NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON SECTION 954(c)(6)

December 4, 2006

New York State Bar Association Tax Section
Report on Section 954(c)(6)

I. OVERVIEW

This Report[1] discusses issues raised in connection with section 954(c)(6),[2] which provides an exclusion from foreign personal holding company income status for payments made by a controlled foreign corporation (a "CFC") to a related CFC, where the payments consist of interest, rent, royalties, or dividends. This Report provides recommendations regarding issues that should be addressed in connection with guidance to be provided under section 954(c)(6). Our recommendations are summarized as follows:

1. Section 954(c)(6) provides that in order for an amount to be eligible for the exclusion, it must be allocable to non-subpart F income, and that in determining whether payments are allocable to non-subpart F income, payments should be allocated under the rules applicable to payments under the regulations promulgated under sections 904(d)(3)(C) and (D). While there is some potential for mismatching in applying the foreign tax credit rules of section 904 – which differentiate between passive and active income – to section 954(c)(6), which differentiates between subpart F and non-subpart F income, we see no compelling reason to deviate from the statute. Regulations should address the situation where a distribution is

---

[1] The principal author of this report is Peter Connors. Substantive contributions were made by Kimberly Blanchard, Matt Clausen, Joseph Czajkowski, Paul Housey and Peter Palsen. Helpful comments were made by Peter Blessing, Patrick Brown, Kevin Glenn, David Hardy, Abe Leitner, Richard Loengard, David Miller, David Sicular, Andrew Solomon, Andrew Walker, Daniel Dunn, Deborah Jacobs, Judy Jacobsen, Thomas O'Donnell and James Reardon.

[2] Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

allocable to previously taxed income ("PTI") and confirm that pre-acquisition earnings qualify for look-through treatment. Additionally, we believe that (i) in determining whether an amount is allocable to non-subpart F income, interest, rents and royalties that are deducted against amounts that would otherwise qualify for the high-tax exception should be considered to be allocable to non-subpart F income and (ii) if a payment fails to qualify under section 954(c)(6) because of a deficit in the earnings and profits ("E&P") of the payor (as provided in the Technical Corrections Bill), the recipient should be entitled to an offsetting deduction, as, when and if the payor is required to recapture subpart F income under section 952(c)(2).

2. Unlike the same-country exception in section 954(c)(3), which excludes payments allocable to subpart F income, section 954(c)(6) requires that a payment be allocable to non-subpart F income. The latter formulation technically disqualifies any payment by a related CFC that has no income, even if it also has no subpart F income. We are uncertain whether this result was intended. The Report outlines three possible approaches to address this issue.

3. Factoring discount treated as income equivalent to interest under section 954(c)(1)(E) is explicitly made eligible for the exclusion under section 954(c)(6) by including the discount income within the definition of "interest." We believe that in factoring arrangements that constitute financings, the seller of the receivable should be treated as the payor of the interest. It is appropriate for this purpose to treat the source of the discount income differently from discount arising in a sale of a trade or service receivable subject to the related person factoring rules of section 864(d), which look to the obligor rather than the seller.

4. Payments that are treated as "dividends" under the new provision should include payments treated as dividends under section 304 and amounts treated as dividends under section 964(e).

5. The rules currently applicable to payments received by partnerships under Treasury Regulation § 1.702-1(a)(8)(ii) and § 1.952-1(g) should apply for purposes of determining whether an amount is eligible for exclusion. No specific provision like those contained in Treasury Regulations §§ 1.954-1(g), 1.954-2(a)(5)(ii), 1.954-3(a)(6), and 1.954-4(b)(2)(iii) would appear relevant.

6. With respect to payments paid by a partnership, the existing rules applicable to partnership payments under Treasury Regulation § 1.954-2(b) provide an appropriate framework for purposes of determining whether an amount is eligible for exclusion. Under these provisions, if a partnership whose partners consist of corporate partners makes a payment of interest, rents, or royalties, a corporate partner will be treated as the payor of the interest, rents, or royalties if the rent or royalty payment gives rise to a partnership item of deduction to the extent the item of deduction is allocable to the corporate partner under section 704(b) or, where it is not specifically allocable, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)). Regulatory guidance should extend these provisions to section 954(c)(6).

7. Section 954(c)(6) authorizes the Secretary to promulgate anti-abuse rules. In doing so, the Secretary could take either of two approaches. One approach is to adopt an anti-abuse rule along the lines of the partnership anti-abuse rules, denying effect to any transaction that reduces the taxpayer's tax liability and that is inconsistent with the intent of section 954(c)(6), setting forth examples of transactions that are consistent with the intent of the section and those which are not. An alternative approach would be to write a narrow anti-abuse rule aimed at specific transactions, providing specific examples of prohibited transactions and

transactions that do not invoke application of the prohibition. Transactions covered by the anti-abuse rule might include those that contain conduit features as a result of which the character of an item of income is changed from subpart F to non-subpart F income. Many of our members do not believe that anti-abuse rules should extend to foreign tax credit planning generally.

8. Two transition issues are presented by the enactment of section 954(c)(6). The first is with respect to the situation where payments were made between related CFCs in periods preceding the enactment date, but following the effective date. The second is for those taxpayers that find it necessary to reorganize in the event the legislation is not extended past its sunset. Some of our members believe that a technical correction to the statute is necessary to address the first issue.

II. DISCUSSION

A. Overview of Provision.

Foreign personal holding company income ("FPHCI") generally includes gross income from (a) dividends, interest, royalties, rents and annuities, (b) gain from property transactions, (c) gains from commodities transactions, (d) foreign currency gains, (e) income equivalent to interest ("IEI"), (f) income from notional principal contracts used to hedge any of the previous types of income, (g) payments in lieu of dividends and (h) income from certain personal services contracts.[3] One exception to FPHCI treatment involves the so-called same-country exception, which excepts dividends and interest received from a related person that is (1) a corporation created or organized under the laws of the same foreign country under the laws of which the recipient CFC is created or organized, and (2) has a substantial part of its assets used in its trade

[3] Section 954(c)(1).

or business located in such same foreign country.[4] The exception also applies to rents and royalties received from a corporation that is a related person for the use of, or the privilege of using, property within the country under the laws in which the CFC is created or organized.[5] The same-country exception is limited in two relevant respects. First, the exception does not apply to the extent interest, rent, or royalty income reduces the payor's subpart F income or that of another CFC, or creates (or increases) a deficit which under section 952(c) may reduce the subpart F income of the payor or another CFC.[6] Second, it does not apply to any dividend that is attributable to E&P of the distributing corporation accumulated during any period during which the recipient did not own stock of the payor either directly, or indirectly through a chain of one or more related subsidiaries.[7]

In many respects, new section 954(c)(6) can be seen as a limited-term expansion of the same-country exception. With respect to periods commencing after January 1, 2006, and through December 31, 2008,[8] dividends, interest, rents and royalties received or accrued from a CFC that is a related person shall not be treated as FPHCI "to the extent attributable and properly allocable (determined under rules similar to the rules of subparagraph (C) and (D) of section 904(d)(3)) to income of the related person that is not subpart-F income." The section further

---

4 Section 954(c)(3)(A)(i). The provision also states that to the extent provided in regulations, payments made by a partnership with one or more corporate partners shall be treated as made by such partners in proportion to their respective interests in the partnership. Regulations issued under section 954 provide that if the payment is allocable to a partner, it will be considered to be made by the partner. A person is a "related person" under section 954(d)(3) if such person (a) is an individual, corporation, partnership, trust, or estate that controls or is controlled by the CFC; (b) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons that control the CFC. Rules similar to the rules of section 958 apply.

5 Section 954(c)(3)(A)(ii).

6 Section 954(c)(3)(B).

7 Section 954(c)(3)(C).

8 We note that section 3 of H.R. 6288, 109th Cong. 2nd Sess., which was introduced on September 29, 2006, would make the provision permanent.

provides that interest shall include factoring income that is treated as IEI for purposes of section 954(c)(1)(E). The section directs the Secretary to prescribe such regulations as are appropriate to prevent the abuse of the purposes of the rule.

The legislative history indicates that the purpose of the new provision is to allow U.S. companies to redeploy their active foreign earnings (CFC earnings subject to U.S. tax deferral) in appropriate circumstances without additional tax burden:

> The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States. [9]

The legislative history explains that the provision adopts the related person definition of section 954(d)(3), stating that ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control and that "a related CFC is a CFC that controls or is controlled by the other CFC or a CFC that is controlled by the same persons or persons that control the other CFC." It is noteworthy that the same-country rules apply to payments from related persons, not only related persons that are CFCs.[10]

---

9 H.R. Rep. No. 109-304, at 45.

10 The attribution rules under subpart F (sections 954(d)(3) and 958) are broader than the attribution rules for foreign tax credit basketing purposes (sections 904(d)(3), Treas. Reg. § 1.904-5(i), and section 318). Despite the reference to section 904(d)(3) in section 954(c)(6)(A), it would appear that the attribution rules of section 958 apply for purposes of determining whether a CFC is a "related party" under section 954(c)(6)(A). Application of the related party rules of section 954(d)(3) for purposes of section 954(c)(6) is appropriate, notwithstanding the reference to section 904(d)(3) in section 954(c)(6). In this regard, section 904(d)(3) should apply here for the limited purpose of determining if income is "attributable or properly allocable ... to income of the related person which is not subpart F income." Confirmation of this treatment would be helpful.

