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November 22, 2004

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
Room 3000 IR  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Regulations Governing Pro Rata Share  
Determinations Under Subpart F (REG-129771-04)

Dear Commissioner Everson:

Enclosed are comments on proposed regulations governing pro rata share determinations under subpart F, which were prepared by individual members of the Section of Taxation's Foreign Tax Credits and Subpart F Task Force and the Section's Foreign Activities of U.S. Taxpayers Committee. These comments represent the individual views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon  
Chair, Section of Taxation

Enclosure:

cc:

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**COMMENTS ON PROPOSED REGULATIONS  
GOVERNING PRO RATA SHARE DETERMINATIONS UNDER SUBPART F  
(REG-129771-04)**

The following comments were prepared by individual members of the Foreign Tax Credit and Subpart F Task Force (“Task Force”) and the Foreign Activities of U.S. Taxpayers Committee (“FAUST”) of the Section of Taxation of the American Bar Association. The Task Force is a multi-committee Task Force of the Section of Taxation, which includes representatives from each of eight committees: Corporate Tax, Financial Transactions, Energy and Environmental Taxes, Partnerships and LLCs, U.S. Activities of Foreign Taxpayers, FAUST, Transfer Pricing and the Foreign Lawyers Forum. These comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Principal responsibility for the preparation of these comments was exercised by Elinore Richardson, Carol Tello and Lowell Yoder. Substantive contributions were received from Reuvan Avi-Yonah, Rafic Barrage, Bruce Cohen, Tim Devetski, Chip Harter, Michael Lloyd, Markus Malik, Frank McCrystle, Greg Walker and Lowell Yoder. The comments were circulated to and approved by the representatives of the constituent committees of the Task Force. The Comments were reviewed by Robert E. Liles, II of the Section of Taxation’s Committee on Government Submissions and by N. Susan Stone, Council Director for the Task Force and FAUST.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed herein or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: November 22, 2004

## EXECUTIVE SUMMARY

These comments address the Proposed Regulations (“Proposed Regulations”) governing “pro rata share” determinations under the Subpart F anti-deferral rules. The comments are in response to the solicitation for comments in a notice of proposed rulemaking published on August 6, 2004 in the Federal Register.

The Proposed Regulations would revise the existing Treasury Regulations under section 951, which include a “hypothetical distribution rule” for determining shareholders’ pro rata shares. The Proposed Regulations contain certain targeted rules designed to alter the operation of the hypothetical distribution rule, generally in cases involving stock with discretionary distribution rights and in situations involving redemptions or restrictions on distributions. The preamble to the Proposed Regulations indicates that these changes are necessary to reflect changes in the business environment since promulgation of the existing regulations.

Section III of these comments identifies technical issues arising under the Proposed Regulations and suggests resolution of these issues. Among other things, the comments suggest that the proposed valuation rule for determining pro rata shares when a CFC has outstanding stock with discretionary distribution rights would be extremely difficult both for taxpayers and the government to apply and may be open to manipulation. Thus, the comments suggest the use of a facts and circumstances test to determine shareholders’ relative economic rights (referred to as a “fallback” rule) in such unusual circumstances.

Section III of these comments also suggests that the proposed targeted rules ignoring redemptions and restrictions on distributions may not achieve the appropriate goal of distinguishing distributions that represent a return *of* capital from distributions that represent a return *on* capital for purposes of determining pro rata shares of economic earnings. The comments suggest that, rather than promulgating such targeted rules, the interests of the government and taxpayers may be further advanced by eliminating the hypothetical distribution rule as a generally applicable standard and promulgating regulations containing (i) specific guidance illustrating the proper operation of the pro rata share rules under certain typical CFC capital structures and (ii) a general “fallback” rule to be applied in unusual cases. Section V elaborates on this potential alternative regulatory approach.

Section IV of these comments discusses the interaction of the pro rata share rules of the Proposed Regulations with other pro rata share determinations, and suggests the need for additional guidance with respect such other pro rata share determinations. Section VI addresses certain effective date issues and, in light of the large number of technical issues arising under the Proposed Regulations, suggests that some deferral of the effective date of the Proposed Regulations may be warranted.

## A. COMMENTS ON PROPOSED REGULATIONS

### I. Introduction

These comments relate to the Proposed Regulations governing certain pro rata share determinations and are in response to the solicitation for comments in a notice of proposed rulemaking published on August 6, 2004.<sup>1</sup> Section II of these comments provides background regarding the Proposed Regulations. Detailed comments on the Proposed Regulations are set forth in sections III through VI below.

