a hypothetical self-amortizing installment obligation with a greater than fifteen year term will be relatively small.

[39] Cf. section 1297(d)(2)(B), discussed immediately below.

Example (2). A CFC makes a single payment of $1 million for a five year license of intangibles used in the active conduct of its trade or business at a time when the mid-term AFR is 10% compounded annually. If the CFC had borrowed $1 million to be repaid in equal installments over 5 years with interest of 10%, compounded semi-annually, the debt would have the following payment schedule (in thousands):

Year	Payment
1	$ 259
2	$ 259
3	$ 259
4	$ 259
5	$ 259
Total	$ 1,295

Under the installment obligation paradigm, the basis credit would be equal to 300 percent of the portion of each hypothetical payment or $777 in each year (and each quarter of such year). The basis credit, however, would not be $3,000 in year 1.

5. Application of Basis Credit for Research Expenditure Royalty and Lease Payments. Section 1297(e) provides that basis credit for research expenditures be given for "payments made during the taxable year and the preceding 2 taxable years," and the basis credit for royalty payments be equal to 300 percent of the "payments made during the taxable year." However, section 956A(c) requires that the adjusted bases of a CFC's assets be computed quarterly. It is unclear how these two rules operate together.

> Example (3). A CFC using a calendar year tax accounting system makes research expenditure payments of 0 in 1995 and 100 in each quarter (400 annually) of 1996, 1997 and 1998. For purposes of calculating its total and passive assets for the second quarter of 1998 (at which point it has made expenditures aggregating 1,000), should the basis credit equal (i) 1,200, reflecting credit for all of 1998 and the preceding 2 taxable years, (ii) 1,000, reflecting basis credit for the payments made to date during the taxable year and the preceding 2 taxable years, or (iii) 1,000, reflecting basis credit for the 12 preceding quarters? Is the result different if the CFC makes a research expenditure payment of 400 on December 31 of 1996, 1997, and 1998 instead of 100 quarterly in each of those years?

We recommend that, consistent with the language of section 1297(e), the regulations provide that basis credits for research expenditure and royalty payments be given for any payment made during the current taxable year, regardless of whether the payment was made during, before or after a measurement quarter. This method would simplify the computation and will avoid improper discrimination against CFCs that make annual payments at the end of a taxable year for the use of an intangible asset during that year. Moreover, if our proposal to treat lump sum payments for multiple year licenses as the payments on a hypothetical installment obligation is adopted, giving credit in each quarter for payments made over the taxable year will not permit abuse. Thus, in Example (3), the CFC would be entitled to basis credit of 1,200 in the second quarter of 1998 notwithstanding that 200 would not actually be paid until after that quarter.[40]

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[40] Congress might also consider providing the CFC in Example (3) with basis credit in 1995 if it enters into a binding contract in that taxable year to make the payments in each of 1996, 1997 and 1998. For example, the CFC could get basis credit equal to the present value of

6. Treatment of Certain Leased Property.

Section 1297(d) provides that rental payments for tangible personal property under a lease with a term of at least 12 months produce an asset, for purposes of the PFIC rules and section 956A, whose adjusted basis will, under regulations, be the unamortized portion of the present value of the rental payments, determined under section 1274 principles.[41] The apparent intent of the statutory scheme is to approximate the treatment of an acquired asset with a life equal to the lease term.

First, we believe that Congress should consider broadening the rule so that it applies not only to tangible personal property, but to other assets as well, such as leased realty. This would more appropriately reflect the taxpayer's investment in, for example, a lease on an office used in the taxpayer's business.

Second, we believe that regulations should clarify that the adjusted basis of the deemed asset at the beginning of each year is equal to, the present value of the rental payments, discounted at the AFR, with semi-annual compounding, on the date

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the future research expenditure payments to be made in the subsequent three years, discounted at the AFR. This approach would be consistent with section 1297(d), discussed immediately below, which gives a lessor basis credit for future payments, but would not have any direct support in section 1297(e). Arguably, it also would be inconsistent with any position adopted in accordance with our recommendation above, that even cash actually paid should not necessarily be taken into account all at once in the case of prepaid royalties.

[41] See section 1297(d)(2). Exceptions apply if the lessor is related to the lessee (within the meaning of section 954(d)(3)), or the principal purpose of the lease was to avoid section 956A or the PFIC provisions. Section 1297(d)(3).

the lease was entered into, amortized over the term of the lease.[42] The following example illustrates how we view the operation of section 1297(d).

> <u>Example (4)</u>. A CFC enters into a five year lease agreement for tangible property that provides for annual lease payments of $200 each year, payable at the end of the year. The mid-term AFR at the time the lease is entered into is 10%. The exceptions to section 1297(d) are not applicable. The present value of the annual lease payments, computed as of the beginning of the lease term, is $753. The amount of the asset taken into account in each year is:

Year	Deemed Asset Basis
1	$753
2	$602
3	$452
4	$301
5	$150

In Example (4), the lease would be treated under section 1297(d) as an asset with an adjusted basis of $753 at the beginning of year one, as an asset with an adjusted basis of $602 at the beginning of year two, etc.

B. <u>Passive Assets.</u>

As discussed above, section 956A was designed to prevent United States shareholders from reinvesting the active earnings of their CFCs in excess passive assets under circumstances that the CFC would not be treated as a PFIC.

42 While our example assumes amortization on a straight-line basis, other approaches reasonably could be taken. For example, regulations could require basis to be depreciated under the method that would be applicable to the asset were it actually acquired and depreciated under section 168.

However, Congress did not express any intention to extend the PFIC rules or the definition of subpart F income to require United States shareholders of CFCs reinvesting their earnings in active business activities to be subject to inclusions of those undistributed earnings, where no such inclusions would otherwise result under pre-OBRA 93 law. The distinction between these two situations depends on the interpretation of "passive assets."

1. Working Capital. Notice 88-22,[43] which provides the most authoritative guidance on the definition of passive asset for purposes of the PFIC rules and section 956A, provides that "working capital" (defined as "cash and other current assets readily convertible into cash, including assets which may be characterized as the working capital of an active business") is a passive asset because it produces passive income. This rule, in connection with the new requirement that CFCs use adjusted basis rather than fair market value to determine whether they are subject to section 956A or the PFIC rules, exposes the United States shareholders of CFCs that maintain necessary working capital but have a low or no basis in their active business assets to inclusions under section 956A or the PFIC rules. Thus, the United States shareholders of many CFCs engaged in active service businesses or with tangible assets that have been depreciated will suddenly be subject to current inclusions of active earnings.[44]

Section 1296(b)(2) defines a passive asset as an asset that produces passive income or which is held for the production of passive income. As a preliminary matter, we believe that

[43] Supra, note 23.

[44] Although section 956A provides a 25 percent exclusion for passive assets, by calculating assets with reference to basis, such CFCs may not benefit from the 25 percent exclusion.

working capital that is not invested in an interest-bearing account (such as "petty cash") and is immediately used in an business producing only active income does not satisfy either criteria. Such non-interest bearing working capital is more akin to inventory or a trade receivable that is inherently connected to active business activities and produces only active income. We recommend that regulations clarify that, notwithstanding Notice 88-22, non-interest bearing working capital that is held for use in an active business is partly active and partly passive in proportion to the character of the income produced by that business.[45]

Second, the fact that working capital is held in an interest-bearing account before being used in an active business and therefore produces an incidental amount of passive income should not cause its conversion from an entirely (or largely) active asset into an entirely passive asset that increases the likelihood of the foreign corporation being subject to section 956A or the PFIC rules.[46] On the other hand, we recognize that

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[45] In the case of this recommendation and several others in this section III.B, we considered how a particular asset should be classified, <u>i.e.</u>, either passive or non-passive. Options include either entirely active, entirely passive or partly active and partly passive. If the latter, we considered how the allocation should be made, with reference to associated assets, associated gross income or associated net income. The precedent for looking to associated income is found in Notice 88-22, which provides that assets that generate both passive and non-passive income are classified as passive or non-passive in proportion to the relative amounts of income produced by the business in which the assets are used. The Notice, however, does not specify whether the determination is made based on net income or gross income. In this regard, we note that the use of gross income might not fully carry out the purposes of section 956A since relatively small amounts of active assets can generate relatively large amounts of gross income that might dwarf the gross income generated by substantial amounts of passive assets.

[46] <u>cf</u>. Notice 88-22, supra note 23 ("Assets which generate both passive and nonpassive income in a taxable year shall be treated as party passive and partly non-passive in proportion to the relative amounts of income generated by those assets in that year.")

the difficult distinction between working capital and passive investments may have, in part, led Congress to enact section 956A in the first place.

To balance the concern that treating interest-bearing necessary working capital as an entirely passive asset is unduly punitive against the need for objective tests, we propose that the regulations provide a very narrow safe harbor for working capital. We suggest that "working capital," defined as assets reasonably necessary for the operations of an active (or predominantly active) business within a 12 month period and invested in a bank account or in securities with a term of no more than 90 days, should be excluded from the definition of passive asset if the aggregate amount of income from the investment of such working capital over the taxable year does not exceed 5 percent of the otherwise active income of the CFC in such year.[47] Alternatively, the regulations could provide that, if a CFC meets the test in the preceding sentence, its working capital would be treated as 5 percent passive and 95 percent active. If a corporation fails the safe harbor test, its working capital and the income from investment of such working capital would not be accorded any preferential treatment for purposes of Section 956A. We believe that such an exclusion from the definition of passive assets will help prevent active businesses

[47] cf. Section 954(b)(3). In another area where a dramatically different tax analysis could depend upon whether cash is held in an interest-bearing or noninterest-bearing account, the Service has adopted a pragmatic approach. See Revenue Ruling 75-192, 1975-1 C.B. 384 (permitting investment trusts to reinvest monthly mortgage payments in high-grade temporary investments held until maturity without causing them to be treated as partnerships or associations); General Counsel Memorandum 36132 (January 8, 1975) (allowing temporary investments if purpose is to prevent funds from being nonproductive and not to take advantage of market fluctuations). Cf. also section 535(c) (relating to the accumulated earnings credit).

from being subject to section 956A and the PFIC rules, but will not permit abuse.[48]

2. Start-Up and Changing Businesses. Sections 1297(b)(2) and (3) contain exceptions from the PFIC rules for start-up and changing businesses that would otherwise be treated as PFICs. However, because these rules do not affect the definition of passive assets, a start-up CFC or a CFC whose business changes may be subject to section 956A. Although a start-up CFC may not have significant earnings and profits, if it is a member of a CFC group, its excess passive assets will be allocated to members who have earnings and profits and therefore can result in inclusions for United States shareholders. Moreover, a changing business may have significant earnings and profits. We see no reason why the policy behind these PFIC exceptions should not apply equally in the context of section 956A. Therefore, we recommend that, for purposes of Section 956A, Congress and, if it believes it has the authority, the Service,[49] exclude from the definition of passive assets those assets held

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[48] As alternatives, the safe harbor could be limited to cases in which a corporation's tangible assets did not exceed a given percentage of its gross receipts, or could exclude working capital to the extent its adjusted basis is less than a specified percentage (e.g., 10 percent) of the adjusted bases of the foreign corporation's total assets. Cf. section 1202(c)(6) (for purposes of defining a qualified small business, "working capital" may not exceed 50 percent of the assets of the corporation). This even more restrictive safe harbor would aid companies with relatively high bases in active assets (such as manufacturing companies), but would not help active service companies and other companies with a low or no basis in active assets. And, as noted above, any basis-based test frequently discriminates arbitrarily against older businesses.

