NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on

Proposed Regulations Regarding The Determination of a Shareholder's "Pro Rata Share" Under Section 951

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I. Introduction

This report, prepared by the New York State Bar Association Tax Section Committee on Foreign Activities of U.S. Taxpayers,[1] responds to proposed regulations under section 951,[2] which were issued by the Internal Revenue Service (the "IRS") and the Treasury Department on August 6, 2004 (the "Proposed Regulations").[3] The expressed purpose of the Proposed Regulations is to update the rules set forth in existing Treas. Reg. § 1.951-1(e), which address the determination of a United States shareholder's pro rata share of section 951(a)(1) amounts,[4] and to provide guidance on

[1] The principal authors of this report were David R. Sicular and John E. Harrell. Helpful comments and substantial contributions were made by Kimberly S. Blanchard, Michael Farber, Richard O. Loengard, Michael L. Schler, Jodi J. Schwartz, and Andrew P. Solomon.

[2] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, (the "Code") or the Treasury regulations promulgated thereunder.

[3] 69 Fed. Reg. 47822 (Aug. 6, 2004).

[4] The Proposed Regulations adopt the convention of referring to the "section 951(a)(1) amounts." We generally refer to the more colloquial (if technically inaccurate term) subpart F income. In doing so, we note that (i) section 951(a)(1)(A)(ii), which requires a United States shareholder to include in gross income its pro rata share of the CFC's previously excluded subpart F income withdrawn from investment in less developed countries, only applies to such investments made between 1962 and 1975; and (ii) section 951(a)(1)(A)(iii), which requires a United States shareholder to include in gross income its pro rata share of the CFC's previously excluded subpart F income withdrawn from foreign base company shipping operations, only applies to investments made between 1962 and 1986. As a result, these provisions are of limited continuing significance. For a discussion of a United States shareholder's pro rata share of the CFC's section 956 amount, *see infra* note 20 and accompanying text.

the application of those provisions to certain types of capital structures utilized by controlled foreign corporations ("CFCs").[5]

The Proposed Regulations do not reflect a significant rewrite of the existing regulations as applied to the majority of cases. Instead, the core provisions that would be added by the Proposed Regulations are targeted anti-abuse measures designed to respond to specific fact patterns involving potentially artificial allocations of subpart F income: (i) those where the allocation of earnings and profits among multiple classes of stock depends on the discretion of the governing body of the CFC (referred to as "Discretionary Stock");[6] and (ii) those where the allocation of earnings and profits among multiple classes of stock is subject to a restriction or limitation (referred to as "Blocked Stock").[7]

While more general in their application, a significant impetus for the Proposed Regulations is to address issues raised by the widely-reported Enron "Project Apache" transaction, which was reviewed by the Joint Committee on Taxation in 2003.[8] In general, the Proposed Regulations are designed to backstop the hypothetical

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[5] *See* preamble to the Proposed Regulations. ("In the 39 years since the [existing] rules were issued, international business arrangements have become much more complex than contemplated in 1965, reflecting in particular more complex structures for determining return on capital. The current regulations do not take into account these developments. The IRS and Treasury, therefore, believe that updated guidance is necessary to ensure results that are more consistent with the economic interests of shareholders in a CFC.").

[6] Prop. Reg. § 1.951-1(e)(3)(ii).

[7] Prop. Reg. § 1.951-1(e)(5).

[8] Staff of the Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, volume 1 at 258 (Feb. 2003) (the "JCT Enron Report").

distribution rule contained in the existing regulations to prevent taxpayers from allocating subpart F income in a manner inconsistent with their economic interests in a CFC.

Although we are not, in every case, aware of the specific impetus for the new rules,[9] we generally agree with their underlying policy objectives. It is appropriate for the IRS and Treasury to preclude taxpayers from entering into arrangements to allocate subpart F income in a manner inconsistent with their economic interest in the CFC.[10] As discussed in more detail below, however, we do not agree that these policy objectives are best served in every case by the specific mechanical rules that the IRS and Treasury proposed. Accordingly, we recommend that the IRS and Treasury consider modifying the rules set forth in the Proposed Regulations in several significant respects.

II. Background

A. The Existing Regulations

Under the subpart F rules (§§ 951-964), deferral of U.S. tax on undistributed income of a CFC is not permitted with respect to certain kinds of income (generally referred to as "subpart F income"). Instead, subpart F income is taxed to the CFC's United States shareholders currently based on their "pro rata share" of such amounts.[11] Section 951(a)(2) and existing Treas. Reg. § 1.951-1(e) are the applicable

[9] As discussed below, we are not aware of any transaction involving Discretionary Stock of the sort contemplated by Prop. Reg. § 1.951-1(e)(3)(ii).

[10] It has been pointed out that this policy objective is similar to that underlying the section 704(b) rules relating to partnership allocations that lack substantial economic effect. *See* JCT Enron Report at 258 (citing Treas. Reg. § 1.704-1(b)(2)).

[11] § 951(a)(2).

authority for determining a United States shareholder's pro rata share of subpart F income for this purpose.[12]

1. Statutory Definition of "Pro Rata Share"

Under section 951(a)(2), a United States shareholder's pro rata share is generally the amount that would have been distributed with respect to the stock that such shareholder owns in the CFC if the CFC actually had distributed an amount equal to its subpart F income as a dividend to its shareholders.[13]

2. Treas. Reg. § 1.951-1(e)(2) - Multiple Classes of Stock

Existing Treas. Reg. § 1.951-1(e)(2) provides special rules with respect to the determination of a United States shareholder's pro rata share of subpart F income where a CFC has multiple classes of stock. In such a case, the existing regulations require that the pro rata share determination be made as if all the earnings and profits (not just the section 951(a)(1) amounts) of the CFC were distributed to its shareholders on the last day of the taxable year on which the foreign corporation was a CFC. The rule provides that the "amount which shall be taken into account with respect to any class of stock . . . shall be the amount which bears the same ratio to the total of such subpart F income . . . as the earnings and profits which would be distributed to such class of stock if all earnings and profits of [the CFC] were distributed on the last day of [the CFC's] taxable year . . . bear to the total earnings and profits of [the CFC] for such taxable year."[14] This general rule is modified for dividend arrearages, which do not share in the

[12] These rules have remained unchanged since 1965. *See* T.D. 6795, 1965-1 C.B. 287 (1965).

[13] § 951(a)(2).