### II. Background

#### 1. Pro Rata Share Determinations

Pursuant to the Subpart F anti-deferral regime contained in sections 951 through 964 of the Internal Revenue Code,<sup>2</sup> a United States shareholder of a controlled foreign corporation (“CFC”) is required to include in income each year his<sup>3</sup> “pro rata share” of Subpart F income earned by the CFC for such year.<sup>4</sup> For this purpose, section 951(a)(2) generally provides that a United States shareholder’s pro rata share is the amount that would have been distributed with respect to the stock that such shareholder owns (or is considered to own under the special rules of section 958(a)) if, on the last day in its taxable year, the CFC had distributed pro rata to its shareholders an amount equal to its Subpart F income for such year. As described below, regulations promulgated under section 951(a)(2) (the “Existing Regulations”) elaborate on the meaning of a United States shareholder’s “pro rata share” in this context.

The pro rata share rules of section 951(a)(2) and the Existing Regulations are not only relevant for purposes of determining a United States shareholder’s pro rata share of a CFC’s Subpart F income. Such rules are incorporated by reference into a number of statutory and regulatory provisions under Subpart F and the related provisions of sections 367(b) and 1248. For example, in applying the earnings and profits limitation (the “E&P Limitation”) on a CFC’s Subpart F income for a given year, regulations promulgated under section 952(c) provide that a United States shareholder’s pro rata share of a CFC’s Subpart F income for any year shall not exceed his “pro rata share” of the CFC’s earnings and profits for such year.<sup>5</sup> Further, the amount of a United States shareholder’s pro rata share of a CFC’s Subpart F income from a particular “qualified activity” is reduced by such shareholder’s “pro rata share” of any earnings and profits deficit from such activity for a prior year (a “Qualified Deficit”).<sup>6</sup>

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<sup>1</sup> 69 Fed. Reg. 47822 (Aug. 6, 2004).

<sup>2</sup> Unless otherwise indicated, “section” or “§” references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> The statute and the regulations promulgated thereunder use the pronoun “his” for a United States shareholder. We have continued this convention to make it easier to distinguish between references to a United States shareholder and references to a CFC.

<sup>4</sup> I.R.C. § 951(a)(1)(A)(i).

<sup>5</sup> Treas. Reg. § 1.952-1(c)(1); *see also* I.R.C. § 952(c)(1)(A).

<sup>6</sup> I.R.C. § 952(c)(1)(B).

The determinations required under section 956 also require “pro rata share” determinations. The rules under section 956 changed dramatically in 1993. Prior to the Revenue Reconciliation Act of 1993 (the “1993 Act”),<sup>7</sup> the amount includible in income by a United States shareholder under sections 951(a)(1)(B) and 956 (a “section 956 inclusion”) was determined based on the United States shareholder’s “pro rata share” of the CFC’s “increase in earnings invested in United States property” for the year.<sup>8</sup> The amount of this inclusion was determined at the end of each year based upon the excess of (i) the shareholder’s pro rata share of the CFC’s investment in United States property at the end of the current year (to the extent such investment, if distributed, would have constituted a dividend), over (ii) the shareholder’s pro rata share of the CFC’s investment in United States property at the end of the immediately preceding year (to the extent such investment, if distributed, would have constituted a dividend).<sup>9</sup>

As a result of the 1993 Act, a United States shareholder’s section 956 inclusion is no longer determined based upon “snapshots” of the CFC’s investments at the end of the current and immediately preceding years. Instead, such shareholder’s section 956 inclusion is determined based upon the lesser of (i) such shareholder’s pro rata share of the CFC’s current and accumulated earnings and profits (with some modifications) and (ii) the excess of (a) such shareholder’s pro rata share of the CFC’s average investment in United States property for the year, over (b) the amount of the CFC’s earnings and profits that the shareholder has previously taken into account under section 956 (“section 956 previously taxed earnings”). Thus, following the 1993 Act, whenever a CFC makes an investment in United States property, an accounting of a shareholder’s “pro rata share” of a CFC’s earnings and profits *for all prior years* is apparently required, since the shareholder’s pro rata share of the CFC’s current and accumulated earnings and profits will serve as a limitation on the amount of his section 956 inclusion.

Under certain circumstances, a shareholder of a CFC (or foreign corporation formerly treated as a CFC) may also be required to treat a portion of his gain from the sale of stock in the CFC (or foreign corporation) as a dividend (a “section 1248 dividend”).<sup>10</sup> The amount of this section 1248 dividend generally is determined based upon the amount of the current and accumulated earnings and profits of the corporation (and certain lower-tier corporations, if any) that are attributable to the stock sold. For purposes of determining the amount of earnings and profits attributable to stock, regulations promulgated under section 1248 incorporate by reference the pro rata share rules of the Existing Regulations.<sup>11</sup> Because of its focus on current and accumulated earnings and profits, section 1248 (like section 956 discussed above) generally requires an annual accounting of each shareholder’s pro rata share of the foreign corporation’s earnings and profits.