[49] The exception for start-up and changing businesses in the PFIC provisions is located in section 1297(b)(2) and (3) and the definition of passive asset for purposes of section 956A is determined by reference to 1296(b). We recognize that this statutory scheme may raise questions as to the Service's authority to adopt the recommendation made in the text. However, section 1297(b) may be viewed as animating the definition of passive income contained in section 1296(b). See section 1297(b) ("for purposes of this part..."). Under this view, and in light of the Service's broad regulatory authority, the Service may be able to incorporate provisions of section 1297(b) for purposes of section 956A.

by “start up” and “changing business” CFCs, under definitions analogous to those contained in section 1297(b)(2) and (3).[50]

3. Extraordinary Capital Infusions. The change in the PFIC rules requiring CFCs to measure their assets quarterly by reference to adjusted tax basis exacerbates the problem of active foreign companies that receive extraordinary capital infusions. This problem existed prior to OBRA 93 under the PFIC rules and exists today under the PFIC rules and section 956A.

> Example (5). An active CFC manufacturing company wishes to build an additional factory and to do so raises capital through the issuance of stock or debt. However, the factory will take 3 years to build and, in the interim, a portion of the proceeds will be held in an interest-bearing account.

Under the prior and current PFIC rules and new section 956A, the capital infusion is treated as a passive asset and, to the extent of the company's earnings (or the earnings of its CFC group), could result in deemed inclusions to the CFC's United States shareholders. The same result would occur if the capital infusion was insurance proceeds from a casualty involving an existing factory.[51]

We recommend that an exception be provided to the definition of passive asset under the PFIC rules for

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[50] In our report on reform of the PFIC rules, we expect to consider possible improvements in the operation of the current exceptions from PFIC status for start-up businesses and changing businesses. As mentioned below, these might include the addition of rules explicitly covering the receipt of insurance proceeds and significant asset disposition proceeds.

[51] As an alternative to the recommendation below, the case in which a CFC suffers a casualty and receives coverage payments from its insurer could be addressed under the “changing business” rule discussed above.

extraordinary capital infusions[52] that are subject to a commitment (entered into not later than a reasonable period of time after receipt of the funds) to produce or acquire an asset that will give rise to nonpassive income (or substantially nonpassive income), provided the infusion is reasonably expected to be so expended within a reasonable period, say three years, of such receipt.[53] We would require that the commitment be expressed in the form of a binding contract with an unrelated party that would subject the foreign corporation to reasonable commercial penalties and/or damages under contract law for breach. While we are aware that this proposal may give rise to controversies in certain borderline cases, we believe that this important exception will properly exclude from the PFIC and section 956A rules those active CFCs that legitimately expand their active businesses (or that suffer unexpected casualties to their active businesses), and will not permit abusive deferral of U.S. tax on undistributed earnings.

4. Issues Arising Under Section 1296(c). Section 1296(c) provides a special rule that treats a PFIC (or a CFC) owning 25 percent or more of another corporation as if the PFIC (or CFC) held its proportionate share of the assets and received directly its proportionate share of the income of such other company. Section 956A(c)(3)(A) provides that, for purposes of

[52] Extraordinary asset dispositions probably should be covered under an expanded rule for changing businesses as described above. In that case, such dispositions would not be included in the rule for extraordinary capital infusions.

[53] The three year period might be insufficient in the case of certain long term construction projects. Thus, the Service could instead adopt a facts and circumstances test. Conversely, the Service could reasonably take the position that proceeds to be held for a period longer than three years are in fact passive assets, even if intended to be employed in an active business in the future.

Section 956A(c) (defining “excess passive assets”), the rules of Section 1296(c) shall apply.

Now that total and passive assets of CFCs are measured by reference to adjusted basis (rather than fair market value), section 1296(c) would appear to require CFCs to determine the adjusted basis of the assets of their 25 percent or greater owned subsidiaries, even if those subsidiaries are not themselves CFCs. Such a result could present compliance requirements that CFCs are incapable of satisfying.

> Example (6). A CFC purchases 25% of the stock of a foreign corporation for 100. The remainder of the business is owned by unrelated foreign persons. The foreign corporation operates an active business, has assets with a fair market value of 400 and a basis of 10, and has liabilities of 100. The CFC's only other asset is a portfolio debt security with a fair market value and adjusted basis of 10.

First, a literal reading of section 1296(c) would appear to require the CFC to determine the foreign corporation's adjusted basis in its assets (under U.S. tax principles) on a quarterly basis. Where a CFC does not have practical control of the foreign corporation and the foreign corporation has no other reason to make such basis calculations, this may be impossible.

One alternative would be for Congress (or, if it believes it has the authority, the Service) to provide, for purposes of Section 956A, a safe harbor for CFCs owning 25 percent or more of the fair market value of a foreign subsidiary that is not a CFC, under which the CFC could make an irrevocable election to use its adjusted basis in the stock of the foreign subsidiary in lieu of its adjusted basis in the assets[54] of the foreign subsidiary for purposes of determining whether it has excess passive assets. The CFC would then determine the character of the stock interest with reference to the proportion of either the foreign corporation's income or the foreign corporation's assets (by book value) that was passive or nonpassive, determined annually.[55] Of course, such an election will, in effect, require a netting of the liabilities of subsidiaries against their assets and therefore cause CFCs to suffer a different (often worse) result than under pre-OBRA 93 law,[56] but such a rule is consistent with the prohibition against fair market valuations and would give rise to fewer significant compliance difficulties than in its absence.[57]

Second, although the issue also existed prior to OBRA 93, we recommend that, for purposes of Section 956A, Congress treat the sale by a CFC of stock of a 25 percent or greater owned subsidiary[58] as not automatically giving rise to passive income but instead, as giving rise to passive or nonpassive income in

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54 Section 957(a) in effect deems that a shareholder that satisfies the ownership criteria of that section has sufficient control over the foreign corporation so as to require the corporation to provide the shareholder with sufficient information to determine its U.S. tax liability under federal income tax principles

55 See note 45 above, regarding the use of income to characterize an asset as passive or non-passive.

56 In Example (6), for example, the CFC would, under our recommendation, have passive assets of $10 and nonpassive assets of $100. Prior to OBRA 93, the ratio would be 10:200. We recognize that reference to a result under prior law is not necessarily meaningful, but offer the comparison by way of contrast.

57 As a less complete alternative resolution, in the case of a 25 percent owned foreign corporation that is not a CFC, the CFC owner could be allowed to determine its basis in the foreign corporation's assets with reference to such corporation's financial books and records.

58 The characterization of stock sale income is relevant under section 956A in the case where such stock is owned by an entity whose income is being used to characterize its equity (as passive or non-passive) under one of our recommendations relating to stock and partnership interests.

proportion to the character of the assets (by tax basis) or, if elected, the character of the income or assets (by book value) of the subsidiary.[59] This rule, although contrary to section 1296(b) (which through Section 954(c) treats the sale of stock generally as producing passive income), will give full effect to the look-through rule of section 1296(c).

5. Rules Regarding Payments From Related Parties. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") amended section 1296(b)(1), and added section 1296(b)(2)(C) and the flush language to section 1296(b)(2) to provide generally that passive income for purposes of the PFIC rules is the type that would be foreign personal holding company income under section 954(c), and that interest, dividends, rents or royalties received or accrued from a related person (within the meaning of section 954(d)(3)) are treated as nonpassive income to the extent they are allocable, under regulations, to nonpassive income from the payor.[60] The House Report to TAMRA indicates that despite the numerous references to section 954, the Congress intended the PFIC rules to retain the foreign tax credit look-through rules to determine the character of payments from related parties.[61]

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[59] If a CFC has made the election to use its adjusted basis in a foreign subsidiary's stock in lieu of using the foreign subsidiary's basis in its assets, it should also be permitted to make a second election to determine the relevant character (as active or passive) of the income from the sale by reference to the character of income earned by the subsidiary in the taxable year of the sale (or by reference to the character of income earned by the subsidiary over some longer period). Thus, if a CFC sells a foreign subsidiary in a year in which 15 percent of the subsidiary's income was passive, 15 percent of the sales gain would be treated as passive income. This recommendation will avoid the need for the CFC to analyze the character of each asset of its foreign subsidiary.

[60] TAMRA § 1012 (p) (26) (A).

[61] H. Rep't No. 100-795, 100th Cong., 2d Sess. 272 (1988) (hereinafter, "TAMRA House Report") ("(These new look-through rules are substantially similar to the look-through rules under the foreign tax credit provisions, which were intended to apply for PFIC purposes as well.) "); see also Joint Committee on Taxation, "Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238)" (JCS-10-88) 293 (March

Regulations section 1.904-5(c)(2)(ii) provides a rule for interest payments that requires the interest to be characterized in the hands of the payee as passive income to the extent of the payor's passive income, and only thereafter as nonpassive income. This rule, often referred to as the “cream-rises-to-the-top rule” (because passive income “rises” to the top of the payor's income and is skimmed off first in an interest payment to a related party), is in contrast to the rule for dividends, which treats the income as active or passive in proportion to the payor's income.[62] The cream-rises-to-the-top rule is appropriate in the foreign tax credit context, where an interest payment by one foreign corporation to a related foreign corporation may reduce the passive income of the payor and therefore should increase the passive income of the related party. However, it is less clear that this rule is appropriate for determining whether the payee is subject to section 956 because, to the extent that Section 956A is concerned with the characterization of income, it looks to gross income.[63]

> Example (7). A U.S. person owns all of the stock of two CFCs (“CFC A” and “CFC B”). CFC B earns passive income of 100 and nonpassive income of 900. CFC A's only asset is a debt instrument of CFC B that pays annual interest of 10.

