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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR KENNETH J. RUBIN
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FROM: Barbara A. Felker
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SUBJECT:

This Field Service Advice responds to your memorandum dated February 22, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

USParent =

USSub1 =
USSub2 =
FSub =
FCorp1 =
FCorp2 =
Country X =
d =
e =
year 1 =
year 4 =
year 5 =

year 9 =
f =
g =

ISSUE

For purposes of section 902 of the Internal Revenue Code, where FSub settled a year 4 foreign tax controversy by paying additional foreign income tax in year 9, must FSub adjust its pools of post-1986 undistributed earnings and post-1986 foreign income taxes in year 9, or may USParent recompute those pools for year 4 and claim a refund of U.S. tax attributable to additional deemed-paid foreign tax credits based on the recomputed year 4 pools?

CONCLUSION

Because the year 4 taxes accrued and paid in year 9 differ from the amounts claimed in year 4 as credits under section 902 of the Code by FSub's U.S. shareholder, there has been a foreign tax redetermination for purposes of section 905(c) and Treas. Reg. §1.905-3T(c) and (d)(2). Since none of the exceptions of Treas. Reg. §1.905-3T(d)(4) and (7) applies, FSub must adjust its pools of post-1986 undistributed earnings and post-1986 foreign income taxes in year 9. USParent may not redetermine its U.S. tax for year 4.

FACTS

USParent, USSub1, USSub2, and other affiliates filed a consolidated federal income tax return for year 4, a taxable year beginning before January 1, 1998. In that year, USSub1 owned 100% of the stock of USSub2, which owned 100% of the stock of FSub, a Country X corporation.

In year 1, the government of Country X sold the entire interest in FCorp1 to FSub and FCorp2, a foreign corporation unrelated to FSub. FCorp2 was owned by a U.S. corporation. FSub and FCorp2 each received d% ownership of FCorp1. The sale was contingent upon FSub and FCorp2 each selling more than half of its newly acquired interest in FCorp1 to Country X citizens or entities. Pursuant to this requirement, in a series of sales beginning in year 1 and continuing into year 4, FSub and FCorp2 each sold equivalent amounts of shares in FCorp1 so that their individual ownership, after the series of sales was completed, was equal to e%. That amount was more than 10% and less than 25% of the stock of FCorp1. As required, all of the sales were made to Country X citizens or entities. None of the purchasers was a U.S. shareholder as defined in section 951(b) of the Code.

Accordingly, after the series of sales was completed in year 4, FCorp1 was a non-controlled section 902 corporation for purposes of section 904(d).

In year 4, FSub realized gain on its sale of FCorp1's stock in the amount of $f. FSub considered the gain to be nontaxable in Country X and, therefore, FSub did not report the gain on its Country X's income tax return. However, for U.S. tax purposes, USSub2 reported FSub's gain in year 4, less allocated and apportioned expenses, as subpart F income, as that term is defined in section 952 of the Code. USSub2 included that income in its passive income separate category for purposes of section 904(d).

In Year 5, the tax authorities for Country X began auditing FSub's tax return for year 4. The tax authorities questioned FSub's position that the stock sale in year 4 was not taxable. For several years, FSub contested the tax authorities' position on this issue. However, in year 9, the tax authorities and FSub reached a settlement under which Country X assessed, and FSub paid, taxes in the amount of $g on the gain on the sale of FCorp1's stock. USParent filed in year 9 an amended federal income tax return for year 4 requesting a refund in the amount of $g representing additional deemed-paid foreign tax credits for the additional Country X tax assessed and paid by FSub in year 9. Year 9 is a taxable year beginning after December 31, 1997.

LAW AND ANALYSIS

Section 951 of the Code treats certain undistributed earnings and profits of a controlled foreign corporation, primarily subpart F income as defined in section 952, as a current income inclusion of U.S. shareholders (corporate and individual) who own 10% or more of the voting stock of the controlled foreign corporation. A foreign corporation is a controlled foreign corporation if more than 50% of its combined voting power or value is owned or is considered to be owned by U.S. shareholders. Under section 952(a), subpart F income includes foreign base company income, which includes foreign personal holding company income as defined in section 954(c). Foreign personal holding company income includes the excess of gains over losses from the sale of stock and certain other property. Section 954(c)(1)(B).