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<sup>7</sup> Pub. L. No. 103-66, tit. XIII (1993).

<sup>8</sup> I.R.C. § 951(a)(1)(B) (prior to the 1993 Act).

<sup>9</sup> § 956(a)(2) (prior to the 1993 Act).

<sup>10</sup> § 1248(a).

<sup>11</sup> Treas. Reg. § 1.1248-3(c)(4), (d)(6) (“If a foreign corporation for a taxable year has more than one class of stock outstanding, then . . . the earnings and profits accumulated for the taxable year . . . shall be allocated to each class of stock in accordance with the principles of paragraph (e)(2) and (3) of § 1.951-1(e), applied as if the corporation were a controlled foreign corporation on each day of such taxable year.”). Earnings and profits attributable to amounts previously included in income of a shareholder under Subpart F are excluded from the earnings and profits taken into account with respect to such shareholder for purposes of section 1248. *See* I.R.C. § 1248(d) (setting forth this and other exclusions from earnings and profits taken into account under section 1248).

Similar to section 1248, section 367(b) requires a shareholder to take into account earnings and profits attributable to his stock of a foreign corporation upon certain liquidations and reorganization exchanges. In determining the amount of earnings and profits attributable to stock, regulations under section 367(b) incorporate the rules under section 1248 and thus also require annual determinations of shareholders' pro rata shares.<sup>12</sup>

## 2. Existing Regulations

Treas. Reg. § 1.951-1(e) provides rules for determining a United States shareholder's pro rata share of a CFC's Subpart F income under section 951(a)(2) for a given year.<sup>13</sup> The Existing Regulations also provide the rule for determining a United States shareholder's pro rata share of a CFC's "increase in earnings invested in United States property."<sup>14</sup> As described previously, the quoted phrase is a reference to the pre-1993 Act calculation of a United States shareholder's section 956 inclusion and thus no longer refers to the applicable rule.

Treas. Reg. § 1.951-1(e)(2) sets forth rules for determining a United States shareholder's pro rata share with respect to a CFC that has more than one class of stock outstanding. This paragraph of the Existing Regulations provides that the pro rata share attributable to any class of stock is determined based upon the amount of earnings and profits that would be distributed with respect to that particular class of stock if all the earnings and profits of the corporation for such year were distributed on the last day of the corporation's taxable year (this is sometimes referred to as the "hypothetical distribution" rule). Under this rule, a United States shareholder's pro rata share of a CFC's Subpart F income is the amount that bears the same ratio to the total amount of the CFC's Subpart F income for the year as the amount of the CFC's earnings and profits that would be distributed to the shareholder bears to the total amount of the CFC's earnings and profits for such year.<sup>15</sup>

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<sup>12</sup> Treas. Reg. § 1.367(b)-2(d)(3). We note that the pro rata share rules also are relevant for purposes of determining the amount of a United States shareholder's income inclusion resulting from a reduction in a CFC's investments in less developed countries or in foreign base company shipping operations. From 1962-1975, Subpart F income earned by a CFC but reinvested in a less developed country was not required to be taken into account by the CFC's shareholders currently but instead was required to be taken into account only upon a reduction in the CFC's investment in such less developed country. From 1975-1986, foreign base company shipping income earned by a CFC but reinvested in shipping operations was not required to be taken into account by the CFC's shareholders currently but instead was required to be taken into account only upon a reduction in the CFC's investment in such shipping operations. The Code currently requires a CFC that took advantage of these special deferral rules to recognize Subpart F income upon reduction of its investments in less developed countries or foreign base company shipping operations. *See* I.R.C. § 951(a)(1)(ii), (iii). However, due to the fact that CFCs have not been entitled to defer recognizing Subpart F income under these provisions for at least 18 years, these pro rata share rules may have limited importance and are not discussed in detail in these comments.

<sup>13</sup> According to the Treasury Decision announcing the Existing Regulations, Treas. Reg. § 1.951-1(e) was promulgated pursuant to the Treasury Department's general authority to promulgate interpretive regulations under section 7805. T.D. 6795, 1965-1 C.B. 287, 320.

<sup>14</sup> Treas. Reg. § 1.951-1(e)(1).