31, 1988) (1988). Notice 88-22 also provides that the foreign tax credit look-through rules--and not the subpart F look-through rules--are relevant for PFICs.

62 Treasury regulation section 1.904-5(c)(4).

63 See sections 956A(c)(2)(A) (defining the term “passive asset” as an asset which produces “passive income” as defined in section 1296(b)); 1296(b) (defining passive income with reference to the definition of “foreign personal holding company income” in Section 954(c)); 954(c) (defining foreign personal holding company income as that portion of the gross income which consists of specified items).

Under regulations section 1.904-5(c) (2) (ii), CFC A's interest income is treated as being passive to the extent of CFC B's passive income. Therefore, CFC A's asset produces only passive income and CFC A has excess passive assets under section 956A. As a result, the United States shareholder of CFC A must include 10 in income in respect of CFC A. However, if CFC A owned 25 percent or more of the stock of CFC B (by value), under section 1296(c), the interest payment would be disregarded and CFC A would not have excess passive assets.[64] Alternatively, if CFC A held stock of CFC B that represented less than 25 percent of the value of CFC B and the 10 payment was a dividend on that stock, only 1 would be passive income under regulations section 1.904-5(c)(4).[65]

Although the treatment of interest is inconsistent with the treatment of dividends, and the effects of applying the cream-rises-to-the-top rule in the context of section 956A can therefore produce inequities, we believe that there would be too significant a potential for abuse if that rule were abandoned for purposes of the excess passive assets determination. As discussed in greater detail below, if an active CFC borrows through a

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64 See Joint Committee on Taxation, “General Explanation of the Tax Reform Act of 1986,” 1026 (1987) (the “1986 Blue Book”) (“Under this [25 percent] look-through rule, amounts such as interest and dividends received from foreign or domestics subsidiaries are to be eliminated from the recipient's income in applying the Act's income test ....”).

65 See section 1296(b)(2)(C) (“passive income does not include any income ... which is ... a dividend ... which is received or accrued from a related party (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person which is not passive income.”); section 954(d)(3)(B) (“a person is a related person with respect to a controlled foreign corporation, if ... such person is a corporation ... which is controlled by the same person or persons which control the controlled foreign corporation”; “control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power .... “); Treasury regulations section 1.904-5(c) (4). In Example (7), CFC A and CFC B are related because the U.S. person controls both CFC A and CFC B within the meaning of section 954(d)(3)(B).

related passive CFC instead of directly from a third party lender, the active business' debt obligation can effectively create an active asset in the hands of the otherwise passive CFC. Although we do not recommend that such a transaction be attacked under anti-avoidance regulations, we believe that retention of the cream-rises-to-the-top rule is appropriate to prevent abusive exploitation of this technique.

6. Aggregation of Businesses Conducted by Related Foreign Entities. A problem under the PFIC rules, which is exacerbated by section 956A, is the treatment of an integrated business where that business is not wholly conducted by a single foreign corporation but, instead, elements of that business are conducted by related parties.

> Example (8). A U.S. person is engaged in an active foreign real estate business through two wholly-owned CFCs. CFC A owns the real estate, which is leased to unrelated persons. CFC B is a management company that actively manages the real estate owned by CFC A (as well as providing similar services to unrelated persons).

If the regulations under section 954 were applied to determine whether the income is passive or nonpassive for purposes of section 956A and the PFIC rules, it appears that the CFC owning the real estate would not escape PFIC or section 956A treatment because those regulations require that the lessor itself perform the management services in order for the rental income to escape treatment as foreign personal holding company income.[66] In contrast to subpart F, however, which operates on a

[66] See temporary Treasury regulation section 1.954-2T(c) (lessor, “through its own officers or staff of employees” must perform active and substantial management and operational functions while the property is leased). This rule is appropriate in the context of subpart F generally, which, outside of the section 956A context, operates on a strict

strict company-by-company basis and where the effective tax rate of each individual CFC is relevant,[67] the critical inquiry under the PFIC rules and section 956A appears to be whether the venture is an active business, taken as a whole. Accordingly, section 1296(c) provides for a 25 percent look-through rule and section 956A provides for broad group rules. Each of these provisions is generally designed to disregard the separateness of corporate members of a group that functions in substance as an integrated whole. This intent would be given full effect by applying a broad related party rule for purposes of the PFIC provisions, and thus section 956A, and we recommend that regulations so provide.

Such a rule would allow grouping for purposes of determining whether the income is passive or nonpassive under section 956A and the PFIC rules.[68] The regulations might look to

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company-by-company basis to determine whether the income earned from unrelated parties is subpart F income. Thus, in the absence of regulation section 1.954-2T(c), if CFC A were organized in a tax haven, its rental income from unrelated parties could be exempted from subpart F, even if CFC B were organized in a high-tax jurisdiction.

67 See, e.g., section 954(b)(4) ("high-tax kickout" election based on certain income of CFC being subject to an effective tax rate greater that 90 percent of the maximum U.S. federal corporate income tax rate).

68 Although rules under section 904 are broader than the regulations under section 954, even they would not appear to help the CFCs in Example (8) since CFC B does not earn active rents or royalties. See Treasury regulation section 1.904-4(b)(2)(ii) A broader approach such as that adopted in the section 904 regulations is consistent with the amendments to section 1296 made by TAMRA, and is appropriate in the context of the section 956A and PFIC rules. Prior to TAMRA, passive income for purposes of the PFIC rules was income that is subject to the "passive" foreign tax credit basket (without regard to the exceptions from that basket). See section 1296, prior to enactment of TAMRA (cross-referencing section 904(d)(2)(A)). Thus, prior to TAMRA, it was clear that the rules under section 904 -- and not the rules under section 954 (to the extent they were different) -¬would apply to determine whether the rental income earned by CFC A was passive or active. However, to determine whether income was active or passive for PFIC purposes, taxpayers were required to first turn to section 904 only to learn that it, in turn, referred to section 954. See section 904(d)(2)(A)(i). In TAMRA, Congress simplified the statutory scheme by referring taxpayers directly to 954 -- without the detour through section 904. However, Congress does not appear to have intended to have effected a substantive change with this simplifying amendment.

the consolidated return rules for an appropriate set of grouping rules,[69] reducing the 80 percent consolidation threshold to over 50 percent for purposes of section 956A and the PFIC rules, and combine such rules with a partnership attribution rule.

7. Treatment of Partnership Interests Owned by Foreign Corporations. It is unclear whether an entity or aggregate approach is used to determine the extent to which a partnership interest held by a foreign corporation is a passive asset. Under an aggregate approach, a foreign corporation partner would be treated as if it held its allocable share of the assets of the partnership and conducted the partnership's business directly, and the partner's allocable share of assets would retain the same character (as active or passive) that the allocable share would have if the assets of the partnership and the partnership's business were held and conducted directly by the foreign corporate partner. Under an entity approach, the partnership interest would be treated as a separate asset of the foreign corporate partner that must be evaluated as a passive or nonpassive asset on the basis of some other criteria. The characterization of partnership interests as active, passive or mixed assets is relevant in determining PFIC status and in determining whether a CFC partner has excess passive assets.

> Example (9). A foreign corporation owns a 10% interest in an entity that is treated as a partnership for federal income tax purposes. Unrelated foreign persons own the remainder. The entity is engaged in a manufacturing business but also earns a small percentage (i.e., under 10%) of its income from portfolio (i.e., passive) investments.

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[69] See section 1504(a), (b).

The authorities relevant to a characterization of the foreign corporation's partnership interest conflict. On the one hand, section 954(c)(1)(B) includes the excess of gains over losses from the sale of certain property including partnership interests as foreign personal holding company income, which is passive income for purposes of the PFIC rules and section 956A. Thus, a partnership interest could be viewed (under an entity theory) as a wholly passive asset because it (ultimately) produces passive income or is held for the production of passive income upon its eventual disposition.[70] On the other hand, the authorities interpreting subpart F normally treat a partner as owning its allocable share of the assets owned by the partnership.[71]

The Service and the Tax Court maintain that where the relevant statutory and regulatory provisions do not clearly provide for entity or aggregate treatment, consideration should

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70 See also Notice 88-22, supra note 26 ("In general, an asset will be characterized as passive if it has generated (or is reasonably expected to generate in the reasonably foreseeable future) passive income ....").

71 See Section 958(a)(2) (stock owned by partnership treated as owned directly by CFC partner) Brown Group. Inc. v. Commissioner, 104 T.C. No. 5 (1995) ("we, and other courts, have attributed to a partner the activities and even the property of a partnership to determine whether, by virtue of such activity or property, the partner had a particular status important for determining some aspect of the partner's Federal income tax status") (emphasis added); cf. Revenue Ruling 90-112, 1990-2 C.B. 186 (CFC partner treated as owning United States property owned by partnership for purposes of section 956).

The Service contends, see Revenue Ruling 89-72, 1989-1 C.B. 257, and the Tax Court in Brown has recently held, that a CFC partner is required to include as subpart F income its distributive share of the foreign personal holding company income earned by a partnership, as if the partner conducted the activities, and earned directly the income, conducted and earned by the partnership. A natural extension of this approach would also treat a foreign corporate partner as owning its allocable share of the assets of the partnership.

be given to the policies served by each approach.[72] We believe that a relatively clear case for an aggregate approach is a partnership interest that represents a 25 percent or greater interest in the partnership. If such an interest were treated under an entity approach as an entirely passive asset, it would present the anomalous result of flow-through treatment for 25 percent or greater shareholders (under section 1296(c)) but entity treatment for 25 percent or greater partners.

We further believe that an aggregate approach is appropriate in any case requiring the application of section 956A. First, such an approach appears to be consistent with the weight of authority relevant to the interaction of subpart F and subchapter K,[73] with the exception being section 954(c) (1) (B). Second, if a partnership interest is held by a CFC, the subpart F income earned by the partnership will be included in the income of the CFC's United States shareholders, regardless of the percentage interest in the partnership owned by the CFC.[74] Since United States shareholders will suffer this adverse aspect of pure aggregate treatment, we believe that fair and consistent treatment should also permit the shareholders to treat an interest in a partnership that operates an active business and

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72 See, e.g., Treasury regulation section 1.701-2(e) (permitting Service to treat partnership as aggregate in whole or in part " as appropriate to carry out the purpose of any provision of the Internal Revenue Code ..."); Revenue Ruling 90-112, 1990-2 C.B. 186 (resolution of entity/aggregate issues depends "upon which approach is more appropriate to the specific code section involved"); Brown. 104 T.C. at_("The treatment of partnerships [as an aggregate or an entity] in each context must be determined on the basis of the characterization most appropriate for the situation.").