[14] Treas. Reg. § 1.951-1(e)(2).

hypothetical distribution of earnings and profits for the current taxable year to the extent that they do not exceed accumulated earnings and profits from prior years.[15]

We note that the statutory language of section 951(a)(2) refers to a hypothetical distribution of subpart F income, whereas existing Treas. Reg. § 1.951-1(e) and the Proposed Regulations refer to a hypothetical distribution of the corporation's "earnings and profits." Although not part of the changes made by the Proposed Regulations, we note that this is a distinction that makes a difference. Where there are multiple classes of stock, its effect, as illustrated below, is to prevent preference rights from absorbing the first portion of subpart F income by tying the pro rata share determination to the possibly larger pool of the current year's earnings and profits.

Example 1

> CFC has two classes of stock outstanding, Class A and Class B. Class A is preferred stock, which is entitled to an annual dividend of 5% of its original $1000 investment. Class B is common stock. In Year 1, CFC has $100 of subpart F income and $160 of earnings and profits. Under Treas. Reg. § 1.951-1(e)(2) and the Proposed Regulations, if all earnings and profits of CFC in Year 1 were distributed, the Class A preferred stock would receive the first $50 and the remaining $110 would be distributed to the Class B common stock. The Class A preferred stock's share of earnings and profits is therefore approximately 31% ($50/$160) and the Class B common stock's share is approximately 69%. Accordingly, the Class A preferred stock's share of subpart F income is $31 and the Class B common stock's share is $69. If the determination of pro rata share were based instead on a hypothetical distribution of subpart F income only, the results would be different. The Class A preferred stock would receive $50 and the Class B common stock would be distributed the remaining $50.

Apparently, this distinction has gone largely unnoticed[16] since originally drafted in the 1960s.

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[15] Treas. Reg. § 1.951-1(e)(2).

3. Treas. Reg. § 1.951-1(e)(3) – Discretionary Stock

The existing regulations provide that if the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends on the exercise of discretion by the governing body of the CFC, then such classes of stock are treated as a single class of stock in which each share has an equivalent right to dividends (unless a different method is established as proper).[17] The existing regulations do not expressly address the issue of Blocked Stock.

B. The Proposed Regulations

The Proposed Regulations generally retain the existing rule under Treas. Reg. §§ 1.951-1(e)(1) and (e)(2) with respect to the determination of a United States shareholder's pro rata share of subpart F income where the CFC has only one class of stock outstanding[18] and where the CFC has multiple classes of stock outstanding but does not have Discretionary Stock or Blocked Stock.[19]

1. General Rule – Single Class and Multiple Classes of Stock

The Proposed Regulations make several clarifications to the general rules, which we believe are incomplete in certain respects.

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[16] It has not gone entirely unnoticed. *See, e.g.*, Lowell D. Yoder and Gregory R. Walker, *Prop. Regs. § 1.951-1(e): Pro Rata Share of Subpart F Amounts Taxable to U.S. Shareholders*, 11 TAX MGM'T INT'L J. 611, at n.51. (Nov. 12, 2004); *ABA Comments on Proposed Regulations Governing Pro Rata Share Determinations Under Subpart F*, 2004 TNT 233-13, at n.15 (Nov. 22, 2004) (both noting the effect of a preferred return in determining an allocation of subpart F income by reference to earning and profits).

[17] Treas. Reg. § 1.951-1(e)(3).

[18] Prop. Reg. § 1.951-1(e)(2).

[19] Prop. Reg. § 1.951-1(e)(3)(i).

(a) Section 956

First, the Proposed Regulations would replace the reference in Treas. Reg. § 1.951-1(e)(1) and Treas. Reg. § 1.951-1(e)(2) to "increase in earnings invested in United States property" with "amount determined under section 956" to conform the language in the regulation to the statutory changes made to sections 951(a)(1)(B) and 956 in 1993. In general, current section 951(a)(1)(B) no longer uses the "pro rata share" share concept to determine amounts that a United States shareholder must include in income with respect to earnings invested in United States property; it has been moved to section 956. Under current law, the amount includable under section 956 is based on the calculation of the "§ 956 amount" determined under section 956(a), which, in the most general terms, is the lesser of (i) the United States shareholder's *pro rata share* of the average investment in United States property for the year, over the amount of previously taxed earnings determined under section 959(c) with respect to such shareholder and (ii) its *pro rata share* of the CFC's current and accumulated earnings (as determined under section 956(b)). Because the "pro rata share" determination for this purpose is no longer made under section 951, the interplay between the pro rata share concept in the Proposed Regulations and that in section 956 is unclear, and, consequently, the applicability of principles of the hypothetical distribution rule to that determination deserves clarification. We also note that, for this purpose, the translation of the pro rata share rules to the section 956 arena is not simply a matter of incorporation by reference. The section 951 rules focus only on current earnings and profits while the section 956 rules, as discussed above, focuses to a certain extent on the current year and prior year earnings of a CFC. As such, the pro rata share rules under section 951 do not meet the needs of the mechanics of section 956.

For these reasons, we believe that the references in the Proposed Regulations to section 956 should be deleted and that the IRS and Treasury should propose separate pro rata share rules to update the regulations under section 956 to account for the 1993 statutory changes and make clear its interaction with section 951.[20]

(b) Single Class of Stock

The second change that we regard as a clarification is the addition of Prop. Reg. § 1.951-1(e)(2), which would provide that the hypothetical distribution rule of Treas. Reg. § 1.951-1(e)(2) applies on a per share basis to CFCs with only one class of stock.[21]

(c) Dividend Arrearages

The existing regulations provide that the amount of current earnings and profits that may be allocable to dividend arrearages on cumulative preferred stock is only the amount of such arrearage that exceeds the CFC's accumulated earnings and profits. This rule is unchanged in the Proposed Regulations.[22] We note, however, that this rule creates the possibility that the tax treatment of a distribution (or a hypothetical distribution) may be in tension with the economic relationship of that distribution to the shareholder's investment in the CFC.

[20] In any event, the Proposed Regulations do not correctly address the effect of the 1993 changes in that they continue to refer to Treas. Reg. § 1.956-1(c), which has not been updated to reflect the 1993 revisions to section 956.

[21] Although the existing regulations do not contain a specific rule applicable to this circumstance, it is unclear that there is a reason, other than symmetry, for adding this clarification given the straightforward application of the statute to a CFC with only one class of stock outstanding.

[22] Prop. Reg. § 1.951-1(e)(3)(iv).