B. The Technical Corrections Bill.

On September 29, 2006, a bill was introduced in the House of Representatives making technical corrections to TIPRA (the "Technical Corrections Bill").[11] The Technical Corrections Bill would change the new CFC look-through provision in three ways.[12] First, the bill would require that, in addition to being attributable or allocable to non-subpart F income of the payor, excluded payments must also be attributable or properly allocable to income of the payor that is not treated as ECI.[13] This provision is necessary as section 952(b) generally provides that the subpart F income of a CFC does not include any item of income from sources within the United States which is ECI. The bill's proposed amendment is designed to prevent the situation where a CFC pays interest, rent, or royalties out of its own ECI to a related CFC, the payor taking a

---

While we believe that the above-mentioned technical interpretation is correct, we would also note that the application of different attribution rules for purposes of sections 954(c)(6) and 904(d) could have the anomalous result that a payment of interest, rents, or royalties by one CFC to another CFC could be excluded from subpart F income by reason of section 954(c)(6) but still constitute passive income to the recipient CFC under section 904(d). This result is illustrated in the following example:

Facts: USP, a domestic corporation, owns 100 percent of the stock of two Dutch corporations, NV Holdco and NV Finco. NV Holdco in turn owns 50 percent of the stock of JV Opco, a German corporation that earns non-subpart F general limitation income. The remaining 50 percent of JV Opco is owned by AG Holdco, a publicly owned German corporation. JV Opco is financed, in part, by loans from NV Finco. NV Holdco has purchased one share of stock of AG Holdco on the German stock exchange.

U.S. Tax Treatment: NV Holdco and NV Finco are both CFCs under section 957. JV Opco is also a CFC, as USP is deemed to own more than 50 percent of JV Opco under Treas. Reg. § 1.958-1(b). Dividends received by NV Holdco from JV Opco are (i) excluded from subpart F under section 954(c)(6), and (ii) entitled to look-through treatment under Treas. Reg. § 1.904-5(i)(3) and thus treated as general limitation income. Interest received by NV Finco from JV Opco is (i) excluded from subpart F under section 954(c)(6), but (ii) not entitled to look-through treatment under Treas. Reg. § 1.904-5(i)(1) and thus treated as passive income.

This results from the fact that the determination of whether income is passive income under section 904(d)(3) is largely determined by reference to the subpart F rules in section 954; however, the current regulations fail to apply the expanded section 958 attribution rules in the context of section 904(d)(3).

11 A Bill to Amend the Internal Revenue Code of 1986 to make Technical Corrections, and for Other Purposes, H.R. 6264, 109th Cong., 2d Sess., introduced in the House on September 29, 2006. An identical bill was introduced in the Senate on the same date. See S. 2046, 109th Cong., 2d Sess.

12 The first two changes were proposed in the earlier H.R. 5970, 109th Cong., 2d Sess., introduced in the House on July 28, 2006.

13 See Technical Corrections Bill § 2(a)(1)(A).

deduction for the payment while the payee receives non-subpart F income because the payments are not allocable to the payor's subpart F income.[14]

Second, the bill would expand the Secretary's regulatory authority to "prescribe such regulations as may be necessary or appropriate to carry out this paragraph, including such regulations as may be necessary or appropriate to prevent the abuse of the purposes of this paragraph."[15] Congress intends that regulations issued pursuant to the revised regulatory authority should include rules to prevent the exception from applying to transactions the net effect of which is the deduction of a payment, accrual, or loss for U.S. tax purposes without a corresponding inclusion in the subpart F income of the CFC income recipient, where such inclusion would have resulted in the absence of section 954(c)(6).[16] As an example of such a transaction, the Joint Committee on Taxation explanation mentions transactions involving interest deemed to arise from certain related person factoring arrangements pursuant to section 864(d).[17]

Third, the bill would create an exception to look-through treatment for interest, rent, or royalty payments that create or increase a deficit in the E&P of the payor, if that deficit (or increase) would reduce the subpart F income of the payor or another CFC.[18] The new exception would mirror an existing exception to the same-country rule of section 954(c)(3). The exception is designed to disallow exclusions from subpart F for amounts that reduce the subpart F income

---

14 Staff of the Joint Committee on Taxation, Description of the Tax Technical Corrections Act of 2006 (JCX-48-06), October 2, 2006 ("JCT Description") at 2.

15 Technical Corrections Bill § 2(a)(1)(B).

16 JCT Description at 2.

17 Id. We discuss factoring income in section F., below.

18 Technical Corrections Bill § 2(a)(2).

of the payor under the accumulated deficit rule of section 952(c)(1)(B) or that of a qualified chain member under the chain deficit rule of section 952(c)(1)(C).[19]

The following sections review various issues that arise in connection with future regulatory guidance and provide suggestions as to how these issues should be resolved.

C. The Look-Through Rules.

Section 954(c)(6) provides that rules "similar" to the foreign tax credit look-through rules contained in sections 904(d)(3)(C) and (D) are to be used to determine the extent to which interest, dividends, rents, and royalties received by a CFC from a related CFC are attributable (in the case of dividends) or properly allocable to (in the case of interest, rents, or royalties) either (i) income of the related CFC that is not subpart F income or (ii) upon adoption of the Technical Corrections Bill, income of the CFC that is not ECI. The section 904 rules allocate income between foreign tax credit baskets, generally between passive income and general limitation (active) income. However, section 954(c)(6) requires an allocation between subpart F income and non-subpart F income. Because some subpart F income is "active" and some non-subpart F income is "passive," the application of the section 904 rules in this context might produce some mismatching or uncertainty. This section of the Report reviews whether it is appropriate to deviate from the rules of section 904(d)(3)(C) and (D).

Section 904(d)(3)(C) provides that any interest, rent, or royalty that is received from a CFC in which the taxpayer is a U.S. shareholder[20] is treated as income in a separate foreign tax credit category to the extent that it is properly allocable to income of the CFC in such category as

---

19 JCT Description at 3.

20 A "U.S. shareholder" is a U.S. person who owns, actually or constructively, 10 percent or more of the total combined voting power of all class of stock of the CFC. Sections 904(d)(5)(A) and 951(b).

set forth in Treasury Regulations.[21] Section 904(d)(3)(D) provides that any dividend from a CFC in which the taxpayer is a U.S. shareholder is treated as income in a separate foreign tax credit category in proportion to the ratio of the portion of the E&P of the CFC in such category to the total amount of E&P of the CFC.

Although the regulations under section 904(d)(3) were specifically written to determine the foreign tax credit category of income received from a related CFC, in the context of section 954(c)(6), it appears that Congress intended not to create a new scheme but to layer the existing scheme of section 904 in the application of section 954(c)(6). However, the statute is not clear as to the meaning of rules "similar" to the rules under sections 904(d)(3)(C) and (D). We believe that the section 904 rules can be interpreted so that their application for purposes of section 954(c)(6) makes sense, but should not be modified to create a rule with different tax consequences, even if there may be good reason, because this would not be a "similar" rule but rather a "different" rule.

Set forth below is a discussion of the specific "look-through" foreign tax credit allocation rules under Treasury Regulations under sections 904(d)(3)(C) and (D) for related person interest, rents, royalties, and dividends, together with a discussion of the rules applicable for the determination of whether a payment reduces subpart F income of the payor for purposes of the same-country exception. As set forth below, we believe that there is no reason to deviate from the look-through rules under section 904. While adopting a different regime for the

---

21 Section 904(c)(3)(C) was amended, effective for taxable years beginning after December 31, 2006, to state that interest, rent and royalty income received from a CFC in which the taxpayer is a U.S. shareholder is treated as income in the passive foreign tax credit category to the extent properly allocable to passive foreign category income of the CFC payor. This amendment was designed solely to conform the "look-through" rule to the provisions of the JOBS Act that reduced the number of foreign tax credit categories to two and should not change the analysis discussed herein.

determination of whether a payment reduces subpart F income would be more consistent with the goal of permitting redeployment of earnings, to do so would add unneeded complexity.

1. Allocation of Interest.

Treasury Regulation § 1.904-5(c)(2), issued under section 904(d)(3)(C), provides rules to determine the appropriate foreign tax credit category to which interest paid by a CFC to a U.S. shareholder or related person is allocable.[22] This interest, referred to as "related person interest," is first allocated to the "passive foreign personal holding company income" ("Passive FPHCI") of the CFC payor to the full extent thereof, and then is apportioned among the other separate categories of the payor's income.[23] Treasury Regulation § 1.954-2(b)(4), issued under the same-country exception, provides for the use of substantially similar allocation rules as contained in Treasury Regulation § 1.904-5(c)(2) in determining whether a related person interest payment is allocable to reduce subpart F income of the payor.[24] In the context of section 954, the regulations subdivide the groupings so as to distinguish between Passive FPHCI and income other than FPHCI.[25] That latter category might include income received from a related party, which falls in the general basket for foreign tax credit limitation purposes (including for example foreign base company sales and services income).

---

22 Treas. Reg. § 1.904-5(c)(2)(i). Specially, related person interest is any interest paid or accrued by a CFC to any U.S. shareholder in that corporation (or to any other related person) to which the look-through rules of section 904(d)(3) and Treas. Reg. § 1.904-5 apply.

23 Treas. Reg. § 1.904-5(c)(2)(ii)(C).

24 Treas. Reg. § 1.954-2(b)(4)(ii)(B)(1) applies the allocation rules contained in Treas. Reg. § 1.954-1(c) which, when combined with section 954(b)(5), indicates that related person interest is allocable to reduce passive FPHCI of the payor and thereafter applies the principles of section 861. See also T.D. 8618, 60 FR 46500 (Sept. 7, 1995), indicating that Treas. Reg. § 1.954-1(c) was intended to be consistent with Treas. Reg. § 1.904-5(c)(2).

25 Treas. Reg. § 1.954-1(c)(1)(i)(C)(requiring the allocation of expenses to income other than Passive FPHCI and to Passive FPHCI).