73 See, e.g., sources cited in footnote 71, above. See also Rev. Rul. 91-32, 1991-1 C.B. 107, for application of a look-through approach to partnerships in another foreign context.

74 See Brown Group, supra Rev. Rul. 89-72, supra.

holds active assets as an active asset for purposes of section 956A.[75]

The discussion that follows explains how regulations might implement an aggregate approach. If, however, aggregate treatment is rejected generally, we nonetheless recommend that aggregate treatment be provided for greater than 25 percent partnership interests, whether owned by CFCs or non-CFCs.

Under an aggregate approach, a foreign corporate partner that uses adjusted basis to determine its active and passive assets would have an adjusted basis in each partnership asset equal to its allocable share of the partnership's adjusted basis in each asset. We would allow foreign corporate partners to make this computation as if the partnership had a section 754 election in effect for the year when the foreign corporation purchased its interest. Thus, a foreign corporate partner's initial total basis in partnership assets would not be less than its purchase price for such interest, even if it happens to purchase its interest in a year in which there is no section 754 election in place.

However, in many circumstances a foreign corporate partner will not have the information necessary to determine its allocable share of the adjusted bases of the partnership's assets as determined for U.S. tax purposes, but will be able to determine the percentage of active and passive income earned by

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[75] This last reason may be absent in determining whether a non-CFC foreign corporation that owns a less than 25 percent interest in a partnership is a PFIC. Pure aggregate treatment would favor less than 25 percent investments by non-CFC foreign corporations in active partnerships over equivalent investments in foreign corporations, without any concomitant substantive tax trade-off for the corporation's U.S. investors. However, the absence of this reason does not, in our view, support differing treatment for this case. Moreover, the regulations' complexity would increase if a distinction were made between the section 956A definition and the PFIC definition of passive asset as it relates to less than 25 percent-owned partnership interests. Therefore, we would disagree with a decision to apply entity treatment even to less than 25 percent partnership interests owned by non-CFC foreign corporations.

the partnership in the taxable year or the book value of the partnership's assets. Accordingly, we would permit foreign corporations to make an irrevocable election to treat a partnership interest as active or passive in proportion to the relative amounts of active or passive income earned by the partnership in such year or in proportion to the book value of the partnership's assets.[76] If this election were made, the foreign corporation's initial adjusted basis in its partnership interest would be equal to its purchase price.[77]

A second and more difficult issue exists as to character of the gain on the sale of a partnership interest for purposes of the income test contained in the PFIC rules.[78] Section 954(c)(1)(B) provides that foreign personal holding company income includes the excess of gains over losses from the sale of certain property, which includes partnership interests. Consistent with our recommendations in Part III.B.4., above, regarding the character of gain on a sale of stock, we believe that Congress should act to provide that gain on the sale of an interest in a 25 percent or greater owned partnership is not necessarily treated as passive income. Such gain could be characterized (i) with reference to the gain on a deemed sale of the assets of the partnership,[79] or (ii) as passive and active income in proportion to (x) the character of the income earned by the partnership in the taxable year or (y) the book value of the partnership's assets at the time of the sale or at the end of the quarter or taxable year.

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76 See supra Part III.B.4.

77 See supra note 45 regarding the use of income to characterize assets

78 See note 58 at Part III.B.4. regarding the significance for purposes of section 956A of characterizing income on the sale of an entity's equity.

79 See Rev. Rul. 91-32, supra; cf. section 1296(c).

We believe that applying a look-through to corporations is necessary to give full effect to section 1296(c) and we believe that the same look-through approach should be applied to 25 percent owned partnerships to eliminate an unjustified distinction between 25 percent or more interests in partnerships and in corporations. Moreover, for the reasons discussed above in connection with attribution of a partnership's assets to its partners for purposes of section 956A, we believe that the same look-through approach should be applied to less than 25 percent partnerships.

8. Exclusion of United States Property. Section 956A(c)(2)(B) provides an exclusion from the definition of passive asset for any United States property (within the meaning of section 956) held by a CFC. We believe this exclusion permits abusive transactions.

> Example (10). A United States shareholder owns all of the stock of a CFC. The CFC has 200 of total assets, 75 of passive assets, 25 of pre-1993 income that was previously taxed subpart F income and 20 of post- OBRA 93 (untaxed) active earnings and profits. The CFC loans 25 of its passive assets to its United States shareholder.

In the absence of the CFC's loan to its United States shareholder, the United States shareholder would include 20 in income under section 956A, representing the lesser of 25 (75 passive assets - 25 percent of 200 total assets) and 20 of post-OBRA 93 earnings and profits.[80] A literal reading of section 956A(c)(2)(B) would reduce the CFC's passive assets to 50 (75

[80] Section 959(f) (1) (B) would not apply to exclude any amounts from the gross income of the United States shareholder because none of the CFC's post-OBRA 93 earnings were previously taxed.

passive assets - 25 United States property), its excess passive assets to 0 (50 - 25 percent of 200) and the United States shareholder would be exempted from section 956A. However, as a result of sections 959(a)(2) and (f)(1), the loan would not trigger a Section 956 income inclusion to the United States shareholder.[81] This transaction is abusive because it permits a

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[81] This conclusion requires an extended detour through the statutory thicket.

Section 956(a) provides that a United States shareholder's “section 956 amount” is equal to the lesser of (1) the excess of (A) the United States shareholder's share of the average of United States property held by the CFC at the close of each quarter of the taxable year over (B) the shareholder's share of the amount of earnings and profits described in section 959(c)(l)(A) (i.e., earnings and profits that have previously been included in income as a result of section 956) with respect to such shareholder, or (2) the shareholder's share of the applicable earnings of the CFC. In Example (11), the shareholder's share of the CFC's applicable earnings is 45, the shareholder's share of the CFC's United States property is 25 and the shareholder's share of the CFC's earnings and profits described in section 959 (c) (1)(A) is zero. Thus, the United States shareholder's section 956 amount is 25 (25-0 is less than 45). (Of course, if the 25 of previously taxed subpart F income had been included in the shareholder's income as a result of section 956, the United States shareholder would not even have a section 956.amount. This apparent flaw might be more difficult to address by regulations.)

Section 951(a)(1)(B) requires that a United States shareholder include in gross income its section 956 amount, but only to the extent the section 956 amount is not excluded from gross income under section 959(a)(2).

Section 959(a)(2) provides that a United States shareholder (or, in certain circumstances, other United States persons) excludes the earnings and profits of its CFC that are attributable to amounts which are or have been included in the gross income of the United States shareholder (or such other person) under section 951(a). These excluded earnings income are commonly referred to as “previously taxed earnings.” In Example (11), the CFC has earnings and profits of 45, 25 of which is previously taxed subpart F income and 20 of which is untaxed income. Section 959(f) provides the rules for determining which of the CFC's 45 of earnings are “attributable” to previously taxed earnings. Under section 959 (f) (1)(A), amounts which, in the absence of section 959 would be included in income under section 951(a)(1)(B) -- in other words, 25 in Example (11) -- are attributable first to earnings described in section 959(c) (2) (i.e., subpart F income that is or has been included in gross income under section 951(a)(1)(A)), and then to earnings described in section 959(c) (3) (i.e., all other earnings and profits). Thus, in Example (11), the 25 of earnings and profits of the CFC that would otherwise be included in the gross income of the United States shareholder under section 951(a)(1)(B) is excluded

CFC's investment in United States property to reduce its United States shareholder's total inclusions. The result occurs because the exclusion in section 956A(c)(2)(B) is an asset-based exclusion, but section 959 incorporates earning-based concepts and therefore the two sections permit double exclusion. The same result would occur if the CFC in Example (10) had no previously taxed subpart F income, but invested in United States property subject to a liability equal to the property's fair market value.[82]

It appears to us that, as a policy matter, the exclusion in section 956A(c)(2)(B) should serve only as a backstop to the generally applicable anti-double inclusion rules of section 959. Thus, section 956A(c)(2)(B) should apply only if and to the extent that the United States property gives rise to an income inclusion by the CFC's United States shareholders. This result could be achieved by excluding the investment in U.S. property from the section 956A(c)(1)(B) amount (i.e., excluding the investment in U.S. property from 25 percent of the CFC's total assets).[83] Although this would be accomplished most appropriately by legislation, it is possible that the Service's regulatory

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from such shareholder's gross income under section 959(a)(2) because the earnings are attributable to previously taxed subpart F income.

This reading of the statute is confirmed by the legislative history. See House Report at 259; Senate Report at 330.

82 This result occurs because section 956A(c)(2)(B) excludes United States property (without regard to any liabilities to which the property is subject), but under section 956(a) (flush language), the “section 956 amount” is reduced by any liability to which the property is subject.

83 Of course, if the U.S. investment is excluded under section 959, it should not be re-included by elimination from the section 956A(c)(1)(B) amount.

authority permits it to interpret the statute in a manner consistent with the foregoing recommendation.[84]

9. Treatment of Assets Giving Rise to Passive and Nonpassive Income. We recommend, consistent with Notice 88-22, that regulations clarify that an asset that gives rise to both active and passive income is treated as partially active and partially passive in proportion to the character of the income that is likely to be derived from that asset. In particular, we recommend that regulations clarify that depreciable property should be treated as a passive asset only to the extent that it is used in a trade or business that produces passive income. Notice 88-22 indicates that depreciable property used in a trade or business is a non-passive asset "provided that the trade or business in question is one that does not produce passive income as defined in section 1296(b)." In the absence of guidance, this language could be read to mean that depreciable property used in a trade or business that generates a relatively small amount of passive income is an entirely passive asset. We do not believe that such a draconian reading is correct or was intended.

IV. THE GROUP RULES.

A. Introduction.

Section 956A incorporates a consolidation concept to determine the excess passive assets of a "CFC group."[85] For purposes of determining the excess passive assets of any CFC, all CFCs which are members of the same CFC group are treated as one

[84] See section 956A (f) (granting regulatory authority "to prevent the avoidance of" section 956A).