Example 2

> In years 1-5, CFC has 10 shares of common stock outstanding. The accumulated earnings and profits at the end of year 5 are $10 million. At the beginning of year 6, CFC issues newly-authorized preferred shares to Person A, which have a par value of $10 million and accrue cumulative dividends at the rate of 10% per annum.[23]
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> In each of years 6 through 8, no dividends are paid in respect of the preferred shares, and CFC has no earnings and profits. In year 9, when the preferred shares have $3 million of dividend arrearages, CFC has $5 million of earnings and profits, all of which is subpart F income. Under the Proposed Regulations, the dividend arrearage in respect of years 6 through 8 will not attract an allocation of subpart F income in year 9 unless and until such amounts exceed CFC's accumulated earnings and profits, including those accumulated in years 1-5, with the result that only $1 million of subpart F income (the current year dividend amount) would be allocated to the preferred. Had there been no pre-issuance accumulated earnings and profits, the result would have been that $4 million of subpart F income would be allocated to the preferred. Since as an economic matter the pre-issuance accumulated earnings and profits are unrelated to the dividend arrearage, this difference may not be appropriate.

One alternative approach to this issue is to apply the rule of the Proposed Regulations by taking a snapshot of the CFC at the time the preferred shareholder invests in the corporation. Under this rule, current earnings and profits would be allocable to a dividend arrearage only to the extent that such arrearage exceeds earnings and profits accumulated since the time that the preferred stock was issued. We recognize that the IRS and Treasury may decide that the snapshot rule we suggest may be difficult to administer and that a bright-line rule, such as that set forth in the Proposed Regulations, may be preferable. We note that, if the existing rule is not changed, it should include specific rules for allocating accumulated earnings and profits among multiple classes of

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[23] For ease of illustration, this example assumes that the dividends do not compound. *See infra* note 38 and accompanying text for a discussion of the issues raised with respect to noncompounding cumulative dividends.

preferred stock with dividend arrearages, which is a circumstance not addressed by the Proposed Regulations.

(c) Section 305

In overhauling the section 951 regulations, the IRS and Treasury should consider the effect of intervening changes in law enacted in section 305 (i.e., since the 1960s). The Proposed Regulations do not update the existing regulations to address the effect of items treated as distributions under section 305. We see no reason why such distributions should not attract an allocation of subpart F income under the hypothetical distribution rule and suggest that the final regulations explicitly address such distributions.

2. Blocked Stock – Voluntary Restrictions

(a) Project Apache

In 1999, Enron entered into a transaction (the so-called Project Apache transaction) in which it borrowed money from unrelated foreign lenders through its newly formed CFC.[24] In simplified form, Enron (through an affiliate) contributed cash to a newly formed Dutch company, treated as a CFC for U.S. federal income tax purposes, in exchange for 100 percent of the common units of the CFC. At the same time, the foreign lenders contributed cash in exchange for 100 percent of the preferred units of the CFC. The preferred units were entitled to certain cumulative dividends and an initial liquidation preference in an amount equal to the cash contributed by the foreign lenders and were redeemable at any time at the option of the CFC (the "Optional Redemption").

[24] For a more detailed description of Project Apache, see the JCT Enron Report at 242 and the tax opinion letter delivered to Enron with respect to Project Apache, which is appended to the JCT Report (the "Project Apache Tax Opinion").

The most significant tax consideration in structuring Project Apache appears to have been to ensure that all of the subpart F income generated by the CFC would be allocated to the holders of the preferred units (i.e., the foreign lenders) under the hypothetical distribution rule of Treas. Reg. § 1.951-1(e)(2). To accomplish this, the organizational documents provided that common units held by Enron were not entitled to receive dividends so long as the preferred units were outstanding. An Enron affiliate had an option to acquire the stock of the holder of the preferred units. As a result, that holder was treated under sections 318(a)(3) and 318(a)(4) as the constructive owner of the common units for purposes of section 302. As a result, the Optional Redemption, when exercised, would flunk the section 302(b) tests because there would be no reduction in ownership after application of the attribution rules. Consequently, the Optional Redemption would be treated as a dividend under section 302(d) to the extent of the CFC's earnings and profits.[25] Enron took the position that the hypothetical distribution would be made first to pay dividends on the preferred units, then to redeem the preferred units (also treated as a dividend to the holder of the preferred units) and thus all of the CFC's subpart F income would be allocated to the holders of the preferred units to the extent of the liquidation preference plus the dividends on the preferred units.[26]

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[25] The anticipated "endgame" for Project Apache might have been a redemption of the preferred shares treated in its entirety as dividend, (thus) effectively eliminating earnings and profits and, in turn, permitting a largely tax-free inbound section 332 liquidation.

[26] Enron relied on *Barnette v. Comm'r*, T.C. Memo 1992-371 (1992), in which the court gave effect to a similar restriction for purposes of allocating foreign personal holding company income under Treas. Reg. § 1.551-2(c). *See* Project Apache Tax Opinion at C-551. The IRS has taken the litigating position that a transaction similar to Project Apache does not achieve this result because voluntary restrictions on distributions are not taken into account under Treas. Reg. § 1.951-1(e)(2) and because the preferred units are fast-pay stock within the meaning of Treas. Reg. § 1.7701(l)-3 (having the

(b) Prop. Regs. §§ 1.951-1(e)(4) and 1.951-1(e)(5)

The Proposed Regulations specifically target both the Optional Redemption and the restriction on distributions aspects of Project Apache. First, Prop. Reg. § 1.951-1(e)(4) provides that, for purposes of applying the hypothetical distribution rule, no amount shall be considered distributed to the extent such distribution would constitute a distribution in redemption of stock (even if such redemption would be treated as a section 301 distribution because of section 302(d)). Second, Prop. Reg. § 1.951-1(e)(5) provides that restrictions on distributions of earnings and profits (other than currency restrictions or other limitations described in section 964(b)) by a CFC—what we refer to as Blocked Stock—will not be taken into account in applying the hypothetical distribution rule. As applied to Project Apache, the cumulative effect of these two provisions is to allocate subpart F income upon the hypothetical distribution of earning and profits so that the preferred units generally receive an allocation based on their preferred return for the year and the common units receive the remainder.[27]

3. Discretionary Stock

The Proposed Regulations also address one area of potential abuse that was not involved in Project Apache. The Proposed Regulations alter the existing rule set forth in Treas. Reg. § 1.951-1(e)(3) for determining a United States shareholder's pro rata share of subpart F income where a CFC has multiple classes of stock outstanding and the allocation of a CFC's earnings and profits depends on the exercise of discretion by the governing board of the CFC (defined above as Discretionary Stock).

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effect of attributing the ownership of the preferred units to Enron). *See* Tech. Adv. Mem. 2004-37-033 (May 20, 2004).

[27] Prop. Reg. § 1.951-1(e)(6), Ex. 6 and Ex. 7.