If related person interest exceeds the Passive FPHCI of the CFC payor, the excess related person interest is allocable to other categories of income depending upon the method used by the taxpayer to apportion interest expense under Treasury Regulation § 1.861-9T.[26] As noted above, Treasury Regulation § 1.904-5(c)(2) specifically applies for purposes of allocating expenses to income in separate foreign tax credit categories. Regulations should confirm that, in the application to section 954(c)(6), any reference in Treasury Regulation § 1.904-5(c)(2) to an allocation to a "category" should be interpreted to mean an allocation to non-subpart F income, the categories of adjusted gross foreign base company income (as defined in Treasury Regulation § 1.954-1(a)(3)), adjusted gross insurance income (as defined in Treasury Regulation § 1.954-1(a)(6)) and any other category of income included in the computation of subpart F income under section 952(a). This is consistent with the allocation rules that apply for purposes of the same-country exception.[27] We note that if the Technical Corrections Bill is enacted, a separate income and asset category would be needed to allocate payments to the payor's ECI.[28]

To the extent that an interest payment is allocable to Passive FPHCI of the CFC payor, the Passive FPHCI of the CFC payor would correspondingly be reduced for purposes of determining the subpart F income of the CFC payor.[29] Similarly, to the extent that the interest

---

26 Treas. Reg. § 1.904-5(c)(2)(ii)(D). If the "modified gross income method" is elected, the excess related person interest expense is allocated to the various categories of income of the CFC based on the proportion of total gross income in each category (other than Passive FPHCI) to total gross income (other than Passive FPHCI). Treas. Reg. § 1.904-5(c)(2)(ii)(D)(1). As discussed below, no specific limitation is prescribed for the case in which interest paid exceeds passive income and there is no other gross income. If the taxpayer elects the "asset method" of apportioning interest expense, the excess related person interest expense is allocated based on the proportion of total value of assets in a separate category based on the income that they generate (other than passive) to the total value of assets (other than passive). Treas. Reg. § 1.904-5(c)(2)(ii)(D)(2).

27 Treas. Reg. § 1.954-2(b)(4)(ii)(B).

28 Treas. Reg. §§ 1.904-5(c)(2)(ii)(D)(1); 1.861-9T(j) and 1.861-8(a)(4).

29 Treas. Reg. § 1.954-1(c)(1)(i)(C); section 954(b)(5).

payment is allocable to other subpart F income of the payor based on the method elected to allocate interest expense, the income of the CFC payor in each of these categories will be correspondingly reduced.[30] The net effect of the interest allocation rules is that an interest payment from a CFC to a related CFC would shift subpart F income from the payor to the payee to the extent allocable to Passive FPHCI or other subpart F income of the CFC payor.

> Example 1: Consider the case where USP owns both CFC 1 and CFC 2. CFC 1 has $1,000 of active income and $300 of Passive FPHCI. It pays $900 in the form of interest to CFC 2. Under the foregoing rules, the first $300 of interest would be allocated to the Passive FPHCI of CFC 1 and would not qualify for the exclusion. The $600 balance would be allocated to its active income and would qualify.

It could be argued that the goal of the legislation is frustrated by allocating the interest first Passive FPHCI, as this has the effect of reducing the amount of income eligible for deferral under section 954(c)(6).[31] Because section 954(c)(6) applies only where a payment is allocable to non-subpart F income, one could argue that active income ought to be treated as non-subpart F income such that, in Example 1, where CFC 1 has $1,000 of active income, all $900 of its interest payment should qualify for the exclusion. Countering that argument is the need to reduce complexity. For Treasury to adopt a separate regime for section 954(c)(6) purposes, it would be necessary to distinguish between payments that qualify for section 954(c)(6) and those that qualify for the same-country exception. It would then be necessary to provide a regime to

---

30 Treas. Reg. § 1.954-1(c)(1)(i)(D).

31 See Fuller, "U.S. Tax Review," 42 Tax Notes Int'l 1145 (June 26, 2006) (stating that a question arises as to whether the direct allocation rule is even appropriate under section 954(c)(6), where preservation of passive character should not be necessary).

prioritize between payment flows, presumably allowing taxpayers the ability to elect section 954(c)(6) in instances where the two exceptions overlapped. Moreover, to the extent that the active income of CFC 1 constitutes subpart F income, all that occurs is a shift in the CFC whose income triggers the subpart F income inclusion.

2. Allocation of Rents and Royalties.

By way of background, Treasury Regulation § 1.904-5(c)(3), issued under section 904(d)(3)(C), provides rules to determine the appropriate foreign tax credit category to which rents or royalties paid by a CFC to a U.S. shareholder or related person are allocable. These rules determine the foreign tax credit category of the rents or royalties to the recipient. Rents or royalties received or accrued from a CFC are treated as income in a foreign tax credit limitation category of the recipient to the extent that the expense is allocable to income of the CFC payor in such separate foreign tax credit limitation category under the principles of Treasury Regulations §§ 1.861-8 through -14T.[32] Regulations should confirm that, in the application of section 954(c)(6), any reference in Treasury Regulation § 1.904-5(c)(3) to an allocation to a "category" should be interpreted to mean an allocation to non-subpart F income, the categories of adjusted gross foreign base company income (as defined in Treasury Regulation § 1.954-1(a)(3)), adjusted gross insurance income (as defined in Treasury Regulation § 1.954-1(a)(6)) and any other category of income included in the computation of subpart F income under section 952(a). Again, this is consistent with the allocation rules for purposes of the same-country exception.[33] In addition, presumably, a separate income and asset category would be

---

32 Treas. Reg. § 1.904-5(c)(3).

33 Treas. Reg. § 1.954-2(b)(4)(ii)(B).

made with respect to income that is, and assets that generate income that is, ECI (again, assuming passage of the Technical Corrections Bill).[34]

Under Treasury Regulation § 1.861-8, expenses that are directly related to a class of gross income of the CFC payor are required to be allocated against that same class.[35] Treasury Regulation § 1.954-2(b)(5), issued under the same-country exception, provides for the use of substantially similar allocation rules as those contained in Treasury Regulation § 1.904-5(c)(3) in determining whether the related party rental or royalty payment is allocable to reduce subpart F income of the payor.[36]

> Example 2: Consider the case where USP owns both CFC 1 and CFC 2. CFC 1 has $1,000 of active income and $300 of non business related interest income. It pays $900 for a license to CFC 2 used in its business. Under the foregoing rule, the $900 would be allocated to the active income of CFC 1, as it is directly related to that income.

A class of gross income of the CFC payor includes compensation for services, business income and gains from property sales, among several other types of income.[37] Expenses are considered directly related to a class of gross income of the CFC payor where the expense "was incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate such

---

34 Treas. Reg. §§ 1.904-5(c)(2)(II)(D)(1); 1.861-9T(i) and 1.861-8(a)(4).

35 Treas. Reg. § 1.861-8(b)(1).

36 Treas. Reg. § 1.954-2(b)(5)(ii)(A) applies the allocation rules contained in Treas. Reg. § 1.954-1(c), which applies the principles of section 861.

37 Treas. Reg. § 1.861-8(a)(3).

income."[38] Where the property is used in the business of the CFC payor, rents and royalties typically will be allocable to the business income class of gross income of the CFC payor because these expenses are incurred to generate business income of the CFC payor. As a result, rents and royalties paid by a CFC to a related CFC should not be allocable to subpart F income of the CFC payor, but rather to general business income, and thereby would not constitute subpart F income to the CFC recipient unless the business itself is one which produces subpart F income or the property is used by the CFC payor in a U.S. trade or business.[39] In this case, the payment to the CFC recipient may be excluded from subpart F income to the extent that the "high-tax" exception applies.[40]

Rules comparable to the related person interest rules do not apply in this context under the section 904 regulations or for purposes of the same-country rules. We see no reason for modifying these rules further in the context of section 954(c)(6).

3. Allocation of Dividends.

The statute requires that dividends must be attributable to non-subpart F income in order to be eligible for the exclusion under section 954(c)(6). Given the application of section 959, under which distributions out of PTI do not constitute dividends, the statutory limitation seems to be of limited practical application.[41]

---

38 Treas. Reg. § 1.861-8(b)(2).

39 Treas. Reg. § 1.954-1(c)(1)(i)(B).

40 Section 954(b)(4). To the extent allocable to subpart F income of the CFC payor, the "same-country" exception to subpart F income to the CFC recipient should not apply. Section 954(c)(3).

41 Regulations were recently promulgated under section 959. See REG-121509-00; 71 F.R. 51155-51179 (August 29, 2006).

Example 3: Assume CFC 1 has $90 of passive, subpart F income and $10 of active, non-subpart F income, and pays a $100 dividend to related CFC 2.

By way of background, Treasury Regulation § 1.904-5(c)(4), issued under section 904(d)(3)(D), provides the "look-through" rules to determine the appropriate foreign tax credit category to which dividends paid by a CFC to a U.S. shareholder or related person are attributable. These rules determine the foreign tax credit category of the dividends to the CFC recipient. Dividends received or accrued from a CFC are treated as income in a foreign tax credit limitation category of the recipient to the extent that the dividends are paid or accrued out of the E&P of the CFC payor in proportion to the ratio of the portion of the E&P attributable to income in such category to the total amount to E&P of the CFC payor.[42]

However, these "look-through" rules apply only after the distribution is first determined to constitute a dividend. To the extent that the distribution does not constitute a dividend, the "look-through" rule of section 954(c)(6) would not be implicated. Thus, for example, if a CFC has no E&P, it cannot pay a "dividend." Moreover, if such a CFC had subpart F income, such income would not be includible by a U.S. shareholder due to the limitation provided in section 952(c).[43]

After determining the subpart F income for the year, actual distributions from the CFC for the year are treated, not as dividends, but rather as nontaxable distributions of PTI to the extent of the subpart F income inclusion.[44] Because a distribution of PTI cannot be treated as a dividend, it cannot be attributable to the payor's subpart F income for purposes of

---

42 Treas. Reg. § 1.904-5(c)(4).

43 Treas. Reg. §§ 1.952-1(c)(1) (first paragraph) and (c)(3), Exs. 1(c) and (d); sections 956(b)(1) and 959(f)(2).

44 Sections 959(c)(2) and 959(d); Treas. Reg. § 1.959-3(b)(3), Example.

section 954(c)(6).[45] To the extent that the distribution exceeds PTI, the distribution would be treated as a dividend allocable to non-subpart F income of the CFC. Accordingly, in Example 3, $90 of the distribution should constitute non-taxable PTI and the remaining $10 should constitute a dividend that is attributable to non-subpart F income under section 954(c)(6).