[85] Section 956A(d).

CFC.[86] The excess passive assets of the CFC group are then allocated among the group members in proportion to their respective amounts of applicable earnings.[87]

Under these group rules, a CFC that would have excess passive assets on a stand-alone basis might not have any excess passive assets when its passive assets are combined with those of other members of the CFC group. Conversely, the applicable earnings of a CFC with no excess passive assets might be includible in the income of its United States shareholder if that CFC is allocated excess passive assets of other members of the CFC group.[88]

The definition of a CFC group is modeled on the definition of an affiliated group in section 1504(a). A CFC group is a chain of CFCs connected though stock ownership to a common “top tier” CFC owner which owns directly more than 50 percent of the vote or value of another CFC.[89] A CFC is a member of the CFC group if other members of the group own, directly or indirectly, more than 50 percent of the vote or value of the CFC's stock.[90]

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[86] Section 956A(d)(1)(A).

[87] Section 956A(d)(1)(B).

[88] As such, the group rules favor, at least to some extent, the notion that CFCs should be aggregated for purposes of section 956A without regard to whether that aggregation favors the taxpayer or the government. This is significant when considering the scope of the anti-avoidance rules, discussed below.

[89] Section 956A (d)(2)(A). It should be noted that, although the group rules are modeled on the consolidated return rules, they are much broader. For example, the threshold is “more than 50 percent” rather than “at least 80 percent” and the test is by vote or value, as compared to the conjunctive test in section 1504.

[90] Section 956A (d)(2)(B).

B. Discussion.

1. Full Counting of Assets of a Partially Owned CFC Group Member. A literal reading of the statute would appear t require that all of the assets of a CFC group member be taken into account regardless of minority interests. Therefore, 100 percent of the assets of a 51 percent-owned second-tier CFC subsidiary could taint or cleanse a top tier CFC's assets. It is unclear whether this result was intended.

> Example (11). CFC X owns 60% of the stock of CFC Y. Unrelated foreign persons own the remaining 40% of the stock of Y. X has 100 of applicable earnings, 400 of active assets and no passive assets (and, therefore, no excess passive assets on a stand-alone basis). Y has no applicable earnings, no active assets and 400 of passive assets (and, therefore, 400 of excess passive assets on a stand-alone basis).

Under a literal reading of the statute, the X-Y CFC group would appear to be required to compute its excess passive assets by taking into account all of Y's passive assets even though X only owns 60 percent of Y. If so, the CFC group would have 200 of excess passive assets, all allocable to X, and X's United States shareholders would have an inclusion of 100 under sections 951(a)(1)(C) and 956A. If only 60 percent of Y's assets were counted in the passive asset portion and the total asset portion of the excess passive assets calculation, the CFC group would have 80 of excess passive assets and X's United states shareholders would have an inclusion of 80.

> Example (12). CFC X owns 60% of the stock of CFC Y. Unrelated foreign persons own the remaining 40% of the stock of Y. X has 100 of applicable earnings, no active assets and 100 of passive assets (and, therefore, 100 of

excess passive assets on a stand-alone basis). Y has no applicable earnings, 400 of active assets and no passive assets (and, therefore, no excess passive assets on a stand-alone basis).

Under the all-or-nothing approach, the X-Y CFC group would have no excess passive assets, and X's United States shareholders would have no inclusion under sections 951(a)(1)(C) and 956A. If the X-Y group were allocated 60 percent of Y's assets for purposes of computing the X-Y group's excess passive assets, the group would have 15 of excess passive assets and an inclusion of 15 would result to X's United States shareholders.

The basic approach of Subpart F is to tax United States shareholders on their pro rata shares of Subpart F income.[91] The literal all-or-nothing computation method outlined above is inconsistent with this basic approach. Although it is generally consistent with the consolidated return rules, and does reduce complexity, we believe that the consolidated return rules present distinguishable paradigm and that the marginal additional complexity that would be added to the already complex calculations required under section 956A is insignificant. Therefore, Congress (and, if it believes it has the authority, the Service) should consider addressing this concern by allocating only a pro rata share of the assets of a company to a shareholder.[92] Alternative approaches for accomplishing this result are discussed in the following paragraphs.

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91 Section 951(a)(2).

92 Well advised taxpayers could potentially eliminate this concern by the use of a joint venture entity that is classified as a partnership for United States tax purposes rather than a CFC. There may be no significant non-tax distinctions between partnerships and corporations, however, (see Notice 95-14, regarding potential elective entity characterization), and it is undesirable to promulgate a rule that can be avoided by formalistic planning.

2. Double Counting of Excess Passive Assets. In determining the passive assets of a CFC, the look-through provision of section 1296(c) applies.[93] Section 1296(c) provides that, if a foreign corporation owns, directly or indirectly, at least 25 percent, by value, of the stock of another corporation, then such foreign corporation shall be treated as if it owned its proportionate share of the assets of such other corporation.

As a result of the simultaneous application of this rule and the CFC group rule, the same assets of a single CFC can be counted twice in determining the excess passive assets of two different first tier CFC subsidiaries of two different groups of United States shareholders.

> Example (13). CFC X owns 51% of the stock of CFC Y. CFC Z, whose owners are unrelated to the owners of CFC X, owns 49% of the stock of Y.

Under a literal reading of the statute, for purposes of determining the passive assets of X and Z, X could be deemed to own 100 percent of the assets of Y while, at the same time, Z owned 49% of Y's assets. Congress (and, if it believes it has the authority, the Service) should consider rules that avoid this result,[94] which we believe is incorrect and inconsistent with the statutory purpose. Indeed, the Contract with America Tax Relief Act of 1995 specifically provides that regulations are authorized

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93 Section 956A(c)(3)(A).

94 We also note that other anomalies can result because CFC status and membership in a CFC group are tested with reference to either vote or value. For example, if, in the preceding example, CFC X owned all of the common stock of CFC Y, but CFC Z owned all the shares of a class of nonvoting preferred stock of CFC Y that carried more than 50 percent of the value of CFC Y, then CFC Y could be in two CFC groups at the same time. This issue should be addressed as well.

under Code Section 956A (f) to coordinate the CFC group rules and the 25 percent look-through rules.[95]

There are at least three alternative approaches that might be taken to avoid double counting.

Example (14). CFC X owns 51% of CFC A, CFC Y owns 26% of CFC A and CFC Z owns 23% of CFC A.

(1) The 100 percent attribution under the group rules of section 956A (d) could pre-empt application of the 25 percent look through rule of section 1296(c) in cases where the former applies. Under this approach, all assets would be attributed to CFC X and no assets would be attributed to CFC Y or CFC Z. This approach could be conditioned on full counting of CFC A's assets by CFC X.

(2) Attribution under the group rules of section 956A(d) could be reduced by the percentage attribution otherwise arising under section 1296(c). Under this approach, 74% of the assets would be attributed to CFC X, 26% of the assets would be attributed to CFC Y and none of the assets would be attributed to CFC Z.

(3) Attribution could be made by reference to the actual percentage ownership of each shareholder. Under this approach, 51% of the assets would be attributed to CFC X, 26% of the assets would be attributed to CFC Y and none of the assets would be attributed to CFC Z.

The first approach, pre-emption of the 25 percent rule by the 100 percent rule, would be justified based on the potential for double counting. If our recommendation regarding pro rata attribution contained in the preceding section is

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[95] H.R. 1215, section 603(i)(3) (introduced March 13, 1995); see also H.R. 1121, section 3 (i)(3) (introduced March 3, 1995).

adopted, this justification could be absent in a significant number of cases. If our recommendation regarding pro rata attribution is not adopted, however, the pre-emption approach would be a reasonable accommodation.

The second approach would be equitable, but it would require CFC X to obtain information about the other owners of CFC A. Although this may not be difficult if CFC X owns 51 percent of the common equity of CFC A, the group rules do not exclude preferred stock,[96] and CFC X may not be in a position to learn about CFC A's ownership.[97]

The third approach would be consistent with our recommendation regarding pro rata ownership. It also appears to be the most equitable. Therefore, we recommend the third approach.

With respect to periods prior to the issuance of regulations, we believe that Congress should authorize taxpayers to adopt any reasonable method that prevents double counting. This approach is consistent with the House Report issued in connection with the recently introduced legislation referred to above.[98]

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96 Compare section 1504(a)(4).

97 We note that similar problems could arise under the first approach in connection with CFCs owning between 25 and 50 percent of a lower tier CFC. Such noncontrolling 25 percent owners would need to know whether there was a 50 percent owner before they knew whether to include a pro rata share of the lower tier CFC's assets, or none of those assets. We believe, however, that such situations will raise fewer difficulties than those that could be created under the second approach.

98 See H.R. Rep. No. 104-84, 104th Cong., 1st Sess. 87 (March 21, 1995):

> Pending the promulgation of guidance by the Secretary, it is intended that taxpayers be permitted to coordinate [the look through and group rules] using any reasonable method for taking assets into account only once, so long as the method is

3. Previously Taxed Excess Passive Assets.

> Example (15). United States corporation A owns all the stock of CFC X, which owns all the stock of CFC Y. In year 1, X has 300 of excess passive assets but no applicable earnings and Y has no excess passive assets but 500 of applicable earnings. In year 2, X still has the same 300 of excess passive assets but now has 400 of applicable earnings and Y has neither excess passive assets nor applicable earnings.

In year 1, 300 of excess passive assets is allocable in full to Y since the allocation of excess passive assets in a CFC group is made based on the members' respective applicable earnings. As a consequence, A recognizes 300 of income due to the presence of X's excess passive assets and Y's income. In year 2, X's excess passive assets are allocated in full to X. As a result, A recognizes 300 of income due to the presence of the same excess passive assets that generated income recognition to A in year 1.

If X and Y were merely divisions of CFC D, D would have 300 of excess passive assets and 500 of applicable earnings in year 1, resulting in a 300 income inclusion to A under section 956A. In year 2, although 400 of additional earnings are generated, there are no additional excess passive assets. As such, no additional income inclusion will result under section 956A.

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consistently applied to all controlled foreign corporations (whether or not members of any CFC group) in all taxable years.

The anomaly of two inclusions of 300 to A results from the manner in which the statute provides an exclusion for amounts previously taxed under section 956A. As discussed above, the interaction in section 956A of both earning and asset concepts can create results unintentionally favorable to taxpayers.[99] In this context, however, it puts taxpayers in a worse position than they would have been in had the group rules not applied. We believe this is inappropriately harsh. Therefore, we recommend that Congress (or, if it believes it has the authority, the Service) ameliorate the operation of this rule. The following approach might be considered.