It is our understanding that the motivation behind Prop. Reg. § 1.951-1(e)(3)(ii) is the concern that existing Treas. Reg. § 1.951-1(e)(3) might be subject to manipulation because it ties the determination of a United States shareholder's pro rata share of subpart F income to an absolute number of shares owned by such shareholder in the different classes of stock (the "Per Share Rule"). As a result of the Per Share Rule, the allocation of earnings and profits under the hypothetical distribution rule may result in an allocation of income in amounts that do not reflect the holder's economic interest in the CFC.

Example 3

> Assume that a CFC has two classes of Discretionary Stock outstanding. Class A, which is held by a United States shareholder, has 20 shares outstanding, which represent 80% of the value of the entity. Class B, which is held by a foreign person, has 80 shares outstanding, which represent 20% of the value of the entity. Under existing Treas. Reg. §1.951-1(e)(3), the two classes would be treated as "one class of stock in which *each share* has the same rights to dividends as any other share."[28] In this example, the deemed class (for purposes of applying the hypothetical distribution rule) would consist of 100 shares (20 Class A shares and 80 Class B shares) and allocations would be made to each share pro rata, notwithstanding the fact that each Class A share represents 16 times ((80/20)/(20/80)) the value of each Class B share.[29]

The Proposed Regulations would change the results under the Per Share Rule. Under the new rule, earnings and profits of the CFC for the taxable year would be allocated first to any class of stock with nondiscretionary distribution rights (e.g.,

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[28] Treas. Reg. § 1.951-1(e)(3) (emphasis added).

[29] Under this analysis, there is no limit to the distortive effects that high-value or low-value shares could have on the allocation of earnings and profits for this purpose. Consequently, it would appear that this technique could be used to allocate a significant amount of the earnings and profits away from United States shareholders to foreign holders or other tax indifferent parties.

preferred stock with a fixed return). Next, earnings and profits for the taxable year would be allocated to each class of Discretionary Stock in an amount that bears the same ratio to the remaining earnings and profits of the CFC for the taxable year as the value of all shares of such class of stock bears to the total value of all shares of all classes of Discretionary Stock. Finally, the Proposed Regulations mandate that if two or more classes of Discretionary Stock have "substantially the same" value on a per-share basis, the allocation of earnings and profits shall be made as if such classes of stock constituted one class of stock.[30]

As applied to Example 3, Prop. Reg. § 1.951-1(e)(3)(ii)(A) would require that the holders of the Class A shares be allocated 80 percent of the subpart F income and the holders of the Class B shares be allocated 20 percent of the subpart F income.

III. <u>Discussion</u>

A. Project Apache

As noted above, the Proposed Regulations would respond to Project Apache by (i) adopting a special rule to address the problem of Blocked Stock; and (ii) providing that no amount be considered distributed to the extent such distribution would constitute a distribution in redemption of stock (even if such a distribution is treated as a dividend under section 302(d)). While we generally endorse the broader tax policies underlying these rules, we believe that they should be modified in certain respects.

1. Blocked Stock

Blocked Stock presents the issue of whether voluntary acts of the CFC should be taken into account for purposes of determining a United States shareholder's

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[30] Prop. Reg. § 1.951-1(e)(3)(ii)(A).

pro rata share of subpart F income even though such acts would not be taken into account for purposes of section 964(b). We agree with the answer in the Proposed Regulations; they should not be taken into account.

Pursuant to section 952(c), the earnings and profits of the CFC act as a limitation on the amount of its subpart F income that must be included in the gross income of its United States shareholders. In general, a United States shareholder's pro rata share of subpart F income cannot "exceed [its] pro rata share of the earnings and profits . . . of such corporation for such taxable year."[31] For purposes of computing the section 952(c) limitation, a United States shareholder's pro rata share of the CFC's earnings and profits is determined "in accordance with the principles of " Treas. Reg. § 1.951-1(e).[32]

Section 964(b) provides that "blocked foreign earnings and profits" are not taken into account for purposes of computing the section 952(c) limitation. These earnings and profits include any amounts that "could not have been distributed . . . because of currency or other restrictions or limitations imposed under the laws of any foreign country."[33] These expressly do not include restrictions arising from the "voluntary act of" the CFC.[34] We see no policy justification for allowing voluntary restrictions to allocate subpart F income away from the United States shareholder in a multiple class structure when similar restriction would not do so where there is only a single class of stock.

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[31] Treas. Reg. § 1.952-1(c)(1).

[32] Treas. Reg. § 1.952-1(c)(2)(iii).

[33] § 964; Treas. Reg. § 1.964-2(a).

[34] Treas. Reg. § 1.964-2(b)(4).

Examples 4 and 5 illustrate this point.

Example 4

U.S. person ("USP") owns 100% of the outstanding stock of CFC. CFC earns $100,000 of earnings and profits from operations in Country X in Year 1, all of which is subpart F income. During Year 1, USP enters into a loan agreement with foreign lender B pursuant to which B advanced $1 million. Pursuant to the terms of the loan, CFC is prohibited from making any distributions on its stock for as long as the loan is outstanding. Under the hypothetical distribution rule, if CFC were to distribute all of its earnings and profits, they would be allocated to USP. Accordingly, USP's pro rata share of subpart F income under Treas. Reg. § 1.951-1(e) is $100,000. The restriction on distributions in the loan agreement is a voluntary act of the CFC is not a restriction described in Treas. Reg. § 1.964-2 and therefore is not taken into account in calculating USP's section 952(c) limitation. Accordingly, USP's pro rata share of earnings and profits for purposes of the section 952(c) limitation is also $100,000. Because USP's pro rata share of subpart F income does not exceed its pro rata share of the corporation's earnings and profits, USP is required to include the entire $100,000 in gross income under section 951(a)(1).

Example 5

Assume the same facts as in Example 4, except that in connection with the loan, CFC amended its organizational documents to provide that no distributions could be made to the common stock as long as the loan is outstanding. Upon a hypothetical distribution of the CFC's earnings and profits under Treas. Reg. § 1.951-1(e)(2), USP would receive no distributions. Accordingly, USP's pro rata share of subpart F income is 0. This is true even though USP's pro rata share of earnings and profits for purposes of determining its 952(c) limitation is not affected by the voluntary restriction on distributions.