<sup>15</sup> We note that section 951(a)(2) focuses explicitly on a hypothetical distribution of Subpart F income—not a hypothetical distribution of all of a CFC's current earnings and profits. The Existing Regulations' focus on the latter, instead of the former, generally results in preferred shareholders not being preferred with respect to allocations of Subpart F income. That is, the Existing Regulations *do not* result in preferred shareholders being automatically allocated the first share of Subpart F income, with common shareholders being allocated any

Treas. Reg. § 1.951-1(e)(3) provides rules for determining a United States shareholder's pro rata share when allocation of the CFC's earnings and profits to two or more classes of stock under the general rule would depend upon the exercise of discretion of the CFC's board of directors. Under such circumstances, these separate classes of stock are considered to constitute a single class and each share is considered to have the same rights to dividends as any other share, unless a different method of allocation is established as appropriate by the United States shareholder.

### 3. Proposed Regulations

On August 6, 2004, the Treasury Department and the IRS published the Proposed Regulations, which would modify the pro rata share rules of the Existing Regulations.<sup>16</sup> According to the preamble to the Proposed Regulations (the "Preamble"), the Proposed Regulations are intended to update the regulations to take into account increasing complexity in international business arrangements and to provide for results that are more consistent with the economic interests of shareholders in a CFC.<sup>17</sup>

## III. Specific Comments on Proposed Regulations

### 1. Technical Issues

This section addresses several technical issues arising under the Proposed Regulations and suggests modifications to the Proposed Regulations to address these issues.

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remainder (i.e. the excess of the CFC's Subpart F income over the preferred shareholders' preferential return for the year). Instead, under the Existing Regulations, preferred and common shareholders share in Subpart F income based upon their relative shares of a hypothetical distribution of all of the current earnings and profits of the CFC.

If the goal of Subpart F is simply to ensure that a certain amount of a CFC's current earnings are included currently in the income of the CFC's United States shareholders, then we question whether the hypothetical distribution rule is the appropriate guide for determining pro rata shares. In many situations, preferred shareholders will be required to include in income each year an amount of the CFC's earnings and profits as an actual dividend (or deemed dividend under section 305). The Existing Regulations would not take the amount so included in income into account as a dollar-for-dollar reduction in the amount of subpart F income to be allocated among the CFC's shareholders. While we question whether this is appropriate, due to the long history of the Existing Regulations, we generally do not recommend altering this approach in a typical case (although we do request that more specific guidance be provided regarding the application of these rules under certain common business arrangements). See section V for a further discussion and a potential alternative approach to be used in unusual cases.

<sup>16</sup> 69 Fed. Reg. 47822 (Aug. 6, 2004). Certain minor corrections are published at 69 Fed. Reg. 57896 (Sept. 27, 2004).

<sup>17</sup> Although not explicitly stated in the Preamble, the Proposed Regulations appear to be intended to address certain transactions similar to the transaction described in TAM 200437033 (May 20, 2004). As described in section III.3.b, the litigating position of the Internal Revenue Service ("IRS") appears to be that, even under the Existing Regulations, the transaction described in TAM 200437033 does not achieve the taxpayer's intended objectives. See TAM 200437033. The Proposed Regulations generally would modify all of the rules the taxpayer relied upon to achieve these objectives. See *id.*

a. References to “Amount Determined Under Section 956”

The Proposed Regulations would replace the references in the Existing Regulations to the “increase in earnings invested in United States property” with references to the “amount determined under section 956.” The Preamble states that this modification is intended to update the regulations to reflect the 1993 Act changes to sections 951(a)(1)(B) and 956. We believe that updating the regulations to reflect the 1993 Act changes will require additional and different regulatory modifications.

For example, as proposed to be modified, Treas. Reg. § 1.951-1(e)(1) would provide that “a United States shareholder’s pro rata share of a [CFC]’s . . . amount determined under section 956 . . . for any taxable year is his pro rata share determined under . . . [the general rule of] paragraph (c) of § 1.956-1.” We believe that there are several technical problems with this proposal. First, the phrase “amount determined under section 956” for a CFC is undefined and may not be completely clear since section 956 inclusions are not determined based on a shareholder’s pro rata share of a single section 956 “amount.” If this phrase is intended to be a reference to the average amount of United States property held by a CFC, then the Proposed Regulations should be modified to make this clear. In any event, we suggest that the reference to Treas. Reg. § 1.956-1(c) should be eliminated, as this regulation has not been updated to reflect the 1993 changes to sections 951(a)(1)(B) and 956.