In general, section 956A(a) provides that the section 956A inclusion is the lesser of (i) the shareholder's portion of the CFC's applicable earnings (after allowing for current year section 956 inclusions) and (ii) the excess of (A) the shareholder's portion of the CFC's excess passive assets over (B) the earnings and profits previously taxed under section 956A with respect to such shareholder. The problem discussed above could be addressed if the amount described in (ii)(B) were the earnings and profits previously taxed under section 956A with respect to <u>any member of the CFC Group</u>. Alternatively, the problem discussed above would appear to be resolved if, instead of the earnings-related amount described in (ii)(B), the asset-related amount in (ii)(A) were reduced by another asset-related amount, such as the amount in a “previously utilized excess passive assets account.”[100] Another alternative that the Service might consider

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99 See Part III.B.5. above.

100 Among the complexities that would have to be addressed in connection with the establishment of such an account would be the consequences of a departure from the CFC group by either the actual owner or the CFC to which the allocation was made. Would the account disappear, stay with the CFC that actually owned the assets or stay with the other CFC? What if the CFCs are sisters? Would the account stay with the top tier CFC in that case?

would be to approach the problem through section 959, promulgating rules that would allow previously taxed income to be transferred within a CFC group.

4. Treatment of the CFC Group for Income Inclusion Purposes.

> Example (16). CFC X owns all the stock of CFC Y and neither has accumulated earnings and profits or a deficit in accumulated earnings and profits. CFC X has 200 of excess passive assets and a 100 current year loss. CFC Y has no excess passive assets and 100 of applicable earnings.

In this example, the X-Y CFC group will generate a 100 inclusion under section 956A even though, if its income were consolidated the way its assets are consolidated, it would generate no inclusion under section 956A due to an absence of applicable earnings.

This result appears to be required by the statutory language and the legislative history to section 956A.[101] We believe, however, that Congress should reconsider at least its view that current year losses cannot offset applicable earnings within a CFC group.

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[101] See section 956A(b), defining applicable earnings with reference to earnings and profits that would support a dividend under section 316. See also Senate Report at 334 n. 9:

> Inasmuch as the amount of a controlled foreign corporation's applicable earnings can never be less than zero, a corporation with no current earnings and an accumulated deficit is not taken into account in determining the sum of the applicable earnings of all controlled foreign corporations in the CFC group.

5. Asset Allocation from Corporation in Which No Ownership Exists. The statutory scheme allows for a situation in which excess passive assets cause an income inclusion to a United States shareholder that has no direct or indirect ownership interest in the assets.

> Example (17). United States shareholder A owns 100% of the stock of CFC X, CFC X owns 60% of the stock of CFC Y and CFC Y owns 100% of the stock of CFC Z. United States shareholder B owns the other 40% of CFC Y. CFC X has 200 of excess passive assets and no applicable earnings. Neither CFC Y nor CFC Z have excess passive assets but they each have 100 of applicable earnings.

In this example, A would be required to include in income 120 and B may be required to include in income 80. B's inclusion would result from the allocation to Y and Z of the excess passive assets of X, even though B owns no interest in those assets either directly or indirectly and may have no influence over whether those assets are acquired, repatriated or otherwise disposed of. This inclusion would result from a reading of the statute that required the recognition of only one CFC group for both A and B, with X as the top tier corporation in a group that includes both Y and Z.

We believe that the proper approach in this situation would be to recognize two CFC groups -- one with respect to A which would consist of X, Y and Z, and one with respect to B which would consist of Y and Z. We recognize that the consequence would be a lesser inclusion in many cases. In Example (17), only 120 would be included in all United States shareholders' incomes. This, however, appears to be the appropriate result. Subpart F requires income inclusions. In the case of section 956A inclusions, the income to be taxed is measured by assets. It appears to us that the proper measuring rod ought to consist of only those assets in which the United States shareholder has a direct or indirect ownership interest. Congress (and, if it believes it has the authority, the Service) should provide for this result.

6. Constructive Ownership Rules. As noted above, a CFC is part of a CFC group if more than fifty percent of its stock is owned "directly or indirectly" by another member of the CFC group. Code section 958(a) provides rules governing direct and indirect ownership of stock for all purposes of Subpart F, with noted exclusions. Conversely, section 958(b) provides rules for constructive ownership of stock only with respect to specified Code sections within subpart F. Against this statutory background, we think that it is clear that the constructive ownership rules do not apply to the group rules. It would be helpful for the regulations to affirm this conclusion.

V. SECTION 956A ANTI-AVOIDANCE REGULATIONS.

Section 956A (f) grants the Treasury regulatory authority to promulgate regulations as may be necessary "to prevent the avoidance of the provisions of this section through reorganizations or otherwise." The threshold questions posed by this language are (1) what types of transactions have the potential to enable taxpayers to avoid the provisions of section 956A, and (2) what standard should be applied for determining when such transactions should be recast or disregarded. The discussion below first considers the standard that could be used to identify tax-avoidance transactions, and then considers the types of transactions that could be viewed as potentially abusive.

A. Standard.

The legislative history to section 956A appears to contemplate that the relevant anti-avoidance standard should be whether “one of” the principal purposes of the transaction is to avoid section 956A.[102] Congress explicitly articulated this standard in sections 1297(d)(3)(B) and 1297(e)(2)(B)(ii). We do not disagree with this standard. We do, however, recommend that the Service provide examples that establish realistic safe harbors so that, to the extent possible, taxpayers' legitimate transactions are not deemed, in retrospect, to have been abusive. We also recommend that regulations clarify that, in the absence of the requisite principal anti-avoidance purpose, a transaction will not be disregarded for section 956A purposes even though the transaction has a corollary effect of reducing an income inclusion under section 956A.

B. Avoidance Transactions.

1. Reorganizations. As mentioned above, the statute specifically identifies reorganizations as having the potential to enable taxpayers to avoid section 956A. The legislative history to section 956A mentions only divisive reorganizations as potentially abusive.[103] This is consistent with

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102 See House Report at 258 and 262 (setting forth examples which are viewed as proper regulatory targets because “one of” their principle purposes is avoiding taking passive assets into account or avoiding an inclusion under section 956A); Senate Report at 329 and 334; Conference Report at 641-42 (discussing the anti-avoidance rule in section 1297(e)(2)(B)(ii)). This standard is well represented throughout the Code and regulations as an anti-avoidance standard. See, e.g., sections 197(f)(9)(F), 302(c)(2)(B), 306(b)(4), 336(d)(2)(B), 355(a)(1)(D)(ii), 382 (1) (1) (A), 453 (e)(7), 751(d)(1)(B); Treasury regulation sections 1.701-2(b), 1.1275-2T(g); but cf. sections 269(a) and 357(b)(1) (requiring that the principal purpose be tax avoidance).

103 House Report at 262; Senate Report at 334, For purposes of analyzing whether reorganization transactions are potentially abusive, such transactions may be divided into two categories: (1) those that combine

the overall thrust of the statute, which, through the group rules, endorses consolidation of members of a CFC group.[104] Accordingly, we recommend that acquisitive and divisive reorganizations be evaluated differently in determining whether such transactions should be subject to the anti-avoidance rules of section 956A.

a. Divisive Transactions.

> Example (18). On December 31, 1994, a United States shareholder, US1, owns 100% of F1, a CFC. Throughout 1994, F1 has 1000 of total assets, 350 of passive assets and therefore 100 of excess passive assets. In 1994, F1's active assets generate 70 of income and the passive assets generate 30 of income. Under section 956A, US1 must include 100 of income in respect of F1 for 1994. On January 1, 1995, for a valid business purpose, F1 contributes its active assets to a new corporation F2, and spins off F2 to US1.

In the absence of anti-abuse rules, the divisive transaction described above could reduce US1's inclusions under section 956A if the assets and income of its foreign subsidiaries remained constant. In 1995, F2 would have no passive assets, so US1 would have no inclusions in respect of it. F1 would have excess passive assets of 262.50, but income of 30, so US1 would

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multiple CFCs into a single CFC or “CFC group” (as defined in section 956A (d)(2)) (“acquisitive” reorganizations), and (2) those that divide a single CFC or CFC group into multiple CFCs or CFC groups (“divisive” reorganizations).

104 A Treasury official appears to have expressed a similar view. See “Treasury and JCT Officials Discuss New International Tax Provisions,” Tax Notes Today, Sept. 22, 1993 (93 TNT 196-4) (quoting a Treasury official as indicating that (1) the “chain rule” was designed to deal with potential abuses under section 956A if companies could transfer passive assets to related parties without consequence, and (2) regulatory authority was included to give Treasury a way to deal with other transactions that could accomplish what the “ chain rule” was meant to prevent.

be required to include only 30 in income under section 956A. Thus, the divisive transaction would succeed in reducing US1's 1995 inclusions by 70, as compared to its inclusions if the transaction had not occurred.

We believe that this transaction should be addressed by the anti-avoidance regulations. We also believe, however, that the regulations would leave too much uncertainty if they simply required that the earnings and assets of multiple CFCs or multiple CFC groups be aggregated for purposes of applying section 956A as long as “one of” the principal purposes of separately organizing, acquiring or maintaining the CFCs or CFC groups is to avoid an inclusion under section 956A. To ameliorate some of this uncertainty, and as suggested by the section 956A legislative history,[105] presumptions such as those set forth in Treasury regulation section 1.954-lT (b) (4),[106] should be applied to determine whether the requisite anti-avoidance purpose existed. Such presumptions should be rebuttable by taxpayers who provide sufficient evidence that a principal tax avoidance purpose did not exist.

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[105] House Report at 262; Senate Report at 334-35.