A distribution of E&P that accrued during a period in which the payor was not a CFC or was otherwise not owned by the recipient should be entitled to exclusion under section 954(c)(6), and should be characterized on the basis of the income to which it attributable. In contrast to the rule in section 954(c)(3), there is no requirement under section 954(c)(6) that the E&P accrue during a CFC period or period of ownership.[46] Imposing such a requirement would be contrary to the statute as well as to its purpose as reflected in the legislative history to reduce the restrictions on redeployment of offshore capital. Regulations should confirm the applicability of the exclusion in such circumstances.

Based on the foregoing, a distribution from a CFC to a related CFC could constitute subpart F income only to the extent that the CFC payor has ECI, because the distribution would either constitute a distribution of PTI or a distribution of E&P that is not subpart F income. However, a payor CFC's E&P could be allocable to U.S. source ECI.[47] Presumably, a separate income and asset category would need to be created with respect to income that is, and assets that generate income that is, ECI (again assuming passage of the Technical Corrections Bill).[48]

4. Allocation to Non-Subpart F Income.

---

45 Treas. Reg. § 1.959-3(b)(3), Example.

46 Cf. section 954(c)(3)(C) and Treas. Reg. § 1.954-2(b)(4)(ii)(A) (requiring the income be earned when the payor was a subsidiary for purposes of the "same-country" exception).

47 Treas. Reg. § 1.904-5(c)(4)(i).

48 See Treas. Reg. §§ 1.904-5(c)(2)(ii)(D)(1), 1.861-9T(j) and 1.861-8(a)(4). Again, the separate category of ECI depends on passage of the Technical Corrections Bill.

Unlike section 954(c)(3), which excludes from the same-country exception payments allocable to subpart F income of the payor, section 954(c)(6) affirmatively requires that a payment be allocable to non-subpart F income. This formulation raises the question whether section 954(c)(6) applies where the payment received from the related CFC exceeds the total income of the CFC payor, or where the payor CFC has no income at all. This situation is illustrated by the following examples:

> Example 4: Consider the case where USP owns both CFC 1 and CFC 2. CFC 1 has $1,000 of non-subpart F income and $2,000 of subpart F income. It pays $6,000 of interest to CFC 2. It allocates interest expense based on the modified gross income method. Under the foregoing rule, $4,000 of the interest payment would be allocated to CFC 1's subpart F income ($6,000 times $2,000/$3,000), notwithstanding that it only has $2,000 of subpart F income.

In Example 4, the payment would be allocable, under the methodology prescribed by the Regulations applicable to the allocation of interest, to more subpart F income than is actually earned by CFC 1. In the same-country exception context, while the statute speaks in terms of a prohibition reducing subpart F income by related person payments, the regulations look to how the income is allocated, suggesting that only if the payment is allocable to subpart F income will it be disallowed.[49]

The issue arises in an even starker setting where the CFC payor had no income at all.

---

[49] Treas. Reg. § 1.954-2(b)(4)(ii)(B)(interest may not be excluded to the extent it is allocable to gross foreign base company income of the payor).

Example 5: CFC 1 lends money to CFC 2 organized in a different country, and CFC 2 pays $1,000 of interest to CFC 1. CFC 2 has no income.

The issue here is whether the $1,000 of interest is eligible for the exemption under section 954(c)(6), given that there is no non-subpart F income to which it can be said to be allocable. There appear to be three possible approaches for determining whether section 954(c)(6) applies: (1) section 954(c)(6) may not apply, since CFC 2 has no non-subpart F income to which the payment can be said to relate; (2) section 954(c)(6) may fully apply, since there is no subpart F income of CFC 2 to which the payment can be considered to relate; or (3) section 954(c)(6) may apply based on the composition of CFC 2's future or historical income or assets.

The first approach is supported by the literal language of the statute. However, it would create a disparity between the treatment of the payment under section 954(c)(6) and the same-country rules. Creating a different standard might invite tax planning designed to take advantage of the difference.[50]

The second approach, that is, that section 954(c)(6) applies without limitation, is consistent with the same-country exception rules. It also appears consistent with the purpose of allowing the free movement of funds offshore, and absent a showing of an abusive purpose, appears to be appropriate.[51] Arguably, the fact that the Technical Corrections Bill denies the exclusion only where a payment creates a deficit suggests that there was no intent to create a limitation in other cases.

---

50 See discussion below regarding the anti-abuse issues.

51 In this case, any deficit created by the interest payment would not reduce subpart F income of the CFC payor and therefore, the Technical Corrections Bill, if adopted, would not prevent section 954(c)(6) from applying.

The third approach reflects the fact that the issue being addressed is really only one of timing. It would analyze the application of section 954(c)(6) based on future or historical income or assets of CFC 2. There are a variety of ways that could be accomplished. For instance, the payment could be exempt in the initial year, and then recaptured as subpart F income in a later year if, looking over some base period, it would have been allocable to subpart F income of CFC 2.[52] Conversely, the payment could be treated as subpart F income in the initial year, with a deduction being permitted if, looking over the base period, it would have been allocable to non-subpart F income. Alternatively, entitlement to the exclusion might be based on CFC 2's historical income or assets.

It is unclear whether Congress intended to create a rule in section 954(c)(6) that operated so differently from the rule of section 954(c)(3). It is possible that the different formulation came about by virtue of the fact that unlike section 954(c)(6), section 954(c)(3) does not require tracing to subpart F or non-subpart F income for same-country dividends, which by definition can never reduce subpart F income.[53] It is possible that the formulation was mere drafting error, especially as there seems to be no important policy goal achieved by requiring that dividends be attributable to non-subpart F income, as noted in the previous section of this Report.

Some of our members believe that adoption of the first approach would require an amendment of the statute, such that it no longer requires that payments be allocable to non-subpart F income but instead conditions the exclusion upon the payment not being allocable to

---

52 Cf. Treas. Reg. § 1.861-10(e), which uses a 5-year period to determine the foreign base period ratio for purposes of applying the CFC netting rules.

53 Section 954(c)(3)(B).

subpart F income. This would also be consistent with the proposed Technical Corrections Bill, which would bring greater parity to section 954(c)(6) and section 954(c)(3).

D. Ordering Rules.

Treasury Regulation § 1.904-5(k) provides ordering rules that we believe should be applicable for purposes of section 954(c)(6) to be consistent with the statute and the same-country rules. The ordering rules classify income in the following hierarchy: (i) rents and royalties, (ii) interest, (iii) subpart F inclusions and distributive share of partnership income and (iv) dividend distributions.[54] If an entity both receives and pays income in any of these categories, the income that it receives is classified prior to classifying income that it pays.[55] If an entity both pays and receives interest to and from a related party, the interest is netted to the extent of the smaller amount prior to classifying income under these rules.[56]

The following example illustrates the principles of these ordering rules, as we believe they would apply in the context of section 954(c)(6):[57] P Corporation is a U.S. corporation, which wholly owns D Corporation, a CFC organized in the Netherlands, and J Corporation, a CFC organized in Japan. D Corporation wholly owns G Corporation, a CFC organized in Germany. During the 2006 taxable year, prior to taking into account related-party payments, D Corporation earned $100 of interest from unrelated third parties classified as passive FPHCI and $200 of general limitation non-subpart F income earned in the active conduct of its business. J earned $300 of general limitation non-subpart F income in the active conduct of its business. Also during 2006, D Corporation paid $100 of interest to each of G Corporation and J

54 Treas. Reg. § 1.904-5(k)(2).

55 Treas. Reg. § 1.904-5(k)(2).

56 Treas. Reg. § 1.904-5(k)(2).

57 The example is based on Treasury Regulation § 1.904-5(l), Example 10 (see also Examples 9 and 11).

Corporation, J Corporation paid $100 in royalties to G Corporation for the use of intellectual property used in the active conduct of its business, and G Corporation distributed $150 to D Corporation.

(i) Pursuant to the ordering rules of Treasury Regulation § 1.904-5(k), income received by these corporations from their related parties is classified in the following order of priority: (i) royalty income, (ii) interest income, (iii) subpart F income and (iv) distributions.

(ii) The $100 of royalty income received by G Corporation should not constitute subpart F income to G Corporation under section 954(c)(6) because it is allocable to income of J Corporation that is neither subpart F income nor ECI.

(iii) The $100 of interest income received by each of J Corporation and G Corporation from D Corporation is then classified. The interest income is first allocable to D Corporation's $100 passive FPHCI on a proportional basis, and thereby $50 of each $100 interest payment would be classified as subpart F income under section 954(c)(6). The remaining $50 of each $100 interest payment is allocable to non-subpart F income of D Corporation and would therefore be eligible for exclusion under section 954(c)(6).

(iv) The subpart F inclusions of P Corporation are then determined. P Corporation would have a $100 subpart F inclusion, $50 attributable to the $100 interest payment made from D Corporation to G Corporation and $50 attributable to the $100 interest payment made from D Corporation to J Corporation.

The $150 distribution received by D Corporation from G Corporation is then classified, first as a $50 nontaxable distribution of the PTI of G Corporation, and then as a $100 dividend that would be non-subpart F income under section 954(c)(6) because it is paid out of E&P of G Corporation that is non-subpart F income.