More important, as we understand the Treasury Department and the IRS are aware, substantial changes to the regulations under Subpart F are required in order to take into account the 1993 Act changes to sections 951(a)(1)(B) and 956. We, therefore, suggest that a new regulations project be opened under section 956 that has as its objective to clarify the manner in which the pro rata share rules will be applied for purposes of sections 951(a)(1)(B) and 956. In the meantime, it may be appropriate to eliminate the reference to “amount determined under section 956” from the Proposed Regulations<sup>18</sup> and instead indicate in the Proposed Regulations that the pro rata share determinations under section 956 are to be made in accordance with the principles of the Proposed Regulations.<sup>19</sup> See below at section IV.2 for further discussion.

b. Prop. Treas. Reg. § 1.951-1(e)(2)

Prop. Treas. Reg. § 1.951-1(e)(2) provides a clarifying rule indicating that, when a CFC has only one class of stock outstanding, a United States shareholder’s pro rata share of the CFC’s Subpart F income is determined by allocating the CFC’s “earnings and profits” on a per share basis. The reference in Prop. Treas. Reg. § 1.951-1(e)(2) to the CFC’s “earnings and profits” is not entirely clear. Based upon other references in the Proposed Regulations, we interpret earnings and profits in this context to mean “earnings and profits for such year.” We suggest, however, that the language of Prop. Treas. Reg. § 1.951-1(e)(2) be modified to make this clear. Also, we suggest that the Proposed Regulations, in various places, clarify that the relevant amount of earnings and profits for the year is unreduced for actual distributions during the year.

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<sup>18</sup> In this event, Treas. Reg. § 1.951-1(e)(1) should not be modified as part of the Proposed Regulations.

<sup>19</sup> Compare Treas. Reg. § 1.1248-3(c)(4) (allocations of earnings and profits are made “in accordance with the principles of paragraph (e)(2) and (3) of § 1.951-1.”).

c. Prop. Treas. Reg. § 1.951-1(e)(3)(ii)

Prop. Treas. Reg. § 1.951-1(e)(3)(ii) provides special “pro rata share” rules (including the “Valuation Rule” described below) that are invoked when allocation of a CFC’s earnings and profits under the general hypothetical distribution rule would depend upon an exercise of discretion by the CFC’s board of directors. Discussion of the conceptual approach and continuing need for these special rules is provided in section III.2 below; comments on the technical language of these rules is provided in the following paragraphs.

i. Prop. Treas. Reg. § 1.951-1(e)(3)(ii)(A)

The first sentence of Prop. Treas. Reg. § 1.951-1(e)(3)(ii)(A) generally tracks the language of a similar provision of the Existing Regulations.<sup>20</sup> At the end of this sentence, however, the term “discretionary distribution rights” appears in parentheses. “Stock with discretionary distribution rights” is then used as a defined term throughout the remainder of the Proposed Regulations. We understand that this part of the Proposed Regulations is intended to provide special rules for stock that, at the discretion of the board of directors, may or may not be entitled to a distribution for a given year. What other types of situations are intended to invoke these special rules is unclear.

We are concerned that the broad operative language of the regulations (i.e., invoking the special rules whenever “allocation . . . depends upon the exercise of discretion” of the board of directors) may encompass certain situations not intended to be covered. For example, many decisions made by a board of directors will affect the amount of a CFC’s earnings and profits for a given year and may affect whether sufficient earnings and profits are available to pay a dividend on preferred stock for such year. A board of directors’ discretion to make such decisions, however, should not invoke the special rules for stock with discretionary distribution rights. We suggest that the focus of this rule be the situation where a CFC has outstanding more than one class of stock and the CFC’s board of directors has the discretionary power to make distributions on one or more of such classes in a given year. If other situations are intended to be covered, we suggest the Proposed Regulations be revised to describe more specifically these types of situations.

ii. Prop. Treas. Reg. § 1.951-1(e)(3)(ii)(B)

Prop. Treas. Reg. § 1.951-1(e)(3)(ii)(B) provides that discretionary distribution rights that invoke special allocation rules “do not include rights to redeem shares of a class of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)).”<sup>21</sup> As discussed in further detail below, we agree that, as a

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<sup>20</sup> See Treas. Reg. § 1.951-1(e)(3). Note that the term “foreign corporation” in the Existing Regulations has been replaced with “controlled foreign corporation” in the Proposed Regulations. No explanation is provided for this change.