Here, FSub was a controlled foreign corporation and USSub2 was the U.S. shareholder of FSub. USSub2 reported FSub's gain in the amount of $f on the sale of FCorp1's stock in year 4, less allocated and apportioned expenses, as subpart F income. For foreign tax credit limitation purposes, USSub2 included that income in its passive income separate category as required by section 904(d)(2)(A) of the

Code, which generally defines passive income to include foreign personal holding company income.

Section 960 of the Code provides that U.S. corporate shareholders that are required to include amounts attributable to the earnings and profits of controlled foreign corporations in gross income under section 951(a) are deemed to have paid a portion of the foreign taxes paid, accrued or deemed to have been paid by the controlled foreign corporation on or with respect to their earnings and profits, as if the amount so included were a dividend under section 902. Under section 902, U.S. corporations owning at least 10% of the voting stock of a foreign corporation are deemed to have paid a share of the foreign income taxes paid by the foreign corporation in the year in which the corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.

Prior to the Tax Reform Act of 1986, deemed-paid taxes were determined based on annual accounts of earnings and taxes from which dividend distributions were sourced on a last-in, first-out basis. When a foreign subsidiary had profits (subject to foreign tax) in some years and deficits in other years and did not distribute all its earnings currently, some of the foreign taxes would never be creditable since dividends could not be paid out of deficit years. Also, under previous law, the amount of the credit was affected when the foreign corporation's effective tax rate changed from year to year.

Section 905(c) of the Code requires a recomputation of the taxpayer's U.S. tax liability for the year or years affected whenever "accrued taxes when paid differ from the amounts claimed as credits by the taxpayer." Related to the year-by-year determination of deemed-paid credits under pre-1987 law, a redetermination of U.S. tax was required whenever a foreign tax redetermination with respect to a foreign subsidiary affected the amount of foreign taxes deemed paid by the U.S. shareholder under section 902.

In order to alleviate the problems associated with the year-by-year approach to the determination of deemed-paid taxes, Congress in 1986 revised section 902 of the Code to provide that the U.S. shareholder of a foreign corporation determines the amount of foreign taxes deemed paid by it on the basis of multi-year pools of undistributed earnings and foreign income taxes. Revised section 902 generally applies to earnings and profits accumulated in years beginning after December 31, 1986, and foreign income taxes attributable to those earnings. This change was intended to alleviate the situation described above in which deemed-paid foreign tax credits were lost as a result of a deficit in a foreign corporation's earnings and profits. In addition, this change limits the ability of taxpayers to claim a deemed-paid credit that reflects foreign taxes higher than the average rate over a period of

years, by averaging the high tax years and the low tax years of the foreign corporation in determining the foreign taxes attributable to the dividend. *See* H. R. Rep. No. 99-426, 99th Cong., 1st Sess. (1986), 1986-3 C.B. Vol. 2 355-358.

Also in 1986, Congress enacted section 989(c)(4) of the Code, which authorized the Secretary of the Treasury to issue regulations providing for an alternative adjustment to the recomputations of a taxpayer's U.S. tax liability for the years or years affected by a foreign tax redetermination as then required by section 905(c). Treas. Reg. §1.905-3T(d), issued in 1988 pursuant to the authority granted in section 989(c)(4), provides that a foreign tax redetermination that affects foreign taxes deemed paid by a U.S. taxpayer under section 902 will be accounted for through an adjustment, on a prospective basis, to the affected pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation. Under the regulations, as subsequently modified by Notice 90-26, 1990-1 C.B. 336, a U.S. taxpayer's tax liability for the year or years affected by a foreign subsidiary's foreign tax redetermination is recomputed only in four limited circumstances, each of which involves an overstatement of the originally claimed credit and none of which applies here:

1. If the foreign tax liability is in a hyper-inflationary currency;
2. If the foreign tax redetermination occurs after a distribution to a U.S. shareholder and the redetermination would cause the foreign corporation's pool of foreign taxes to be reduced below zero (*e.g.*, tax is refunded after it is deemed paid and removed from the pool);
3. The Service in its discretion may require a taxpayer to redetermine its U.S. tax liability if the amount of the foreign tax liability accrued in foreign currency exceeds the amount of foreign tax paid in foreign currency by at least 2%; and
4. If a U.S. shareholder of a controlled foreign corporation receives a distribution of previously taxed earnings and profits and the controlled foreign corporation's income out of which the distribution was made had been subject to the foreign country's corporate income tax, which is reduced because of the distribution.