E. Interplay of Payor Subpart F Exceptions.

The question arises as to the interplay of various other subpart F exceptions with section 954(c)(6). Existing rules coordinate the same-country exception with these other exceptions. Treasury Regulation § 1.954-1(a) indicates that the so-called de minimis exclusion from subpart F treatment and the so-called full inclusion rule are applied first to the payor in order to

determine whether any or all of the income of the payor could constitute subpart F income.[58] After allocating the payments to the classes of income of the payor, Treasury Regulation § 1.954-1(a)(5) and (7) indicate that the section 952(c) limitation and the high-tax exception of the payor are then applied to determine whether the remaining subpart F income of the payor could be excluded from subpart F income.[59] In some cases, the application of these rules produces anomalies, as discussed in the following examples.

> Example 6: Assume that CFC 1 operates in Germany, where it is subject to tax at the rate of 45 percent. Assume that it earns foreign base company income of $5,000. Assume that it makes a payment to CFC 2 of $1,000, leaving "net foreign base company income" of $4,000. All of CFC 1's net foreign base company income is considered high-taxed, leaving zero adjusted foreign base company net income.

The high-tax exception is determined after the allocation of expenses.[60] This means that even if the payor is in a high-tax jurisdiction, the recipient of related person payments will not be eligible for section 954(c)(6) with respect to interest, rents and royalties, unless the tax rate is sufficiently high that the high-tax exception would apply even if the related person payment were not deducted from the calculation. The same issue arises in the same-country context because of the requirement that the payment not be allocable to foreign base company income.[61] Although there may be added complexity, we believe that this is the incorrect result in both circumstances

---

58 Treas. Reg. § 1.954-1(a)(3)(adjusted gross foreign base company income is determined after the determination of de minimis and full inclusion provisions) and Treas. Reg. § 1.954-2(b)(4)(ii)(B)(1) and (5)(ii)(deductions may not reduce payor's adjusted gross foreign base company income).

59 Treas. Reg. § 1.954-1(a)(5).

60 The determination of the high-tax exception is after the allocation of expenses, including interest. Treas. Reg. § 1.954-1(a)(4) and (5).

61 Treas. Reg. § 1.954-2(b)(4)(ii)(B)(interest may not be excluded to the extent it is allocable to gross foreign base company income of the payor).

and we recommend modification of Treasury Regulation § 1.954-1(a)(4) and (d)(1) with respect to this result as to the payee for both section 954(c)(6) and same-country purposes.

Additional issues are raised in connection with the deficit recapture rule of section 952(c). The Technical Corrections Bill, if enacted, would provide that section 954(c)(6) does not apply to a payment to the extent that the payment creates or increases a section 952(c) deficit. This is illustrated by the following example:

> Example 7: Assume that CFC 1 has foreign base company income of $5,000 and has an E&P deficit, attributable to its active business, of $6,000. CFC1 makes an interest payment to related CFC 2 of $1,000.

The interest payment would not qualify for the exception under section 954(c)(6) due to the deficit in E&P (assuming enactment of the Technical Corrections Bill). As and when CFC 1 earns enough E&P to result in a positive E&P account, the section 952(c) deficit will be recaptured as subpart F income. In this case, however, it seems appropriate that the relevant U.S. shareholder of CFC 2 should be entitled to "recapture" as a deduction the previous subpart F income created by the payment by CFC 1 as and when subpart F income is "recaptured" in respect of CFC 1 under section 952(c)(2). Such a rule is necessary to prevent a double inclusion of income (that is, in respect of CFC 1 upon its own recapture and in respect of CFC 2 on receipt of the payment creating the deficit).

> Example 8: Assume that in 2006 CFC 1 has a section 952(c) deficit that is recaptured as subpart F income in 2007 where the only income of CFC 1 is non-subpart F income. Also in 2007, CFC 1 makes an interest payment to CFC 2 of $1,000.

The issue is whether CFC 2 may treat the interest payment as eligible for the section 954(c)(6) exclusion in the year of recapture (2007). Under the existing regulations,[62] a distinction is made between "adjusted gross foreign base company income" and "adjusted net foreign base company income." Under the regulations, items that are recharacterized under section 952(c) are taken into account as adjusted *net* foreign base company income. Under the same-country rules, payments may not reduce "adjusted *gross* foreign base company income," but there is no limitation on the reduction of "adjusted *net* foreign base company income." Thus, the implication is that the interest payment is not considered to be allocable to subpart F income, since it is part of adjusted net foreign base company income. If the intent is to follow the same-country rules, the interest payment in Example 8 should either be considered not allocable to subpart F income or allocable to non-subpart F income, depending on which scheme is ultimately adopted.[63]

F. Factoring Income.

1. Background.

As noted, section 954(c)(6) explicitly includes "factoring income that is treated as IEI" as a category of income that can benefit from the exclusion. The section does not explicitly include related person factoring income described in section 864(d). Subject to the adoption of an anti-abuse rule as described below and in the legislative history of the Technical Corrections Bill, We believe Treasury should clarify that related person factoring is nonetheless within the ambit of the exception. In this regard, a distinction must be drawn between the types of transactions covered by section 864(d) and those covered by the IEI rules.

---

62 Treas. Reg. § 1.954-1(a)(7).

63 Treas. Reg. § 1.954-2(b)(4)(ii)(B)(with respect to interest) and Treas. Reg. § 1.954-2(b)(5)(ii)(A)(with respect to rents and royalties).

Section 954(c)(1)(E) provides for the IEI category of FPHCI for purposes of subpart F. IEI includes income (including discount or service fee income, but excluding stated interest) derived from the acquisition and collection or disposition of a factored receivable.[64] A "factored receivable" is an account receivable or other evidence of indebtedness arising out of the sale of property or performance of services (whether issued at a discount and whether or not bearing stated interest) if the evidence of indebtedness is acquired by a person other than the person who sold the property or provided the services.[65] Implicit in the foregoing definition is that the transaction involves a transfer that is not itself a financing transaction for federal income tax purposes where the factor's income would be interest.

Section 864(d) treats related person factoring income (income from a trade or service receivable acquired from a related person) as interest on a loan to the obligor for purposes of foreign tax credit limitation and subpart F.[66] In order to be subject to the rules of section 864(d), the receivable acquired must be a "trade or service receivable," which is defined in section 864(d)(3) as an evidence of indebtedness arising out of the disposition by a related person of property described in section 1221(a)(1) (inventory-type property) or the performance of services by a related person. For these purposes, income includes stated interest, discount and service fees.[67] Notably, related person factoring income (along with income treated as interest under the

---

64 Treas. Reg. § 1.954-2(h)(4)(i).

65 Treas. Reg. § 1.954-2(h)(4)(iii). IEI factoring is in some respects broader than section 864(d) factoring as there is no requirement for a related-party transaction, and the definition of property is not limited to inventory-type property. In other respects, IEI factoring is narrower in that it requires an actual acquisition of an obligation (not just an interest in an obligation) and does not explicitly include indirect or surrogate transactions.

66 Section 864(d)(2).

67 See Treas. Reg. § 1.864-8T(a)(1).

surrogate factoring rule of section 864(d)(6)) is excluded from the definition of IEI.[68] Thus, in general, IEI can be seen as applying to unrelated-party factoring transactions, while section 864(d)(1) can be seen as applying to related-party factoring transactions.

> Example 9: Assume USP owns CFC 1 and CFC 2. USP sells inventory property to CFC 1 and sells to CFC 2 the receivable created from the sale. The transaction would be subject to section 864(d)(1), and the discount income earned by CFC 2 would be treated as interest income from a loan to CFC 1. The transaction would be excluded from the definition of "factoring income" under Treasury Regulation § 1.954-2(h)(4), and thus would not be IEI for purposes of section 954(c)(1)(E).

It is clear from the face of section 954(c)(6) that the new exception covers unrelated person factoring income. As a matter of statutory interpretation, the exception should also cover related person factoring income described in section 864(d). Section 864(d)(5)(A) lists particular subpart F exceptions that do not apply to related person factoring income, but does not create a broad statutory exclusion and does not list section 954(c)(6). However, given the absence of section 864(d) in the text of the new provision, there could be an argument that related person factoring is not covered.

Congress seems to have intended that section 864(d) would not trump all subpart F exclusions. Section 864(d) was introduced by the 1984 Tax Reform Act ("1984 Act").[69] The Joint Committee report to the 1984 Act provides:

---

68 Treas. Reg. § 1.954-2(h)(4)(ii)(A). This is true even if the related person factoring income is treated as not described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7).

69 P.L. 98-369, 98 Stat. 494 (1984).

> Congress intended to subject related person factoring income to tax if that income is earned by any controlled foreign corporation with earnings and profits. Therefore, related person factoring income does not benefit from exceptions to the subpart F rules.[70]

In contrast to a blanket prohibition against relying on subpart F exceptions like that described in the legislative history, the statute itself uses a provision-by-provision override approach. Thus, section 864(d)(5)(A) currently overrides the de minimis exception of section 954(b)(3)(A), the export financing exception of section 954(c)(2)(B) and the same-country exception of section 954(c)(3)(A). The statute as initially adopted also overrode a now-repealed subpart F banking exception in existence in 1984; however there is no indication that Congress intended for the section 864(d) factoring treatment to override the exception for active financing income provided by section 954(h).[71]

Given that Congress did not carve out section 954(c)(6) from the related person factoring rules, it seems correct to say that the new exception applies to such transactions under a plain reading of section 864(d)(2)(B). Indeed, the reference to related person factoring in the legislative history of the Technical Corrections Bill suggests that Congress is aware of the issue and intends related person factoring to be included in the new provision.[72] However, the fact that section 954(c)(1)(E) factoring is explicitly provided for in the new statute and section 864(d) factoring is not, in conjunction with the legislative history cited above, could be seen to imply

---

70 Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369), JCS-41-84 ("1984 Bluebook") at 368.