<sup>21</sup> We note that a shareholder’s put right or right to require a corporation to redeem his stock, as opposed to a corporation’s discretionary right to redeem such stock, should not cause the shareholder’s stock to be subject to these special rules, since as described in section III.2.b below, these special rules only apply when a CFC’s *board of directors* has the power to take actions that would result in the allocation of earnings and profits between or among

general principle, entitlement to distributions that economically represent a return *of* capital should not be taken into account as rights to receive a return *on* capital for purposes of determining pro rata shares of earnings or Subpart F income. As a technical matter, however, we suggest that Prop. Treas. Reg. § 1.951-1(e)(3)(ii)(B) may not be necessary in light of the fact that Prop. Treas. Reg. § 1.951-1(e)(4) states generally, “no amount shall be considered to be distributed with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent such distribution would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), as a distribution in liquidation, or as a return of capital.”

d. Prop. Treas. Reg. § 1.951-1(e)(3)(iv)

Prop. Treas. Reg. § 1.951-1(e)(3)(iv) provides that, if an arrearage exists with respect to a class of preferred stock of a CFC, the CFC’s current earnings and profits will be allocated to the preferred shares only to the extent that the arrearage exceeds the earnings and profits of the corporation “remaining” from prior taxable years beginning after December 31, 1962. The language of the Proposed Regulations with respect to dividend arrearages thus is identical to the language of the Existing Regulations in this regard.<sup>22</sup> Nonetheless, we believe that in some circumstances the regulations as written may inappropriately focus on a CFC’s accumulated earnings and profits. We recommend that the Proposed Regulations instead focus on the manner in which distributions would have been made, and whether an arrearage would have existed, under the hypothetical distribution rule as applied for prior years.

Example 1. CFC is wholly-owned by United States shareholder. CFC has \$200 of accumulated earnings and profits. On January 1, Year 3, CFC issues preferred stock to a foreign corporation (“FC”). The preferred shares are entitled to a \$50 cumulative preferred dividend. CFC has no current earnings and profits or Subpart F income in Year 3 and makes no distributions with respect to FC’s preferred shares. In Year 4, CFC has \$100 of current earnings and profits and Subpart F income.

Analysis. Under Prop. Treas. Reg. § 1.951-1(e)(3)(iv), the arrearage in dividends on FC’s preferred shares (\$50) does not exceed the earnings and profits of CFC remaining from prior taxable years (\$200). Thus, under the precise regulatory language, \$50 of CFC’s Year 4 earnings and profits would be treated as distributable to FC with respect to the Year 4 dividend preference but none with respect to the \$50 arrearage.

We recommend that the Proposed Regulations be revised to state that arrearages are taken into account for allocating Subpart F income under the pro rata share rules only to the extent they would have existed if actual distributions of current earnings and profits had been made in the same manner as hypothetical distributions would be made under the Proposed Regulations for all prior years while the preferred stock was outstanding. Accordingly, in the above example, \$100

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two or more classes of stock. By contrast, once a shareholder put right is granted, the exercise of such right generally is not subject to the discretion of the corporation’s board of directors.

<sup>22</sup> Treas. Reg. § 1.951-1(e)(2) (second sentence); *see also id.* § 1.951-1(e)(4) (Example 2).

of Year 4 earnings and profits would be allocated to the preferred stockholder under the hypothetical distribution rule (i.e., determined by taking into account the arrearage).

e. Prop. Treas. Reg. § 1.951-1(e)(5)(i)

As described in greater detail in section III.3 below, Prop. Treas. Reg. § 1.951-1(e)(5)(i) indicates that a restriction or other limitation on distributions of earnings and profits will not be taken into account in determining (i) the amount of earnings and profits allocable to a class of stock *or (ii) the amount of a United States shareholder's pro rata share of a CFC's Subpart F income*. As indicated above, although the Proposed Regulations would be incorporated by reference for purposes of a number of other pro rata share determinations, the main purpose of the Proposed Regulations we understand, is to provide rules for allocating a CFC's current earnings and profits among shares of stock for purposes of the general rule that Subpart F income is allocated in accordance with the hypothetical distribution rule. Thus, the second part of the regulatory provision (i.e., which indicates that a restriction or other limitation will not be taken into account in determining the amount of a pro rata share of Subpart F income), is merely confirmatory of the first part and not independently operative. We urge that the intended effect of the second part of this provision be clarified or that this part of the Proposed Regulations be eliminated.

f. Prop. Treas. Reg. § 1.951-1(e)(5)(ii)

Prop. Treas. Reg. § 1.951-1(e)(5)(ii) defines a “restriction or other limitation on distributions” to include any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a CFC *to a United States shareholder*. Other provisions of the Proposed Regulations indicate that a restriction or other limitation on distributions *to any shareholder* are relevant for purposes of determining the amount of earnings and profits allocable to a given share of stock.<sup>23</sup> To be consistent and balanced, we suggest the definition of a “restriction or limitation” in Prop. Treas. Reg. § 1.951-1(e)(5)(ii) be expanded to include a limitation on distributions to any shareholder.

g. Prop. Treas. Reg. § 1.951-1(e)(6), (7)

Prop. Treas. Reg. § 1.951-1(e)(7) clearly provides that the Proposed Regulations apply for taxable years of a CFC beginning on or after January 1, 2005. Yet, the examples in Prop. Treas. Reg. § 1.951-1(e)(6) all refer to computations being made with respect to the calendar year 2004. In order to avoid confusion, we recommend that the examples in the Proposed Regulations be modified to conform to the effective date in Prop. Treas. Reg. § 1.951-1(e)(7).