We believe that there is no policy justification for the different results in Example 4 and Example 5.[35] It is inconsistent for restrictions that do not give rise to

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[35] As noted, the IRS has taken the litigating position that restrictions that do not count for purposes of section 964(b) also do not count for purposes of section 951(a)(1). *See* Tech. Adv. Mem. 2004-37-003 (May 20, 2004) ("Under subpart F, there is no limitation on a United States shareholder's inclusion in gross income of its pro rata

blocked earnings and profits under section 964(b) in determining a United States shareholder's section 952(c) limitation to be given effect in determining a United States shareholder's pro rata share of subpart F income under Treas. Reg. § 1.951-1(e). We believe that it is appropriate for the IRS and Treasury to backstop the hypothetical distribution rule to make clear that such restrictions on distributions are not taken into account to the extent that they do not give rise to blocked earnings and profits under section 964(b).[36]

2. Other Issues that Regulations Should Address

We are concerned that the Proposed Regulations do not go far enough in addressing the shortcomings of the hypothetical distribution rule in the existing regulations. We recommend that the final regulations address these issues.[37]

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share of its CFC's subpart F income as a result of a voluntary restriction on payment of dividends" within the meaning of section 964(b)). As noted above, *Barnette v. Comm'r*, T.C. Memo 1992-371 (1992) reaches an opposite conclusion in the analogous context of Treas. Reg. § 1.551-(2)(c).

[36] Prop. Reg. § 1.951-1(e)(5)(iv) provides that the following (nonexclusive) list of restrictions are not taken into account:

> An arrangement that restricts the ability of the controlled foreign corporation to pay dividends on a class of shares of the corporation owned by United States shareholders until a condition or conditions are satisfied (e.g., until another class of stock is redeemed);
>
> A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or
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> An arrangement that conditions the ability of the controlled foreign corporation to pay dividends to its shareholders on the financial condition of the controlled foreign corporation.

[37] Because the rules we propose below are not contained in the Proposed Regulations, we believe that it may be appropriate for the IRS and Treasury to consider revising the proposed regulations prior to finalization to take our comments into account, rather than to simply include them in the final regulations.

Our concerns relate to the manner in which the hypothetical distribution rule gives effect to certain types of preferential dividend rights. As drafted, the hypothetical distribution rule allocates subpart F income in respect of a stated return on preferred shares without regard to whether or when dividends are or will be actually paid. As a result, it may be possible to mimic the results of Blocked Stock by creating a right to dividends that will attract an income allocation under the hypothetical distribution rule that will never be matched by an actual distribution (i.e., a dividend that will never get paid) or that will only be matched by an actual distribution at a much later date that has a substantially lower present value. In either case, this mismatch will have the effect of allocating income away from the holders of other classes of shares and, if aggressively structured, might accomplish a similar result as an outright restriction on distributions such as that targeted by Prop. Reg. § 1.951-1(e)(5). Because the Proposed Regulations do not address such potential effects of dividend rights, the hypothetical distribution rule may continue to have unintended consequences in certain cases.

These points are illustrated below.

(a) Noncumulative Dividends

One arrangement likely to result in allocations of subpart F income in a manner inconsistent with the shareholders' interests in the CFC is a capital structure in which "old fashioned" noncumulative preferred stock is held by a foreign or other tax indifferent party.[38] Under the hypothetical distribution rule, this dividend right will receive an income allocation without regard to whether dividends will ever be paid.

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[38] A noncumulative preferred stock is a class of preferred stock that does not accumulate unpaid dividends. If the board votes not to pay dividends in a given year, the dividends cannot be carried forward and be paid in another year. There is, of course, nothing inherently abusive about noncumulative preferred stock. It was the

Example 6

> A CFC has two classes of shares outstanding, Class A Preferred Shares and Class B Common Shares. The Class A Preferred Shares are owned by a non-U.S. person. The Class B Common Shares are held by a U.S. Person. The Class A Preferred Shares are entitled to noncumulative dividends in each year equal to a fixed return of 10% before distributions may be made to the Class B Common Shares (the "Preferred Return"). No distributions are made in years 1 through 7.
>
> Upon a hypothetical distribution of the earnings and profits in each of years 1 through 7, the Class A Preferred Shares would receive the Preferred Return. Accordingly, under Prop. Reg. § 1.951-1(e)(3), the Class A Preferred Shares receive an allocation of earnings and profits in those years in respect of the Preferred Return.
>
> Because the dividends are noncumulative and because no distributions are made during years 1 through 7, the existence of the Preferred Return has the effect of allocating subpart F income away from the United States shareholder in manner that does not reflect the shareholders' economic interests in the CFC.

We do not believe that the types of arrangements highlighted in Example 6 should have the described results. Under a literal application of the Proposed Regulations, however, the CFC would appear to successfully allocate subpart F income away from the United States shareholder. Accordingly, we believe that the Proposed Regulations should be revised to account for such dividend rights, perhaps to provide that such rights will not be taken into account if as of some appropriate date (for instance, the end of the taxable year or the due date of the shareholder's tax return), it is clear that such dividends have not been paid and will never be paid.

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first type of preferred stock issued by domestic corporations in the United States and continues exist in the marketplace. *See, e.g.*, Arthur Stone Dewing, *The Financial Policy of Corporations* 58 (1926) (early preferred stock was often noncumulative because of the speculative nature of industrial enterprises).

(b) Noncompounding Cumulative Dividend Rights

Dividend rights will also attract an artificially high income allocation whenever a preferred share is entitled to receive cumulative, noncompounding dividends over time but only receives an actual distribution in respect of those dividend rights at a much later date. This mismatch is more complicated than that described in Example 6 in that it requires a comparison of the present value of the income allocations under the hypothetical distribution rule and the present value of the dividends paid on the preferred stock.

Example 7

> In year 1, CFC issues two shares, a Class A Preferred Share and a Class B Common Share. The Class A Preferred Share is owned by a non-U.S. person. The Class B Common Share is held by a United States shareholder within the meaning of section 951(b). The Class A Preferred Share has a par value of $100, is non-convertible, accrues cumulative, noncompounding dividends at the rate of 20% per annum, is optionally redeemable by the corporation at an amount equal to par, plus accrued dividends, at any time and is mandatorily redeemable on the 20th anniversary of its issue date. The parties do not expect a redemption prior to maturity.
>
> In each of years 1 through 20, CFC has $100 of earnings and profits, all of which is subpart F income, but no dividends are paid. Under the hypothetical distribution rule, $20 is allocated to the Class A Preferred Share and $80 to the Class B Common Share. In Year 20, the Class A Preferred Share is redeemed for $500 (20*$20 + $100). In year 1 dollars, the value of the amount paid at redemption to the Class A Preferred Share in respect of such allocations is $100, which represents a yield to maturity of 8.38%. Using this yield as a discount rate, the present value of the income inclusion on the preferred stock in year 1 dollars is $190, or twice the stock's initial value. Because no distributions were made in respect of the Class A Preferred Share in years 1 through 20, the present value of the dividends is substantially less than the present value of the income allocations to which they relate. As a result, there is a significant mismatch between the present value of the amount allocable to the preferred shareholder included under section 951(a) and the present value of the amount actually paid in respect of those inclusions.