Treas. Reg. §1.905-3T(d)(4) and (7).

In 1997, Congress revised section 905(c) of the Code to expand the definition of a foreign tax redetermination to include situations where accrued taxes are not paid before the date two years after the close of the taxable year to which those taxes relate. As revised, section 905(c)(2)(B)(i)(I) codifies the prospective pooling adjustment rule of Treas. Reg. §1.905-3T(d), expressly providing that no redetermination of a U.S. shareholder's tax liability or deemed-paid taxes shall be

made on account of a foreign subsidiary's tax payment made more than two years after the year to which the payment relates. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1102(a)(2), 111 Stat. 788, 964-5 (1997). The amendment to section 905(c) applies to only foreign taxes which relate to taxable years beginning after December 31, 1997. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1102(c), 111 Stat. 788, 966 (1997). The 1997 statutory change does not apply here even though year 9, the year of the settlement between FSub and the Country X tax authorities, began after December 31, 1997, since the foreign taxes at issue relate to year 4, a taxable year that began before that date. However, the result is the same under Treas. Reg. §1.905-3T(d), which applies to year 4.

Here there is a foreign tax redetermination for purposes of section 905(c) of the Code and Treas. Reg. §1. 905-3T since the amount of deemed-paid tax accrued by FSub and claimed as a credit in year 4 by USSub2 differs from the amount of accrued taxes paid in year 9. Accordingly, a prospective adjustment must be made in year 9 to FSub's passive income separate category pools of post-1986 undistributed earnings and post-1986 foreign income taxes to reflect the additional tax payment. To the extent allowed under section 902, USParent will be eligible to claim credit for these taxes in connection with a passive dividend or income inclusion from FSub in year 9 and later years.

It has been asserted that here there is not a foreign tax redetermination for purposes of section 905(c) of the Code and Treas. Reg. §1. 905-3T because the amount of foreign tax paid by FSub to Country X on the gain from the stock sale in year 4 is identical to the foreign tax accrued on that transaction and claimed as a credit on the amended return. It is correct that because the tax was contested, the tax did not accrue under the all-events test until the controversy was resolved, which here was in year 9. *See Dixie Pine Products Co. v. Commissioner,* 320 U.S. 516, 519 (1944) and Treas. Reg. §1.461-2(a)(2). Under the relation back concept applicable to foreign tax credits, although accrued and paid in year 9, the tax relates back to and is considered to accrue in year 4. *See* Rev. Rul. 84-125, 1984-2 C.B. 125; Rev. Rul. 70-290, 1970-1 C.B. 160; Rev. Rul. 58-55, 1958-1 C.B. 266.

The assertion incorrectly focuses on the fact that the amount of tax ultimately paid by FSub was identical to the amount of tax ultimately accrued. The argument fails to take into account the statutory test that section 905(c) of the Code applies when the amount of accrued foreign tax when paid differs from the amount of foreign tax claimed as a credit. The test applies to compare the amount originally accrued and claimed as a credit with revised accrued amounts that are paid and allowed as a credit. Since the tax must be both properly accrued and paid for credit to be allowed, see section 905(b), and the amount of foreign tax accrued and paid by FSub differed from the amount used to calculate USParent's deemed paid credits

on its year 4 return as originally filed, section 905(c) and Treas. Reg. §1. 905-3T apply and dictate the result in this case.