71 The list of overrides in section 864(d)(5) was not amended at the time of introduction of section 954(h). Furthermore, neither the committee reports nor the Joint Committee explanation of section 954(h) includes any reference to section 864(d), despite numerous inclusions of factoring income in section 954(h). An analogous situation is presented by Congress' decision not to add CFC look-through to section 964(e)(2), which provides that the same-country exception to subpart F does not apply to gains on the sale of a CFC's shares by another CFC that are treated as dividends under section 964(e)(1).

72 See discussion *supra,* in text accompanying footnote 16.

that section 864(d) factoring is not covered. We feel it is appropriate for Treasury to clarify that section 954(c)(6) covers both types of factoring.

2. Source of Payor.

As noted above, section 954(c)(6) expressly provides that interest includes income treated as IEI under section 954(c)(1)(E). Unlike section 864(d)(1), the IEI provisions do not characterize factor discount as "interest" for purposes of subpart F generally. And unlike section 864(d), which explicitly treats the interest as paid by the obligor, the IEI rules do not specify the source of the income received by the purchaser of the receivable. Since section 954(c)(6) applies only to payments between CFCs, it is necessary to consider the source of the factoring discount income to know whether the new exception will apply to a given factoring transaction.

Several authorities have considered this question in the past, without conclusive effect. In an early case, the Tax Court addressed the characterization of a factoring arrangement involving the sale of conditional automobile sales contracts by a dealer to an unrelated factor.[73] Following the sale of the contracts, the automobile buyers made payments to the factor. The Tax Court noted: "The petitioner simply steps into the shoes of the dealer when it purchases the conditional sales contracts and notes from the dealer."[74] The court dismissed the Service's allegation that the discount represented interest to the factor during the period prior to the time that stated interest accrued on the payment, noting that "the buyer is not interested in borrowing

---

73 Elk Discount Corp. v. Comm'r, 4 T.C. 196 (1944). This case is cited and discussed in the Committee Reports to the 1984 Act that introduced section 864(d) factoring.

74 Id. at 202.

money from the factor."[75] This case supports an argument in favor of factoring income being sourced with the obligor of, rather than the seller of, the receivables.

The IRS Chief Counsel also addressed this issue in General Counsel Memorandum ("GCM") 39220 (dated May 31, 1983, issued in conjunction with PLR 8338043). That GCM concluded that a foreign subsidiary that factors a U.S. parent's trade accounts receivable is considered to be performing a service for its parent and receives a commission for its service.[76] By characterizing the factoring income as commissions, the GCM would have caused the source of the income to be determined by the location of the services provided, rather than by reference to the seller of the receivable. However, GCM 39220 was revoked in 1987 by GCM 39652, which indicated that the issue of the characterization of related-party factoring income was being reconsidered.[77]

In discussing the state of prior law in the Joint Committee explanation of the 1984 Act introducing section 864(d), the Joint Committee stated that factoring income in a transaction involving a CFC factor related to the seller arguably could have been treated as interest or as the performance of services for a related party.[78] Section 864(d), as previously discussed, treats related-party factoring as interest on a loan to the obligor. However, that provision was designed

---

75 Id. at 201.

76 The Service indicated in the GCM that an interest component might be imbedded in the arm's-length fee paid by the seller of the receivable to the purchaser.

77 PLR 8338043 was concurrently revoked by PLR 8748030.

78 1984 Bluebook at 364.

to curtail certain abusive transaction between related parties, and the same policy concerns are not present in unrelated factoring transactions.[79]

Treasury considered the character of factoring discount outside section 864(d) in the preamble to the 1995 Treasury Regulations relating to the IEI provisions under section 954. In Treasury Decision 8618, Treasury rejected a comment that factoring discount was distinguishable from an interest equivalent and was more similar to other types of income, such as compensation for services. The preamble stated:

> It is true that the income attributable to the discount at which a controlled foreign corporation acquires a receivable reflects not only the time value of money, but also certain other elements (for example, collection risk and cost). However, the factoring income derived by the controlled foreign corporation is analogous to interest income derived from a loan made by a bank, which reflects not only the time value of money, but also the other elements of the discount income received in the factoring transaction described above.[80]

The Preamble did not discuss whether the source of the interest equivalent should be with the obligor or the seller of the receivable, and such a determination was not required for purposes of the regulations then being issued. However, it seems appropriate that the deemed loan giving rise to the interest equivalent be a loan from the seller rather than the obligor, since it is the seller that is paying the discount amount in exchange for the use of the factor's money.

Since IEI factoring is explicitly included in "interest" under section 954(c)(6), it is unnecessary to determine the character of the discount income as interest or service income. On balance we believe that the source of factoring income should turn on whether the relationship

---

79 See generally 1984 Bluebook 364-366. See also Roin and Rosenbloom, "Bringing foreign profits back to the U.S. by factoring: how to use this technique," *Journal of Taxation*, p. 164 (March 1983).

80 T.D. 8618, 60 FR 46500 (Sept. 7, 1995).

between the factor and the owner of the receivable constitutes a financing in the nature of a "repo," or instead constitutes a true sale. In the former case, we would favor a rule that sources the income to the residence of the seller/financed party, since it is appropriate to view such a factoring arrangement as a transaction between the factor and the seller of the receivable. In the latter case we would treat the obligor as the source of the income.[81] We note that our approach would conflict with section 864(d)(1) in cases where the factored receivable is a related party receivable but the transaction constitutes, in substance, a financing rather than a true factoring transaction. Nevertheless, we believe this is the better rule for purposes of section 954(c)(6).

G. What is a Dividend?

1. Background.

Regulations should define "dividend" for section 954(c)(6) purposes. Several provisions of the Code specify that amounts will be recharacterized as dividend income. Specifically, section 304 (related-party sales of stock), section 1248 (sales of CFCs) and section 964(e) (sales of stock by CFCs treated as dividends by analogy to section 1248) each recharacterizes income from the sale of stock as a dividend. Similarly, boot in certain reorganizations can be recharacterized as a dividend.[82] In most of the transactions that give rise to dividends, sale treatment would generate subpart F income under section 954(c)(1)(B). This section reviews whether it is consistent with the purposes of section 954(c)(6) to treat the deemed dividends arising in these transactions as dividends eligible for exclusion. We note that, consistent with the legislative history, section 965 (a similar "pro-taxpayer" provision) included in the definition of

---

81 We note, however, that the presence of stated interest could disqualify the discount income from IEI treatment, which would have the effect of changing the source of the income from the seller to that of the obligor. Treas. Reg. § 1.954-2(h)(4)(ii)(B) (IEI rules not applicable to obligations acquired on or after the commencement of interest accrual where there is stated interest greater than 120 percent or greater of the short-term AFR.)

82 See section 356(a)(2).

dividend "cash amounts included in gross income as dividends under sections 302 and 304."[83] Unlike section 965, section 954(c)(6) has no legislative history providing guidance on this point.

Example 10: Assume USP owns CFC 1 and CFC 3, and CFC 1 owns CFC 2. CFC 1 sells CFC 2 to CFC 3. Assume that CFC 3 has E&P equal to the proceeds. Section 304 characterizes the payment from CFC 3 as a dividend from CFC 3 to CFC 1 (or in the absence of E&P, from CFC 2).

Example 11: Assume CFC 1 sells CFC 2 to a third party. The payment is characterized as dividend under section 964(e) to the same extent that it would be characterized as a dividend under section 1248 if CFC 1 were a U.S. shareholder.

2. Discussion.

The purpose underlying provisions that recast sale proceeds as dividends is generally to prevent taxpayers from converting ordinary income into capital gain. These provisions were not drafted with consideration of the purpose underlying section 954(c)(6). There is thus some room for debate whether sale proceeds recast as dividends ought to be considered "dividends" for purposes of section 954(c)(6).

In the case of section 964(e) amounts, it can be argued that Congress must have assumed that the amount recharacterized as a dividend would fall into the definition of "dividend" at least for purposes of the same-country exception of section 954(c)(3). Otherwise, Congress would not have enacted section 964(e)(2), explicitly removing the recharacterized amount from the reach of section 954(c)(3).[84] Thus there is an argument that, without clarification from Congress that the

---

83 H.R. Conf. Rep. No. 108-755, at 314-15; see also Notice 2005-10, 2005-6 I.R.B. 474.

84 See Fuller, U.S. Tax Review, 42 Tax Notes Int'l 1145 (June 26, 2006).

recharacterized amount is also excluded from section 954(c)(6), 964(e) "dividends" qualify for the new exception. One might argue that since there is no reduction of E&P for amounts associated with either section 1248 or section 964(e), such amounts might not be treated as dividends for purposes of section 954(c)(6).[85] However, because PTI travels with the purchaser of a CFC's stock,[86] the possibility of duplicating earnings is reduced. Moreover, sales proceeds can be converted into dividend income by declaring a dividend prior to the time a contract of sale is entered into, thereby sidestepping any actual dividend requirements.[87] For these reasons, we believe that amounts treated as dividends for other purposes of the Code should be treated as dividends for purposes of section 954(c)(6).

H. Partnership Distributions and Payments.

1. Background.

The exponential growth of partnerships and hybrid entities resulting from the adoption of the entity classification regulations creates a need to address the characterization of partnership

---

85 See Rev. Rul. 90-31, 1990-1 C.B. 147 (earnings and profits of a CFC are decreased by amounts previously included in gross income of the transferor shareholder as a dividend under section 1248 at the time of the actual distribution of the section 951(a)(1)(A) amount attributable to such section 1248 dividend) and section 959(d) and (e); cf. section 312(a). Under newly proposed regulations, section 304 transactions would cause a reduction in E&P. Prop. Reg. § 1.959-3(h)(4). The Preamble to those proposed regulations indicates that Treasury is already concerned with the possibility that the new provision may require additional section 959 regulations:

> [I]n addition, the IRS and Treasury Department are currently studying the new section 954(c)(6) rule enacted by the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222), which provides for look-through treatment of payments between related CFCs under the foreign personal holding company rules of section 954(c), to determine whether that rule requires any additional regulatory guidance under section 959. Any such guidance will be included in a subsequent project.