We believe that this result is inconsistent with the purpose of the pro rata share rule under section 951(a) and that the Proposed Regulations should be revised to address it. We propose that the IRS and Treasury adopt a narrow anti-abuse rule to target the types of transactions described in Example 7. We believe that an appropriate rule would provide that if the amount required to be included with respect to any class of stock under Prop. Reg. § 1.951(e)(3) differs substantially on a present value basis from the amount expected to be paid with respect to such class of stock, then the determination of a United States shareholder's pro rata share of subpart F income be made as if the allocation of earnings and profits to which such difference relates were not taken into account to the extent of such difference.[39] If desired, this rule could be tempered by safe harbors, perhaps including a safe harbor for dividends that compound at least annually.

We also believe that such an anti-abuse rule should in appropriate cases target shareholder-level agreements that are inconsistent with the economic terms of the underlying stock. For example, it may be appropriate to disregard the accrual of unpaid, compounding dividends on preferred stock in whole or in part where that stock is held by a foreign (or other tax-indifferent) shareholder and a United States shareholder has an option to acquire preferred stock from a foreign (or other tax-indifferent) party for less than its par value plus accrued dividends.

[39] This rule is consistent with the rule proposed by the Joint Committee on Taxation. *See* JCT Report at 258. ("The Joint Committee staff recommends adding an exception to the subpart F allocation method set forth in the regulation for cases involving allocations of earnings and profits to tax-indifferent shareholders if such allocations are made for a tax avoidance purpose.").

3. Redemptions

As a policy matter, we agree generally with the proposed modification to the hypothetical distribution rule that a redemption, at least if it is a true return of capital, should not give rise to an allocation of subpart F income, although we have some concern that it may be overbroad in excluding all redemptions treated as section 301 distributions. We assume that the Proposed Regulations' broader approach to redemptions is, in large measure, a response to the position, taken by Enron in Project Apache, that a hypothetical redemption distribution in respect of certain preferred shares would attract an allocation of subpart F income under the hypothetical distribution rule because, by reason of the application of the attribution rules (in that case sections 318(a)(3) and 318(a)(4)), the distribution would have been treated as a dividend under sections 301 and 302(d). We are not of a single viewpoint, however, regarding whether the specific rule proposed should be adopted in its current form.

From one perspective, we believe that the source of the problem in Project Apache is, at least in part, the attribution rule giving rise to dividend treatment under section 302(d) and not the hypothetical distribution rule itself. We note, however, that even in light of other highly-publicized transactions designed to cause putative redemptions to flunk section 302(b) (such as the Seagrams/Dupont transaction that led to the enactment of section 1059(a)(2)), there has been no serious move to reform the attribution rules.

Some of us believe that, in the absence of such reform, there may be no better mechanism for addressing the position taken in Project Apache than the approach adopted by the Proposed Regulations. Accordingly, as to transactions that would accomplish dividend treatment for a distribution that is economically a return of capital

(and many transactions that involve option attribution may be just that), we understand the need for the approach in the Proposed Regulations despite our concerns regarding its overbreadth.

Others of us agree with the policy rationale of this approach but do not believe that the concerns regarding overbreadth can be easily dismissed in favor of administrative expediency. Under the approach that would be adopted by the Proposed Regulations, every distribution in redemption of stock is in effect treated as a return of capital and therefore never receives an allocation of subpart F income (even if section 302—the longstanding authority for distinguishing a return of capital from a return on capital—would provide otherwise). We have significant concerns about "turning off" a selected provision of the Code in all cases to accomplish a desired result in a specific case. In cases such as Project Apache, a rule that turns off section 302 would appear to reach the right result; in other cases, section 302 would yield a perfectly appropriate result.

Even among those who believe that Section 302 principles should play a role in this setting, there is no consensus as to what that role should be. All in this group agree that a redemption that actually results in dividend income under section 302(d) to a taxable U.S. person should be taken into account – any other approach creates risks of uneconomic double counting. This subgroup is divided, however, as to whether an actual dividend redemption from a foreign (or otherwise tax-indifferent) shareholder should also be taken into account. We note that we are not entirely certain what the effect of the proposed rule is intended to be in the case of a redemption that does not actually occur in

light of the rule of Prop. Reg. § 1.951-1(e)(5) (disregarding prohibition on payment of dividends on a junior class of stock until a senior class is redeemed).

B. Discretionary Stock

Although we assume that they may well exist, we are unaware of any actual transaction involving Discretionary Stock.[40] As a general proposition, we do not believe that parties would agree to subject the timing and amounts of their return on invested capital to the discretion of the governing body of the CFC in the absence of other agreements or relationships that would have the effect of providing for a more definitive outcome, or at least, significantly inform an analysis of how the discretion might be exercised (e.g. a put or call right).[41] As a consequence, we believe that, as they relate to Discretionary Stock, the Proposed Regulations will not have a significant impact on the manner in which the capital structures of CFCs are organized.

Assuming, however, that the discretionary stock transactions are, or could become important, we agree that the Per Share Rule may yield unintended allocations of subpart F income that bear no relation to the holder's economic investment in the CFC.[42] Accordingly, we believe that it is appropriate for the IRS and Treasury to revise the Per Share Rule. We have reservations, however, regarding the efficacy of the valuation method set forth in the Proposed Regulations and, consequently, suggest that the IRS and

[40] The Per Share Rule was part of the original package of regulations promulgated in 1965. We are not aware of any reported cases or miscellaneous authorities discussing a transaction involving Discretionary Stock of the sort contemplated by Treas. Reg. § 1.951-1(e)(3) and an informal poll of the members of this committee has revealed no examples of this capital structure being used in the marketplace.

[41] As discussed below, one area in which we have seen bona fide discretionary arrangements is in the trust area.

[42] *See supra* note 29 and accompanying text.

Treasury adopt a more administrable measure to address the shortcomings of the Per Share Rule.

1. Prop. Reg. § 1.951-1(e)(3)(ii)(A) – Valuation Proposal

We do not generally favor valuation rules that require taxpayers to value property that is not publicly traded. Valuation methodologies are increasingly complex. They involve a costly and time consuming process that, even when performed in good faith and in observance of settled valuation principles, will leave taxpayers open to criticism, second-guesses and, often, litigation.[43] These concerns are pronounced in this case as the Proposed Regulations envision an annual valuation that will require taxpayers to continuously value and revalue Discretionary Stock.