[106] Treasury regulation section 1.954-lT(b)(4) provides that two or more CFCs will be presumed to have been organized, acquired or maintained to avoid the de minimis and full inclusion requirements of Treasury regulation section 1.954-lT(b) if the CFCs are related persons (as defined in subparagraph (b)(4)(iii) thereof) and (A) the activities carried on by the CFCs or the assets used in those activities are substantially the same activities that were carried on, or assets that were previously held by a single CFC, and the United States shareholders of the CFCs or related persons are substantially the same as the United States shareholders of the one CFC in that prior taxable year (with the foregoing presumption being rebuttable by proof that the activities carried on by each CFC would constitute a separate branch under the principles of Treasury regulation section 1.367(a)-6T(g) if carried on by a United States person); (B) the CFCs carry on a business, financial operation or venture as partners directly or indirectly in a partnership that is a related person with respect to each such CFC; <u>or</u> (C) the activities carried on by the CFCs would constitute a single branch operation under Treasury regulation section 1.367(a)- 6T(g)(2) if carried on directly by a United States person

Thus, for example, the regulations might presume a principal tax avoidance purpose and, therefore, generally disregard for purposes of section 956A,[107] the tax-free spinoff of a CFC that caused the CFC to leave the CFC group. Similarly, splitting up a single CFC group by creating two or more “top-tier corporations” could be presumptively disregarded for purposes of section 956A. However, a corporate business purpose for either transaction could be a factor that would rebut a tax-avoidance presumption.[108] Moreover, the absence of a significant control relationship between the CFC and the entity or person with which it engages in a reorganization transaction could be a factor in rebutting a presumption of tax avoidance.[109] Thus, for example, where a CFC contributes its assets to another corporation in a section 351 transaction, the fact that the other members of the control group are not related to the CFC (within the meaning of section 954(d)(3)) could be a factor that rebuts a tax-avoidance purpose.

We also note that section 956A (f) is targeted at the avoidance of section 956A. Therefore, the regulations should make clear that they do not affect the status of a reorganization for purposes other than section 956A.

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[107] Disregarding the transaction for purposes of section 956A raises significant issues. For example, US1 in Example (18) would aggregate FI and F2 to determine its inclusions under section 956A, but if US1 were actually a group of shareholders, some of whom disposed of their FI or F2 stock, the consequences would be less clear.

[108] See, e.g., Treasury regulation section 1.355-2(d)(3)(ii) (corporate business purpose as evidence of nondevice in a section 355 transaction).

[109] See supra note 106.

b. Acquisitive Transactions.

For the reasons set forth below, we believe that the regulations should provide that reorganization transactions that combine the earnings and assets of CFCs or CFC groups generally will be respected for purposes of section 956A, even if they are undertaken with a principal purpose to reduce or eliminate inclusions under section 956A.[110] As the legislative history to section 956A indicates, the purpose of section 956A is to discourage U.S. taxpayers from accumulating excessive amounts of passive assets abroad.[111] We understand that, in addition to preventing avoidance of section 956A, the group rules of section 956A (d) were intended to mitigate the harsh and inconsistent excessive accumulations of passive assets on an aggregate basis where those holdings were actually structured in a manner similar to an affiliated group. We therefore believe that the regulations should permit a United States shareholder to take advantage of the CFC group rules by combining some or all of its CFCs or CFC groups into one CFC group and thereby reducing or eliminating income inclusions under section 956A.[112]

> Example (19). On December 31, 1994, a United States shareholder, US1, owns directly 100% of two CFCs, F1 and F2. On January 1, 1995, US1 contributes all of the stock of F1 and F2 to a

110 Combining CFCs or CFC groups could eliminate or reduce an income inclusion under section 956A by reducing the amount of passive assets as a proportion of total assets or by maximizing use of foreign tax credits under section 960.

111 See House Report at 253-54; and Senate Report at 323.

112 Moreover, we note that, if such combining transactions were not exempt from anti-avoidance regulations, a United States shareholder could be subject to differing consequences under section 956A depending on whether, at the time when OBRA 93 became effective, its foreign holdings were (i) held directly in multiple sister CFCs, (ii) held in a single CFC, or (iii) held in separate CFCs that are part of a CFC group. It seems unfair to treat taxpayers differently solely because of the foreign investment structure they had employed prior to, and maintained after the effective date of OBRA 93.

newly formed CFC, FP, which is wholly-owned by US1 and which has no assets other than the stock of FI and F2. Throughout 1995, (i) Fl has 1000 of total assets, 400 of passive assets and therefore excess passive assets of 150, (ii) F2 has 1000 of total assets, 100 of passive assets and therefore has no excess passive assets, and (iii) as of December 31, 1995, Fl and F2 each have 500 of current and post-9/30/93 accumulated earnings and profits.

On a separate company basis, Fl would have 150 of excess passive assets and therefore US1 would have a 150 section 956A income inclusion for 1995. After the transaction, the CFC group would have 2000 of total assets, 500 of passive assets and therefore no excess passive assets. Accordingly, if the transaction were respected for section 956A purposes, US1 would results of applying section 956A on a CFC-by-CFC basis by allowing a U.S. person's foreign holdings to be tested for not have any section 956A income inclusion in respect of the CFC group.

We believe that the foregoing transaction should be respected for purposes of section 956A, even if the principal purpose of the transaction was to avoid an income inclusion under section 956A, because, on a worldwide basis, US1 did not accumulate excess passive assets. Therefore, we recommend that, as long as they have a bona fide business purpose, acquisitive reorganizations not run afoul of any anti-avoidance regulations that are promulgated.

Under this standard, however, the regulations may effectively permit a United States shareholder to make selective tax-free combinations of CFCs or CFC groups so as to reduce its section 956A inclusion to an amount less than the amount that would be included if all of the shareholder's CFCs were aggregated for section 956A purposes. It is not clear whether, as a policy matter, such selective tax-free combinations of CFCs or CFC groups with a purpose to minimize or eliminate inclusions under section 956A should necessarily be viewed as objectionable. Because Congress apparently did not view transactions that combine CFCs or CFC groups as abusive, one could argue that the regulations should not inhibit selective combinations. Indeed, the CFC group rule could be viewed as an invitation to taxpayers to combine CFCs into CFC groups in the most advantageous manner.

On the other hand, recognizing that Congress did not enact a rule that measures excess passive assets on a worldwide basis, one could view the group rule primarily as an anti-avoidance provision[113] and secondarily as a narrow "relief provision." It prevents taxpayers who have excess passive assets on a worldwide basis from avoiding the consequences of this fact by moving assets among related corporations (the anti-avoidance provision), and it enables taxpayers who do not have excess passive assets on a worldwide basis to implement, within defined limits, a structure that gives effect to this reality (the relief provision).

In determining whether to attack selective tax-free combinations of CFCs, the Service should also consider what the consequences of such an attack would be. Under one alternative, regulations could provide that selective tax-free combinations of CFCs or CFC groups will be disregarded for purposes of section 956A as long as the United States shareholder lacks a bona fide principal non-tax business reason for excluding certain CFCs or CFC groups from the transaction. Although this rule would be a relatively finely tuned instrument for deterring and detecting abusive transactions, "disregarding" a merger may not be

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[113] See supra Part IV.

practical. Moreover, such a rule might be difficult to administer, by reason of the fact-sensitive analysis that would be required to refute a claimed business purpose for the transaction at issue.

The other alternative that comes to mind, although perhaps more administrable, could easily yield draconian results. It would treat the section 956A inclusion, computed by-aggregating all of a United States shareholder's CFCs or CFC groups, as a floor below which the shareholder's section 956A inclusion could not be reduced by reason of selective combinations of CFCs or CFCs groups.[114]

> Example (20). On December 31, 1994, a United States shareholder, US1, owns all of the stock of four CFCs, F1, F2, F3 and F4. On January 1, 1995, US1 creates a CFC group by contributing the stock of F2 and F3 (but not FI or F4) to FP, a newly formed wholly-owned CFC with no other assets. Throughout 1995, F1 and F2 each have 1,000 of total assets and 650 of passive assets, F3 has 1,000 of total assets but no passive assets and F4 has 1,000 of total assets, all of which are passive. As of December 31, 1995, FI and F3 each have 250 of applicable earnings, F2 has 350 of applicable earnings and F4 has 50 of applicable earnings.

Taking the combination transaction into account, the FP group has 150 of excess passive assets and 600 of applicable earnings, so US1 has a 150 income inclusion attributable to the FP group (87.5 from F2 and 62.5 from F3); F1 has 400 of excess passive assets and 250 of applicable earnings, so US1 has a 250 income inclusion with respect to F1; and F4 has 1,000 of excess passive assets and 50 of applicable earnings, for a total income

[114] This rule could apply even where a bona fide principal nontax business reason existed for excluding a CFC or CFC group from the transaction.

inclusion of 450. If the CFC group had not been created, US1 would have had a total income inclusion of 650: 250 attributable to F1, 350 attributable to F2 and 50 attributable to F4 (because they would have had excess passive assets of 400, 400 and 750 respectively, and applicable earnings of 250, 350 and 50, respectively). On a worldwide basis, however, treating all of US1's CFCs as one CFC group, US1 would have had 1,300 of excess passive assets and 900 of applicable earnings, resulting in a 900 income inclusion (attributable 250 to each of Fl and F3, 350 to F2 and 50 to F4).[115]

We think the deficiencies of both approaches, combined with the most reasonable interpretation of the statute and the legislative history, militate against the adoption of regulations attacking acquisitive reorganizations, whether they be selective or complete. We urge the Service to follow this approach.

2. Transactions Affecting Basis. As noted above, the computation of excess passive assets is made with reference to the basis of a CFC's assets. A United States shareholder could therefore eliminate or mitigate the impact of section 956A by causing CFCs in a CFC group to engage in taxable reorganizations or intercompany asset sales in order to step up the basis of active assets and/or step down the basis of passive assets owned by CFC members and thereby reduce the CFC group's excess passive assets. We believe that intercompany asset sales and taxable reorganizations among related parties undertaken for a valid

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[115] It is true that these results could be mitigated if the regulations adopting the second approach provided that, if US1 had a bona fide principal non-tax business reason for excluding Fl and F4 from the CFC group, the transaction would be respected, and US1's inclusion would be 450, even if one of US1's principal purposes was to reduce its section 956A inclusion. This measure would, however, substantially eliminate the administrability advantage of the second approach and, therefore, would leave this approach without any significant justification.

nontax business purpose should be respected for purposes of measuring the excess passive assets of a CFC group.[116] Alternatively, Treasury could adopt a standard based on whether the transaction was entered into in the ordinary course of business.

It appears from the statute and legislative history that, when enacting the group rules, Congress had in mind the paradigm of an affiliated group filing a consolidated return.[117] Under both the existing and the proposed consolidated return rules, a purchasing member is able to obtain a stepped-up basis in the acquired asset.[118]

Moreover, the Conference Report indicates that, in the case of intercompany factoring of receivables among members of a CFC group, during the period when the receivable is held by the purchasing member, the basis of the receivable in the hands of the group, for purposes of applying the group rules, is the cost incurred by that member to acquire the receivable in the factoring transaction from the selling member.[119] Although the factoring of a receivable would usually involve a step-down in

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116 Section 482 would, of course, attach collateral consequences to such a transaction if it were not undertaken at an arm's length price.