REG-121509-00; 71 F.R. 51155-51179 (August 29, 2006).

86 Treas. Reg. § 1.959-2(a) (the exclusion applies with respect to any other United States shareholder who acquires from such United States shareholder or any other person any portion of its interest, "but only to the extent the acquiring shareholder establishes to the satisfaction of the district director the right to such exclusion.")

87 Boot dividends under section 356(a)(2) arising from internal transactions give rise to some of the same issues.

income and corresponding distributions and payments. Separate issues arise in the context of payments received by a partnership and payments made by a partnership. The issue is complicated by the fact that there is a history of treating partnerships as separate entities for subpart F purposes in spite of the generally-applicable approach of treating partnerships as aggregates.[88]

2. Payments Received by Partnerships.

The situation that is the subject of this section can be illustrated by the following example:

> Example 12: USP has two subsidiaries, CFC 1 and CFC 2, which are organized in the same jurisdiction. Assume an entity, FPS, which is classified as a partnership for U.S. tax purposes, and whose partners are CFC 1 and CFC 2, receives an interest payment from a corporation that is also a CFC with respect to USP and is related to CFC 1 and CFC 2.

The issue arises whether the interest payment should be characterized as a payment between related CFCs, since FPS's income passes through to CFC 1 and CFC 2. This issue is largely a question of whether the aggregate or entity approach should be used in characterizing the payment and the relationship of the CFC payor to the partners of FPS.

The issue is not entirely clear in the same-country context because no regulation specifically addresses this issue. However, following the Brown Group case, several regulations

---

88 For instance, a U.S partnership can be a U.S. shareholder under section 957(c). See also MCA, Inc. v. United States, 685 F.2d 1099, 1104-05 (9th Cir. 1982) (refusing to expand the pre-1987 definition of "related person" to include controlled partnerships). Brown Group, Inc. v. Commissioner, 77 F.3d 217, Doc 96-2911, (8th Cir. 1996), rev'g 104 T.C. 10, (1995), on motion for reconsideration, 102 T.C. 616 (1994) (character of an item must be determined at partnership level under Subpart F).

were modified that can be viewed as reflecting the view that a partnership should be treated as an aggregate of its partners in this context.

Specifically, Treasury Regulation § 1.702-1 states that each partner must take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.[89] Thus, if any partner is a CFC, items of income that would be gross subpart F income if separately taken into account by the CFC must be separately stated for all partners. A plain reading of this provision suggests that if the item is not subpart F income, it need not be separately stated. However, this does not address whether it is appropriate to look through the partnership to the underlying CFC payor to make the determination as to whether it is subpart F income or not.

Treasury Regulation § 1.952-1 states that a CFC's distributive share of any item of income received by a partnership will have the same subpart F categorization under section 951(a) as it would have if it had been received by the CFC directly.[90] However, while this does suggest that the aggregate approach is the right way to analyze a transaction in order to determine whether an item is subpart F income, it does not specifically address the determination of whether an amount received by a partnership would be eligible for the new exclusion. The regulation then cross-references certain provisions elsewhere in the subpart F regulations addressing the treatment of a distributive share of partnership income under various provisions of subpart F.

---

89 Treas. Reg. § 1.702-1(a)(8)(ii).

90 Treas. Reg. § 1.952-1(g).

Treasury Regulation § 1.954-1(g), entitled "Distributive share of partnership income," provides the rule for determining the extent to which a CFC's distributive share of any item of a partnership's gross income would have been subpart F income if received directly. Under this section, if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, such determination shall be made by reference to such CFC and not by reference to the partnership.[91] Thus, to the extent it is necessary to determine whether a payment is from a related party, it is appropriate to look to the CFC, not the partnership.

Read together, both provisions reflect the aggregate view of partnerships and there is no reason to depart from this approach under section 954(c)(6). To this end, we recommend that Treasury Regulation § 1.954-1(g) be amended to clarify that an allocation of income from a partnership to a partner that is a CFC may be eligible for exclusion under section 954(c)(6).

3. Payments by a Partnership.

Under section 954(c)(6), there is no specific rule addressing payments by partnerships. However, a 1989 amendment to section 954(c)(3)(A) granted Treasury regulatory authority to treat interest, rent and royalty payments made by a partnership to a related CFC as having been made by the partners in proportion to their respective interests in the partnership for purposes of

---

91 By contrast, each of Treas. Reg. §§ 1.954-2(a)(5), -3(a)(6), and -4(b)(2)(iii) contain specific rules applicable for the exclusions under subpart F for amounts received in an active trade or business and the exclusions applicable for foreign base company service income and sales income. While there is a specific provision dealing with payments by partnerships, there is no rule with respect to payments to or income allocable to a partnership in the context of the same-country rules.

determining whether the same-country exception is applicable to such payments. This provision was implemented in T.D. 8618.[92]

Consider the following example:

> Example 13: USP owns CFC 1, CFC 2, and CFC 3, all of which are organized in the same country. CFC 1 and CFC 2 are equal owners of FPS, which is engaged in a non-U.S. manufacturing business and earns $1,500 of net income for the year. Assume FPS receives a dividend of $500 from a CFC that it wholly owns, and makes an interest payment of $1,000 to CFC 3.

In order to determine whether the interest payment made by FPS to CFC 3 qualifies for the same-country exclusion, it would be necessary to determine whether the payment gives rise to a deduction for U.S. tax purposes. If it does, the payment must be allocable to the corporate partners (in this case, CFC 1 and CFC 2) under section 704(b). If there is no deduction, a partnership item reasonably related to the payment must be allocable to CFC 1 and CFC 2 under an existing allocation in the partnership agreement. Applying those rules, and absent a special allocation, CFC 1 and CFC 2 would each be allocated $1,000 of gross income, and an interest deduction of $500. To the extent of the interest deduction allocated to CFC 1 and CFC 2, CFC 3 would be able to exclude the interest under the same-country exception. It seems sensible to

---

[92] See Treas. Reg. §§ 1.954-2(b)(4)(i)(B) and (5)(i)(B). The Preamble to those regulations states: "To reflect amendments to section 954(c)(3)(A) by the Revenue Reconciliation Act of 1989, the final regulations provide that if a partnership with one or more corporate partners makes a payment of interest, rent or royalties, the interest, rent or royalty payment will be treated as paid by a corporate partner to the extent the payment gives rise to a partnership item of deduction that is allocable to the corporate partner or to the extent that a partnership item reasonably related to the payment would be allocated to the corporate partner under an existing allocation under the partnership agreement. To the extent the payment is treated as made by the corporate partner, it will be excluded from the foreign personal holding company income of the recipient if the corporate partner otherwise satisfies the conditions of section 954(c)(3)(A)." T.D. 8618, 60 FR 46500-46530 (September 7, 1995).

apply this paradigm in the context of section 954(c)(6) as well. Although there is no specific guidance in either the statute or the legislative history, this analysis would appear to be within the scope of the interpretative guidance that could ordinarily be issued under section 954(c)(6).[93] Because there is already a similar rule in the same-country area, Treasury should not be precluded from implementing the same rule here.

With respect to the passive dividend income earned by FPS, there is a question of how to determine whether the interest payment by the partnership is allocated to the non-subpart F income of the CFC partners, and how that allocation affects the analysis of the exclusion for the related party interest payment.[94] Assuming that the related person look-through rules of section 904(d) are adapted to the context of section 954(c)(6), this might be an area for possible clarification.

I. Anti-Abuse Issues.

1. Background.

The statute provides authority for the issuance of anti-abuse regulations, both as enacted and as the Technical Corrections Bill[95] would amend it. As enacted, the section directs the Secretary "to prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph."[96] The Technical Corrections Bill would expand the regulatory

---

93 See section 7805(a) (permitting the Secretary to "prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue").

94 See Treas. Reg. § 1.904-5(h) (a partner's distributive share of partnership income is in a separate category to the extent that it is a share of income earned or accrued by the partnership in such category; payments to a partner not acting in a capacity as a partner are in a separate category to the extent that the payments are interest, rents, or royalties and the partner receiving the payment owns 10 percent or more of the value of the partnership).

95 The Technical Corrections Bill is discussed in section II. B., above.

96 Section 954(c)(6)(A).

authority to "prescribe such regulations as may be necessary or appropriate to carry out this paragraph, including such regulations as may be necessary or appropriate to prevent the abuse of the purposes of this paragraph." The legislative history of the Technical Corrections Bill explains that Congress intends regulations to include rules to prevent the exception from applying to transactions "the net effect of which is the deduction of a payment, accrual, or loss for U.S. tax purposes without a corresponding inclusion in the subpart F income of the CFC income recipient, where such inclusion would have resulted in the absence of" section 954(c)(6).[97] As an example of such a transaction, the Joint Committee on Taxation mentions transactions involving interest deemed to arise from related party factoring arrangements pursuant to section 864(d).

> Example 14: Assume that USP sells goods to CFC 1 and takes a trade receivable of $100. USP subsequently sells the receivable to CFC 2 at a loss of $5. The sale, apart from the application of section 267, would generate a loss of $5. The discount earned by CFC 2 would ordinarily qualify for CFC look-through treatment, sourced by reference to the residence of the obligor, here CFC 1.