In addition, although we are not valuation experts, we suspect that it may prove difficult to value stock where all of the distributions are contingent on the discretion of the governing body of the CFC. The core of modern valuation techniques is the discounted cash flow (or capitalization of income) method, which involves discounting to present value anticipated income based on the relative certainty of future

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[43] As the Tax court observed:

> Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous. Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear.

Auker. v. Comm'r, 75 T.C.M. 2321, 2333 (1998).

distributions.[44] Where such distributions are entirely subject to the discretion of the governing body, we believe that it may prove difficult, as a practical matter, to arrive at a fair value with any degree of certainty and the alternative valuation techniques, such as those based on historical cost or the value of comparable property, may be equally difficult to apply.

Although we applaud the IRS and Treasury for trying to provide certainty to taxpayers by adopting an objective valuation proposal, we believe that the rule selected masks significant difficulties in application. In light of these difficulties, we do not believe that the valuation proposal should be adopted. As outlined below, we believe that a more appropriate rule for determining the allocation of subpart F income to classes of Discretionary Stock would be a "facts and circumstances" test in which valuation is but one of the considerations. As discussed below, we believe that this is consistent with the rules in analogous contexts.

2. Section 958 – Discretionary Stock Redux

While we are not aware of instances of discretionary stock in the marketplace, we believe that discretionary, or "sprinkle," trust arrangements, in which a trustee has the discretion to distribute trust income among a class of beneficiaries, are quite common. Where these trusts are foreign trusts that own stock of a CFC, it is

[44] *See, e.g., Estate of Renier,* T.C. Memo 2000-298 (describing such methods). *See also* Rev. Rul. 59-60, 1959-1 C.B. 237. We note that the authorities discussed in the preamble to the Proposed Regulations are not helpful in making this determination with respect to multiple classes of stock. The preamble cites *Framatome Connections USA, Inc. v. Comm'r.*, 118 T.C. 32 (2002) (discussing, *inter alia*, valuation of CFC stock) and Treas. Reg. § 1.1502-32(c) (allocating amounts in respect of multiple classes of stock for purposes of the investment adjustment rules based on facts and circumstances), which do not discuss (or indeed provide any obvious insight as to) a methodology for valuing a class of stock with discretionary distribution rights.

necessary to determine each beneficiary's pro rata share. In order to do so, the amount of stock "owned" by a United States shareholder must first be determined. For this purpose, section 951(a)(2)(A) provides that stock taken into account includes stock that such shareholder indirectly owns within the meaning of section 958(a). The determination of stock indirectly held by a U.S. beneficiary of a foreign discretionary trust requires a determination of that person's interest in the discretionary trust. Determining a U.S. beneficiary's interest in a discretionary trust presents the same problems for determining stock ownership that Discretionary Stock presents for determining a United States shareholder's pro rata share of subpart F income.

To resolve this issue under the indirect ownership rules, section 958(a)(2) provides that stock owned, directly or indirectly, by or for a foreign trust will be considered as being owned "proportionately" by its beneficiaries, which is further defined in Treasury regulations to mean "on the basis of all the facts and circumstances in each case."[45] Although it is unclear whether this principle reflects a considered rejection of a more narrow valuation rule, we believe that the section 958 rule, unlike the Proposed Regulations, appropriately addresses the difficulty of valuing interests entitled to discretionary distributions.

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[45] Treas. Reg. § 1.958-1(c)(2) ("[g]enerally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) . . . are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a reference to such person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation."). We note that the determination of a U.S. beneficiary's interest in a foreign trust in other contexts is made under a different analysis. A complete discussion of the various contexts in which this determination is relevant is beyond the scope of this Report, and our discussion of the determination under section 958(a) is included for illustrative purposes only.

In at least one analogous context, the IRS explicitly has rejected the application of a narrow valuation rule in favor of a facts and circumstances test. For purposes of applying the personal holding company ownership test, section 544(a)(1) provides that stock owned directly or indirectly by or for a trust shall be considered as being owned proportionately by its beneficiaries, which the IRS has held to mean in proportion to the beneficiary's actuarial interest in the trust.[46] The IRS has recognized, however, that this valuation-type rule is impossible to apply in the case of a purely discretionary trust:

> Because the trustees of the Trust have unrestricted discretion in selecting the recipients of income and principal, the Trust's beneficiaries do not have actuarial interests in the Trust that can be computed . . . . Accordingly, it is necessary to prescribe an alternative basis for attributing ownership of the Trust's stock to the beneficiaries in this situation. While it is possible to postulate various methods to accomplish this allocation, we believe in this situation the "facts and circumstances" method . . . is appropriate.[47]

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[46] Rev. Rul. 62-155, 1962-2 C.B. 132. We note that there may be an argument that an actuarial rule would also apply under the section 958(a) indirect ownership rules. Section 951(b) defines a "United States shareholder" for purposes of subpart F as a U.S. person who owns, within the meaning of section 958(a), or is considered as owning by applying the constructive ownership rules of section 958(b), 10% or more of the voting stock of a foreign corporation. For purposes of determining constructive ownership, Treas. Reg. § 1.958-2(c)(1)(ii) provides that a stock owned by or for a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Given the similarity of section 958(a) to section 958(b), it would appear that the actuarial rule might also be applied to determine a U.S. beneficiary's indirect ownership of a CFC for purposes of that section. The IRS has indicated that it may not agree. It is unclear whether this uncertainty reflects a rejection of the valuation approach. *See* FSA 1999-52-014 (Dec. 29, 1999) ("section 958(b) and Treas. Reg. § 1.958-2(c)(1)(ii) expressly determine constructive ownership with reference to actuarial interests, thereby suggesting that section 958(a)(2) and Treas. Reg. § 1.958-1(c)(2) need not mandate application of the same rule.").

[47] Priv. Ltr. Rul. 1990-24-076 (Mar. 21, 1990).

Under the alternative facts and circumstances approach, the IRS reasoned that each beneficiary's interest should be determined with reference to such factors as "patterns of past distributions, appropriate mortality assumptions, the trustee's fiduciary duties and the relationships among the trustees and beneficiaries."[48] The IRS concluded that if it is possible to discern a pattern of past distributions, each beneficiary receiving distributions under such pattern should be deemed to own an income interest in the trust in the same proportion that the amount of distributions he or she receives bears to the total amount of the distribution.