117 Compare section 956A (d)(2) with section 1504(a)(1); see Conference Report at 639.

118 See Treasury regulation section 1.1502-13(d)(7) (basis of property acquired by a purchasing member of a group filing a consolidated return in a deferred intercompany transaction is determined as if separate returns were filed); proposed regulation sections 1.1502-13(c) (3) (i) and (c)(4) (Example (1)) (although sale between members of a group filing a consolidated return is treated as taking place between two divisions of a single corporation, buyer's gain computed based on cost basis in acquired asset). We recognize that the consolidated return paradigm may be distinguishable in that both the gain and the increased basis remain with a single taxpayer under the consolidated return rules.

119 Conference Report at 639.

the basis of the asset, it appears that, by providing this example, Congress intended that the basis adjustment regime of the current intercompany transaction regulations be applied, at least in the case of bona fide transactions between CFC group members.

3. Sale or Contribution of Active U.S. or Foreign Assets to a Passive CFC. The regulations should address whether, and under what circumstances, the sale or contribution of active U.S. or foreign assets to a CFC or CFC group of that shareholder will be respected for section 956A purposes, where a principal purpose of the transaction is to eliminate or reduce inclusions under section 956A.[120] As noted above, the anti-abuse regulatory authority granted to Treasury is extremely broad. Based on this authority, the Service could take the view that the contribution or sale of active assets to a CFC should be disregarded for section 956A purposes (forever or for a certain period of time) if the transaction lacks a principal non-tax business purpose or is part of a plan a principal purpose of which is to avoid section 956A.

There is no evidence in the statute or legislative history that Congress considered such transactions to be abusive. We recognize that the major policy objective of section 956A is to discourage taxpayers from accumulating excessive amounts of passive assets abroad and that repatriating passive assets is the conduct which the legislation may have been designed to encourage. However, the technical language of the statute does not require that assets be repatriated, and the measuring rod for

[120] This would include the acquisition for cash (a passive asset) of active assets from a related party, the incorporation of an existing foreign branch and the placement of a new CFC in the U.S. shareholder's foreign investment structure.

inclusions, "excess passive assets," is calculated as a percentage, not an absolute number.

An anti-stuffing rule was not included in section 956A.[121] Moreover, such a rule is not found in section 1296(a), which forms the basis for the section 956A excess passive assets determination, or the regulations promulgated thereunder.[122]

For the foregoing reasons, we believe that the sale or contribution of active U.S. or foreign assets to a CFC or CFC group of that shareholder should not be viewed as abusive.[123] Therefore, the regulations should not attack such transactions.[124]

4. "Decontrolling" a CFC with Excess Passive Assets. One method for a United States shareholder to avoid a section 956A inclusion would be to "decontrol" a CFC with excess passive

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[121] It should be noted in this regard that it was pointed out to Congress repeatedly that one effect of section 956A would be to encourage the acquisition of active assets to avoid its impact.

[122] In the case of a section 1291 fund, as that term is defined in proposed Treasury regulations section l.l291-l(b)(2)(v), an anti-stuffing rule would be unnecessary due to the "once-a-PFIC- always-a-PFIC" rule of section 1297(b)(1). In the case of a pedigreed QEF, however, as that term is defined in proposed Treasury regulation section 1.1291-l(b) (2)(ii), an anti-stuffing rule would be necessary if thought appropriate to prevent avoidance of PFIC status.

[123] It might also be argued that insofar as these transactions involve outbound property transfers, any abuse inherent therein is addressed under section 367.

[124] Other intra-group transactions may, however, be appropriate targets for anti-avoidance rules. For example, if a CFC invests in a U.S. corporation holding only stock of the CFC's active U.S. parent, the CFC might be able to arbitrage the differing standards in section 1296(c) for favorable look through treatment and section 956(b)(2)(F) for exceptions from U.S. property status to avoid both sections 956 and 956A in situations not contemplated by Congress. On the other hand, the converse of the transactions described in the text probably should not be viewed as abusive. That is, just as active assets can be moved to an otherwise passive CFC, passive assets can be segregated away from related CFCs' active income-producing assets. We do not believe such a technique to be abusive.

assets. However, by enacting section 956A(e), Congress appears to have made the judgment that decontrol transactions are not abusive.[125] Although section 367 does not tax all decontrol transactions (for example, a capital contribution by a non-U.S. shareholder), that section and its interaction with section 1248 generally provide that such a transaction cannot occur without taxation of the gain or the earnings and profits of the CFC that would have been includible as a dividend under section 1248 in the income of the transferring shareholder.[126] We believe that these rules represent the appropriate responses to the potential abuses of decontrol transactions. Moreover, although the proposed PFIC regulations treat certain decontrol transactions as dispositions by the historic shareholders (see proposed regulation section 1.1291-3(e) (Example 22)), such treatment is appropriate in the PFIC context where dispositions are events to which the PFIC rules attach tax consequences. Section 956A does not independently attach tax consequences to stock dispositions.

For these reasons we believe that the regulations should provide that a transaction undertaken to decontrol a CFC with excess passive assets be given effect for purposes of section 956A, as long as the foreign corporation actually ceases to be a CFC. Of course, transactions that formally decontrol CFCs but

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125 In this regard, we note that section 956A(e) does not, but the regulations could, provide allocation rules where a corporation does not cease to be a CFC during the taxable year, but does case to be a member of the CFC group during the taxable year.

126 See Code § 367(a); Notice 87-85, 1987-2 C.B. 395; proposed Treasury regulation section 1.367(a)-3; Notice 94-46, 1994-1 C.B. 356; Treasury regulation section 7.367(b)-7. Although section 3 67 is aimed at preventing avoidance of tax on appreciation or earnings accumulated prior to a decontrol transaction, and such a transaction might be undertaken in the section 956A context to avoid tax on future earnings under section 956A, we believe that the regulations should not condemn a transaction solely because it has the effect of avoiding future section 956A inclusions. Avoiding the conditions that would generate such an inclusion is, after all, an apparent objective of the statute.

lack economic substance should not be given effect under the regulations.[127]

5. Computation of CFC Group's Applicable Earnings.

Under section 956A(b), the term “applicable earnings” means a CFC's current earnings and profits and also earnings and profits accumulated since September 30, 1993, reduced by distributions during the taxable year and by earnings and profits accumulated since that date that were previously taxed under section 951(a)(1)(B) or (C). As discussed above, the Senate Report indicates that a CFC can never have a “deficit in applicable earnings,” and adds in a footnote that “ [i]nasmuch as the amount of a controlled foreign corporation's applicable earnings can never be less than zero, a corporation with no current earnings and an accumulated deficit is not taken into account in determining the sum of the applicable earnings of all controlled foreign corporations in the CFC chain.”[128] It thus appears that Congress intended for accumulated deficits and current losses of CFC group members to be disregarded for purposes of allocating the excess passive assets of a CFC group among the group members, with the result that the group's excess passive assets will be allocated only to CFC members with current or accumulated earnings and profits.

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127 See Treasury regulation section 1.957-1(b)(2); Koehring Co. V. U.S., 583 F.2d 313 (7th Cir. 1978); Weiskopf v. Comm'r, 538 F.2d 317 (2d Cir. 1976); Kraus v. Comm'r, 490 F.2d 898 (2d Cir. 1974);and Garlock. Inc. v. Comm'r, 489 F.2d 197 (2d Cir. 1973), cert, denied 417 U.S. 911 (1974).

128 Senate Report at 328 and 334, note 9.

In this context, it would be appropriate to limit the effect of losses accumulated prior to any combination of profitable and unprofitable CFCs in a transaction described in section 381(a), one of the principal purposes of which is to reduce section 956A income inclusions by reducing applicable earnings of a CFC in the group. This anti-abuse rule, however, should extend only to losses accumulated prior to the transaction.

6. Intra-Group Loans.

> Example (21). F1 and F2 are CFCs that are related within the meaning of section 954(d)(3). F1 has 30 of passive assets and 100 of total assets. F2 has no passive assets or income, and is in need of 20 in additional capital. Instead of F2 borrowing directly, F1 borrows 20 and onlends it to F2. F2's note provides F1 with a non-passive asset, bringing its total assets to 120 and removing from the reach of section 956A. F2 acquires an additional non-passive asset with the 20.

This transaction involves a situation that could have created adverse consequences to F1 under the “cream-rises-to-the-top” rule, described at section III.B.5 above, if F2 had significant passive income. For example, an intercompany loan 1 from Fl to F2 necessitated by the poor credit of F2 could have adverse consequences to Fl if F2 had significant passive income. As such, the described transaction may be viewed as the necessary consequence of section 1296 (b) (2) (C), which is incorporated by reference in section 956A and works in some cases for taxpayers and in other cases against taxpayers.

Conversely, the transaction may be viewed as a “doubling up” of non-passive assets among related parties. If such doubling up were to be prohibited, it would ideally be prohibited only where the debt would not have been incurred by Fl but for the favorable impact on its asset mix under section 956A. Such a subjective inquiry would, however, breed significant uncertainty. And a broader anti-abuse rule would risk distorting the passive asset computation in the context of legitimate business transactions. Finally, the cream-rises-to-the-top rule is a significant deterrent to abusive transactions. On balance, we recommend that the regulations not prohibit transactions such as those described above.

C. Retroactivity of Regulations.

We recommend that regulations be made retroactive to the enactment of OBRA 1993 only in cases where the regulation specifically gives effect to Congress' intent as evidenced by the legislative history. For example, the legislative history clearly states that short-term or temporary arrangements with respect to a CFC's assets be disregarded in measuring assets as of the close of each quarter of the taxable year, where one of the principal purposes of the arrangement was to avoid taking passive assets into account for purposes of section 956A(c).[129] Moreover, Congress stated its intent that regulations provide that the earnings and assets of two or more CFCs be combined if one of the principal purposes for separately organizing the CFCs was to avoid a section 956A income inclusion. We believe that it would be appropriate to make regulations implementing these views retroactive. However, regulations should not be retroactive where they carry out policies and objectives not clearly evident in the legislative history, such as regulations deterring selective combinations of CFCs or CFC groups.

[129] House Report at 258; Senate Report at 329.