## 2. Stock with Discretionary Distribution Rights

### a. History of Provision

As previously indicated, the Existing Regulations, promulgated in 1965, provide a special rule for determining the earnings and profits allocable to a class of stock when, under the

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<sup>23</sup> See, e.g., Prop. Treas. Reg. § 1.951-1(e)(5)(i).

hypothetical distribution rule, such allocation would depend upon the exercise of discretion by the CFC's board of directors.<sup>24</sup> In such circumstances, the Existing Regulations require that each share of the separate classes to which allocations could be made (i.e., each share of the classes of stock with discretionary distribution rights) should be treated as having identical distribution rights, "unless a different method of allocation of earnings and profits is established as proper by the United States shareholder."<sup>25</sup>

The history and scope of this special rule are not entirely clear. We believe it would be unusual for one shareholder or shareholder group to agree to subscribe for a class of stock which on its terms permits a corporation's board of directors unfettered discretion to make distributions or otherwise allocate earnings to unrelated shareholders owning another class of stock without some proximate, compensating consideration (or donative intent, etc.). We question whether the discretionary distribution provisions of the Existing Regulations reflect events leading up to their promulgation and whether, in light of changes to section 305 enacted after the Existing Regulations were promulgated, there remains a need for special rules for stock with discretionary distribution rights.

During the years leading up to the promulgation of the Existing Regulations, there was significant press coverage of a new capital structure adopted by Citizens Utilities Co. Citizens Utilities Co. had amended its certificate of incorporation to provide for Series A and Series B common stock and authorized its board of directors, in their sole discretion, to declare in respect of either the Series A or Series B stock (or both) either (a) dividends in cash or property or (b) dividends of equal value in Series A common. Despite the flexibility granted to the board, the board expressed its intent to pay dividends solely in cash on the Series B stock and dividends solely in Series A stock on the Series A stock. Shareholders were granted an initial election to exchange their existing common stock for either Series A or Series B stock, and those who elected to receive Series A stock were given the further right, at any time, to exchange their Series A stock for Series B stock.<sup>26</sup>

The IRS issued a private letter ruling to Citizens Utilities, indicating that distributions of Series A stock as part of this arrangement would be nontaxable stock dividends under section 305(a).<sup>27</sup> At the time, section 305(b) generally treated stock dividends as taxable only in the event the recipient shareholder had an election to receive cash instead.<sup>28</sup> Soon after issuing the Citizens Utilities private ruling, the government changed course and proposed amendments to the regulations under section 305(b) to tax stock dividends received pursuant to a Citizens Utilities-type plan.<sup>29</sup> Commentators questioned whether such regulations were a valid interpretation of the statute, however,<sup>30</sup> and the regulations remained in proposed form for

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<sup>24</sup> Treas. Reg. § 1.951-1(e)(3).

<sup>25</sup> *Id.*

<sup>26</sup> Shares of each of Class A and Class B common stock ranked equally with respect to sharing in earnings and profits and in the assets at liquidation. For a discussion of the Citizens Utilities plan, see Boris I. Bittker & James S. Eustice, *Federal Income Tax'n of Corporations & Shareholders* ¶ 8.40[2] (7th ed. 2002).

<sup>27</sup> Priv. Ltr. Rul. 5603146720A (March 14, 1956).

<sup>28</sup> See Internal Revenue Code of 1954 § 305(b)(2).

<sup>29</sup> See 21 Fed. Reg. 5104 (July 10, 1956).

<sup>30</sup> See Charles S. Lowrimore, *IRS Attempts to Stop 2-Class-of-Common Tax-Saving Plan; Legality Questioned*, 5 J. Tax'n 178 (1956).

approximately 13 years prior to the statutory changes to section 305(b) enacted as part of the Tax Reform Act of 1969 (the “1969 Act”). As a result of the 1969 Act, any distribution of property to some shareholders, coupled with an increase in the proportionate interests of other shareholders in the assets or earnings and profits of a corporation, will cause such increase to be treated as a taxable stock dividend.<sup>31</sup>

While it is not clear whether the provision in the Existing Regulations governing stock with discretionary distribution rights was intended to govern a Citizens Utilities-type situation, in light of the current requirements of section 305, we ask that consideration be given to whether discretionary distribution rights present the same challenges they did when the Existing Regulations were promulgated.