We generally agree with the IRS's conclusion that a facts and circumstances test, not a valuation rule, is the appropriate test to determine a beneficiary's interest in a discretionary trust.[49] We also believe that a similar facts and circumstances test is the appropriate test for determining a United States shareholder's pro rata share of subpart F income with respect to Discretionary Stock. Rather than adopt the approach taken in the Proposed Regulations, we believe that the IRS should fashion such a test to account for Discretionary Stock.

3. Prop. Reg. § 1.951-1(e)(3)(ii)(A) – Deemed Class

Finally, we note that the Proposed Regulations would require that where the value of each share of two or more classes of Discretionary Stock is "substantially the same," the allocation of earnings and profits for purposes of determining a United States shareholder's pro rata share of subpart F income be made as if such classes constituted

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[48] *Id.*

[49] We express no view as to whether a pattern of past distributions should, as the ruling suggests, be dispositive.

one class of stock in which each share has the same rights to dividends as any other share.[50]

We believe that, to the extent the valuation proposal outlined above is adopted, the reference to "substantially the same" in Prop. Reg. § 1.951-1(e)(3)(ii)(A) should be deleted and replaced with a bright-line test. As drafted, the proposal would produce needless uncertainty regarding the meaning of "substantially the same" value in close cases. A test that is based on a set percentage of value (e.g., within 5 percent or 10 percent) would be more administrable and should be adopted.

C. Section 958 – Other Issues

The rules set forth in the existing and Proposed Regulations do not address the relationship between the indirect stock ownership rules in section 958 and the hypothetical distribution rule. Given the similarity of the rules governing the determination of a shareholder's proportionate interest in a foreign corporation in Treas. Reg. § 1.958-1(c)(2) (determined, *inter alia*, by reference to such person's interest in the income of such corporation) and the determination of a United States shareholder's pro rata share under the hypothetical distribution rule, one might argue that these rules should be consistently applied.[51] We believe that without specific guidance, it may be difficult to do so.

Example 8

> Assume U.S. Person owns the only share of common stock outstanding of CFC1 and Foreign Person owns the only preferred share outstanding of CFC1. CFC1 owns 100% of CFC2. The preferred share has a $100 par value and accrues dividends at the

[50] *See* Prop. Reg. § 1.951-1(e)(3)(ii)(A).

[51] *See supra* note 45.

rate of 20% per annum. In year 1, CFC1 has no earnings and profits and no subpart F income and CFC2 has $100 of earnings and profits and $100 of subpart F income. How is the hypothetical distribution rule applied?

The answer under the so-called hopscotch rule under section 951 may be that the hypothetical distribution rule is applied such that U.S. Person and Foreign Person have the same interests in the earnings and profits of CFC2 as they do in CFC1 for purposes of applying the hypothetical distribution rule. Applying this approach, the first $20 of subpart F income would be allocated to the preferred share in respect of its preferred return and the remaining $80 would be allocated to the common share.

The Proposed Regulations do not address the question presented in Example 8. Under section 951, the pro rata share determination is made with respect to shares owned directly and indirectly (within the meaning of section 958(a)). It is unclear, however, how allocations of subpart F income are made in respect of those shares under the hypothetical distribution rule. One answer, suggested by Example 8, is to make allocations based on the assumption that the hypothetical distribution should be made as if the upper-tier shareholders have the same interest in the earnings and profits of the lower-tier entity as they do in the upper tier entity. This rationale, however, cannot be applied to every case.

Example 9

Assume the same facts as in Example 8 except that in year 1, CFC1 has $100 in earnings and profits and $100 of subpart F income and CFC2 has $100 of earnings and profits and $100 of subpart F income. How is the hypothetical distribution rule applied?

The answer to this problem is not immediately obvious. If the hypothetical distribution rule is applied as if the CFC1 shareholders have the same interest in the earnings and profits of CFC2 as they do in CFC1, then the preferred share will receive an allocation based on its preferred return twice: once at the CFC1 level and

once at the CFC2 level. This double counting is clearly not the right answer under the hypothetical distribution rule. If, instead, the answer is that the preferred share receives an income allocation only once, then the question becomes which allocation (the CFC1 allocation or the CFC2 allocation) and why? In some cases, it may make a difference.

Example 10

> Assume the same facts as Example 8 except that in year 1, CFC1 has $100 of earnings and profits and $50 of subpart F income and CFC2 has $100 of earnings and profits and $100 of subpart F income.
>
> If the preferred share receives an allocation only in respect of the earnings and profits of CFC2, then Foreign Person will receive $20 of subpart F income from CFC2 and U.S. Person will receive $80 of subpart F income from CFC2 plus an allocation of the entire amount of CFC1's subpart F income or $50 (for a total of $130).
>
> If the preferred share receives an allocation only in respect of the earnings and profits of CFC1, then Foreign Person will receive an allocation of subpart F income based on its share of CFC1's earnings and profits. If all earnings and profits of CFC1 in Year 1 were distributed, the preferred share would receive the first $20 and the remaining $80 would be distributed to the common share. Foreign Person's share of earnings and profits is therefore 20% ($20/$100) and U.S. Person's share is 80%. Accordingly, Foreign Person's share of subpart F income from CFC1 is $10 (20%*$50) and U.S. Person's share of subpart F income from CFC1 is $40. U.S. Person would also receive an allocation of the entire amount of the subpart F income of CFC2, or $100. And therefore the total amount allocable to U.S. Person from both CFC1 and CFC2 would be $140.

We believe that the IRS and Treasury should address these complexities by establishing a separate regulations project under section 958 or through other appropriate public guidance. We note that in doing so, the IRS and Treasury should take into account additional differences that may arise in applying section 960, if the effective tax rates of CFC1 and CFC2 are different.

D. Transitional Relief

The Proposed Regulations would be applicable for "taxable years of a controlled foreign corporation" beginning on or after January 1, 2005. In certain cases, the rules applicable to determine a United States shareholder's pro rata share of subpart F income implicate other provisions of the Code in a backward-looking manner and therefore could be interpreted to apply to years preceding the effective date of the Proposed Regulations.[52] Recalculating earnings and profits back to as early as 1962 is not practical, or necessary, to achieve the regulations' policy goals. The IRS and Treasury should provide appropriate transitional guidance to taxpayers that takes into account such backward-looking provisions.

[52] Treas. Reg. § 1.1248-3(e) (requiring an annual allocation of earnings and profits for purposes of determining the amount of section 1248 gain attributable to the sale of CFC stock); Treas. Reg. § 1.367(b)-2(c)(i) (calculating the all earnings and profits amount by reference to the section 1248 amount).