We understand the above example to be the type of situation referenced by Congress in the Technical Corrections Bill legislative history. While the text of the legislative history itself should be helpful to the IRS in combating such planning, we regard this example as inconsistent with the purpose of the provision (namely, facilitating redeployment of active earnings). As such, we believe regulations designed to forestall the deferral of factor income resulting from an arrangement that creates a U.S. deduction are within the scope of even the more conservative

---

[97] Staff of the Joint Committee on Taxation, Technical Explanation of the "Estate Tax and Extension of Tax Relief Act of 2006 ("ETETRA")," as Introduced in the House on July 28, 2006, JCX-33-06.

regulatory authority in the provision as originally enacted.[98]

2. Scope of the Anti-Abuse Provision.

The initial question in formulating an anti-abuse regulation must be whether it should be broad and general, or whether it should it specify the situations to which it is directed. There are obvious advantages to each approach. A general anti-abuse provision such as one stating that "transactions having as a principal purpose the abuse of this section shall be disregarded" would be effective in thwarting a broad array of transactions.[99] A somewhat more targeted approach would be to adopt an anti-abuse rule similar to that contained in the partnership anti-abuse rules that would deny the benefit of the exclusion to any transaction, a principal purpose of which is to reduce the present value of the U.S. shareholder's aggregate federal tax liability in a manner that is inconsistent with the purposes of section 954(c)(6).[100]

A narrowly-tailored rule such as that contained in the section 894 regulations might also be appropriate, given that the statute is generally taxpayer favorable.[101] Some of our members

---

98 However, we believe that foreign to foreign related party factoring that does not create a U.S. deduction should be eligible for deferral under Section 954(c)(6) to the extent it meets the other requirements of the section.

99 For an example of a broadly-worded anti-abuse regulation, see Treas. Reg. § 1.7701(l)-3(b)(2)(ii) (a redemption treated as a dividend as a result of section 302(d) does not make applicable fast-pay stock treatment unless "there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement").

100 See Treas. Reg. § 1.701-2(b) (if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K).

101 See Treas. Reg. § 1.894-1(d)(2)(ii)(C)(1) and (2). The proposed regulations had provided the Commissioner with the authority to recharacterize, for all purposes of the Internal Revenue Code, all or part of any transaction (or series of transactions) between related parties if the effect of the transaction was to avoid the principles of Treas. Reg. § 1.894-1(d)(2)(ii)(B). T.D. 8999, 67 FR 40157, 40159 (June 12, 2006). In recognition of the potentially overbroad reach of the proposed provision, Treasury narrowed the scope of the final regulations and clarified the circumstances under which the anti-avoidance provision will

believe that it would seem incongruous to engraft a broad anti-abuse rule onto a statute that is designed to permit taxpayers relative freedom to redeploy their active earnings without subpart F inclusion. These members would support a narrow rule, with Treasury and the IRS reserving the right to extend the anti-abuse rule by notice to other structures with notice and comment.

3. Transactions That Should Be Analyzed.

Apart from the foregoing, the legislative history does not discuss what was intended by the regulatory grant. Regardless of the approach adopted, it will be necessary to identify transactions that are within or outside the scope of the anti-abuse provision. Generally, we believe transactions that change the character of the underlying income and which are effected through a conduit vehicle are within the scope of the regulatory grant. Consider the following example:

> Example 15: USP owns CFC 1, which owns CFC 2. CFC 1 is incorporated in Luxembourg. CFC 2 is incorporated in Germany. FC is a German corporation, which is not a CFC, but which is a related person under section 954(d)(3). In order to exclude from subpart F income an interest payment by FC to CFC 1, USP causes the payment to be made through CFC 2. Thus, CFC 2 receives an interest payment from FC that is excluded from subpart F income under the same-country exemption (but which would not qualify under section 954(c)(6) because it is not from a CFC). CFC 2 then pays interest (or a dividend) to CFC 1 which is not subject to net taxation by Luxembourg and which is intended to qualify under section 954(c)(6).

---

apply. Under the final regulations (which apply to transactions involving related parties), the Commissioner has authority to recharacterize a transaction only if four specific conditions are met.

In Example 15, USP has used section 954(c)(6) and section 954(c)(3) together to convert the character of income. Although an argument might be made that this is not inherently abusive, we believe that regulations could disallow the benefits of section 954(c)(6) in this type of situation.

Section 954(c)(6) can also be used to maximize a U.S. taxpayer's use of foreign tax credits. Consider the following examples:

> Example 16: USP owns CFC 1, a Cayman Islands company, which conducts business in France through a disregarded entity. USP also owns CFC 2. CFC 1 transfers the French disregarded entity to CFC 2 in exchange for a loan. The effect of the transaction is to create two separate pools of earnings, one with low-taxed income and the other with high-taxed income.
>
> Example 17: USP owns CFC 1, which owns CFC 2. Both CFC 1 and CFC 2 have an effective tax rate of 10 percent. USP also owns CFC 3, which historically has suffered losses. USP transfers CFC 1 and CFC 2 to CFC 3 in a tax-free transaction and files appropriate gain recognition agreements. Subsequently, CFC 2 pays dividends to CFC 1, which in turn pays dividends to CFC 3. Because of CFC 3's ongoing losses, the effective tax rate of dividends paid to CFC 1 increases from 10 percent to 40 percent. Subsequently CFC 3 makes a dividend distribution to USP.

In Examples 16 and 17, USP has used the new provision to create high-taxed income and in Example 16, to separate high- and low-tax income. However, of the two, Example 16 seems less offensive as it involves the transfer of an entire business. Example 17 might be viewed as more offensive if the transfer of the loss generating entity were merely transitory. However,

many of our members believe that rules dealing with foreign tax credit planning should be left to the regulations under sections 901 and 902, and that it would be inappropriate to use the grant of regulatory authority under section 954(c)(6) to regulate this activity. While new section 954(c)(6) may make it easier for taxpayers to accomplish cross-crediting, to make that observation does not necessarily lead to the conclusion that such practices constitute an abuse of the new rule.

The new provision might also encourage taxpayers to convert non-CFCs into CFCs in order to take advantage of the more generous look-through rules.

> Example 18: USP has subsidiaries CFC 1 and CFC 2. CFC 1 owns 50 percent of a foreign corporation, FC. The balance is owned by a publicly-traded corporation. In order to cause FC to become a CFC, it purchases a share in the owner of the FC. Under the attribution rules, it is deemed to own more than 50 percent of FC, making it a CFC.

We believe that this Example 18 should not be considered an abuse of section 954(c)(6).[102] Regardless of which regulatory approach is taken, it is important that guidance be published as to which transactions are intended to be covered by the anti-abuse rule and also important to identify routine transactions that should not be subject to the rule.

J. Transition Issues.

1. Background.

The effective date of new section 954(c)(6) creates at least two transition issues. The first issue is whether taxpayers should be allowed to "elect out" of the provision for transactions that

---

[102] Regarding Example 19, cf. Treas. Reg. § 1.701-2(f), Example 3 (use of U.S. partnership to convert a foreign corporation into a CFC not subject to partnership abuse of entity rule).

occurred prior to date of enactment, but within the effective date of the statute. The second issue is whether taxpayers should be granted additional flexibility in restructuring to better cope with the temporary nature of the new provision.

2. Transactions Occurring Prior to the Date of Enactment.

The CFC look-through provision was added in Conference without having been in the Senate bill and enacted on May 17, 2006.[103] Most taxpayers had no advance notice of the new rule, which was made effective for taxable years beginning on or after January 1, 2006. Transactions may have occurred during the period prior to the date of enactment but during the taxable year in which the new rules went into effect. For example, a transaction may have occurred in January 2006 that the taxpayer anticipated being a fully taxable dividend with associated foreign tax credits. However, with the adoption of the CFC look-through rule in May 2006, the dividend will not be taxable.

Given that taxpayers may have detrimentally relied on prior law when undertaking transactions prior to enactment with a retroactive effective date, it would be fair to give taxpayers in this situation the ability to elect out of section 954(c)(6) for transactions that occurred prior to May 17, 2006. In fact, it is possible that Congress merely overlooked the possibility that a retroactive effective date could burden some taxpayers, based on the belief that the new rules were generally taxpayer-favorable. It may be the case that this issue cannot be addressed by regulations and instead requires a statutory change to be effective.[104] In any case, it would be prudent to confirm the regulatory grant with a statutory amendment.

---

103 See H.R. Conf. Rpt. 109-455.

104 A similar technical correction was made to the so-called "10/50" rules enacted in 2004.

3. Sunset Provisions.

The legislation is effective for a three-year period ending on December 31, 2008. The temporary nature of the provision as written is troublesome in that many taxpayers will want to restructure their foreign operations in order to take advantage of the provision, but will be concerned that if the legislation is not extended, it may be difficult or impossible to undo the restructuring. For example, a taxpayer that has used an international holding company with disregarded entities for its foreign operations will either need to transfer the underlying assets to entities regarded as corporations or elect regarded corporate status for its existing entities in order to take advantage of the new rules. If the legislation is not extended past 2008, it would be necessary for the taxpayer to "un-check the box" or otherwise reorganize in order to become tax-efficient again. The 5-year restriction on new check-the-box elections[105] will deter taxpayers from taking the initial step, for fear of being unable to unwind the new structure.

To eliminate this deterrent to the sort of planning that is consistent with the purpose behind the new provision, we recommend that a transitional rule be added to the entity classification regulations to allow taxpayers to revoke entity classification elections in limited circumstances. By analogy, there is precedent for similar transitional relief in the consolidated return area: in cases where there is a change to the consolidated return rules adversely affecting a taxpayer's tax liability, the taxpayer can elect out of consolidated return treatment.[106]

---

105 See Treas. Reg. § 301.7701-3(c)(1)(iv).

106 See Treas. Reg. § 1.1502-75(c)(1)(ii) (notwithstanding requirement to file consolidated return, Commissioner will ordinarily permit group to discontinue filing consolidated returns if amendments to Code and regulations taking effect during the taxable year adversely affect the group's tax liability compared to the tax liability the group would have if its members filed separate returns).