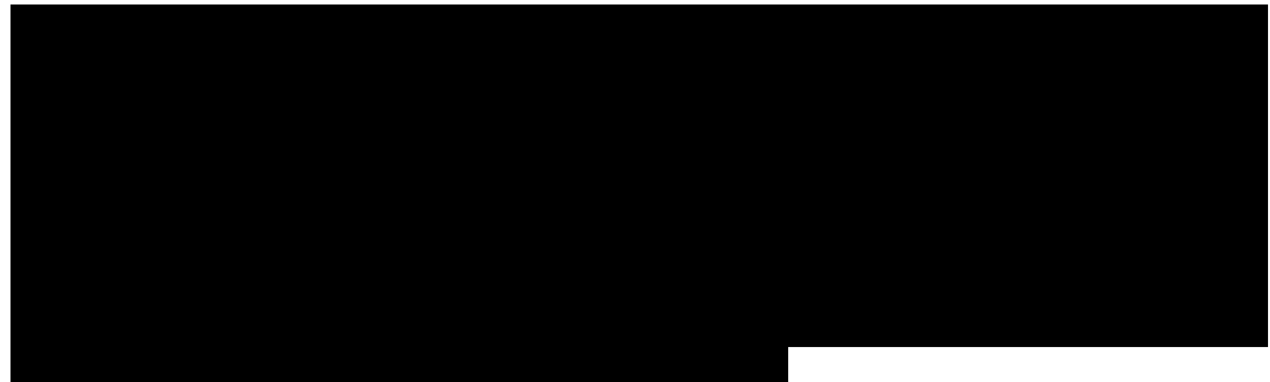
CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Taxpayer has not raised, but could raise in the future after losing the argument on the issue presented in this request for field service advice, the issue of whether Treas. Reg. §1.905-3T is a valid exercise of the regulatory authority granted by section 989(c)(4) of the Code. Prior to the 1997 amendments, section 905(c) on its face required redeterminations of U.S. tax in the event of any change in foreign tax liability that affected the allowable credit. Section 989 is part of subpart J, relating to foreign currency translation and transactions. Congress wanted to permit pooling adjustments in lieu of section 905(c) redeterminations that would otherwise result when currency fluctuations between the date foreign taxes were accrued and paid changed the dollar amount of the allowable credit. *See* H. R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (1986), 1986-3 C.B. Vol. 4 676 and General Explanation of the Tax Reform Act of 1986, pp. 1108-1109 (May 4, 1987). The section 905(c) temporary regulations require pooling adjustments in the case of all foreign tax redeterminations, not just those resulting from currency fluctuations, and thus arguably go beyond "the purposes of this subpart [J]." However, we believe the regulations reasonably implement the statutory purpose, since it would not achieve the Congressional purpose of simplification to permit pooling adjustments for currency fluctuations but require redeterminations of U.S. tax liability in every situation in which the foreign tax paid was not exactly the same as the accrued liability.

Section 905(c) of the Code was specifically amended in 1997 to require that the pools of post-1986 undistributed earnings and post-1986 foreign income taxes be adjusted prospectively in lieu of redeterminations in circumstances like those in this case. Section 905(c)(2)(B)(i)(I). The explicit statutory authority for regulations to provide for pooling adjustments generally, added in 1997 to section 905(c)(1), does not appear even to authorize regulations that would permit a redetermination of U.S. tax in this situation. However, as stated above, both the pooling adjustment regulatory authority and the statutory mandate of a prospective adjustment in these circumstances are only effective for taxes which relate to taxable years beginning after December 31, 1997, and therefore the 1997 amendments do not apply to 1993.

Under the regulations, a prospective adjustment must be made in 1998 to FSub's passive income separate category pools of post-1986 undistributed earnings and post-1986 foreign income taxes. The deduction attributable to the payment of the additional foreign taxes apparently reduces FSub's passive earnings pool in 1998

below zero. Unfortunately, this creates a somewhat sympathetic predicament for USSub2 since none of the taxes can be deemed paid unless FSub generates enough passive earnings in a single year to eliminate the deficit and create a positive balance in the passive earnings pool. Treas. Reg. §1.902-1(b)(4) (no taxes can be deemed paid if post-1986 current plus accumulated earnings are zero or less than zero). Since most passive income is subpart F income that must be currently included in the shareholder's income, there is limited opportunity to accumulate passive earnings in a controlled foreign corporation, and the "nimble dividend" treatment of subpart F income creates the prospect of income inclusions without credits despite the existence of accumulated foreign taxes in the passive category. We note that USParent's ownership of USSub2 was reduced to 79% in 1994 and, therefore, USSub2 was not included in USParent's consolidated return for 1994 and later years. Accordingly, USSub2, and not the USParent group, would be entitled to credit any FSub taxes that could be deemed paid in years after 1993.



Please call (202) 622-3850 if you have any further questions.

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