Example 2. A CFC has two classes of stock outstanding, Class A and Class B stock. United States Shareholder X paid \$1000 for all of the 1000 shares of Class A stock outstanding, and United States Shareholder Y paid \$1000 for all of the 1000 shares of Class B stock outstanding. The Class B stock is convertible into Class A stock at any time, upon the election of the holder of Class B shares. At the outset, the conversion ratio is one-to-one. The board of directors of CFC has the discretionary power to pay cash distributions on either the Class A or the Class B stock at any time; however, any distribution on Class A will be matched with an increase in the number of shares of Class A stock delivered upon a conversion of Class B stock, and any distribution on Class B will be matched with a reduction in the number of Class A shares delivered upon such a conversion.

Analysis. Under the discretionary distribution rule of the Existing Regulations, it may be argued that each share of Class A and Class B stock should be treated as having identical rights to distributions. Consequently, it may be argued that while CFC’s capital structure remains in the form described, United States Shareholder Y has a 50% pro rata share of Subpart F income earned by CFC. Nonetheless, under section 305(b)(2) and (c), the change in the conversion ratio of the Class B stock as described above generally should be treated as a taxable stock distribution.<sup>32</sup> As a result, without regard to the special discretionary distribution rule, the amount of earnings and profits that would be distributed on each of Class A and Class B each year should be identical, since any distribution of a cash dividend on one class would be matched with a compensating taxable stock dividend on the other class. Consequently, under the assumed facts, application of the general hypothetical distribution rule should reach the same result as application of such rule after taking into account the special rule for stock with discretionary distribution rights.

As demonstrated by the preceding example, while the discretionary distribution rule of the Existing Regulations appears to achieve the right result in some cases,<sup>33</sup> it is not clear that

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<sup>31</sup> See I.R.C. § 305(b)(2), (c); *see also* Treas. Reg. § 1.305-3, -5.

<sup>32</sup> See Treas. Reg. § 1.305-7(b)(1).

<sup>33</sup> Through a simple change in the number of shares of Class A and Class B stock, however, the Existing Regulations arguably would provide the wrong answer. Thus, if there was only one share of Class B stock

such a rule remains necessary in light of the current provisions of section 305. Moreover, in light of the other proposed changes to the pro rata share regulations (e.g., ignoring redemptions and restrictions on distributions), we believe the discretionary distribution rule may have limited application. Therefore, as described in section V below, instead of developing a special rule directed toward such unusual cases, we encourage the Treasury Department and the IRS to provide additional guidance and illustrative examples governing the application of the pro rata share rules to common capital structures and to consider providing a general “fallback” rule that may be applied in other cases. In the event that the decision is made to retain a special rule to govern discretionary distribution situations, the following comments on the conceptual approach of the discretionary distribution provisions of the Proposed Regulations are, in our view, pertinent.

b. Relative Value Approach of Discretionary Distribution Provisions

Under the Proposed Regulations, allocations of earnings and profits among classes of stock with discretionary distribution rights depend on the relative values of each such class to the total value of all classes of stock having discretionary distribution rights (the “Valuation Rule”).<sup>34</sup> If a class of stock has both fixed and discretionary distribution rights, earnings must first be allocated to the fixed rights under the hypothetical distribution rule, and thereafter allocated to the discretionary distribution rights under the Valuation Rule.<sup>35</sup>

The Preamble describes the Valuation Rule as “analogous to the approach used for allocating adjustments among classes of stock for consolidated return purposes.” The Preamble refers to Treas. Reg. § 1.1502-32(c) as embodying this “analogous” approach, but in fact, we believe the approach used in that regulation is different from the Valuation Rule. Under Treas. Reg. § 1.1502-32(c), investment adjustments are allocated between two or more classes of common stock “by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement.” In particular, the allocation takes into account (1) the interest of each share in economic profits and losses, (2) the interest of each share in cash flow and other non-liquidating distributions.<sup>36</sup>

The description in the Preamble suggests that the drafters of the Proposed Regulation believed that the Valuation Rule necessarily embodies similar considerations to those under Treas. Reg. § 1.1502-32(c). However, it is far from clear that the Valuation Rule in fact would take all of these factors into account in the same manner as Treas. Reg. § 1.1502-32(c). Certainly, more than one valuation methodology would typically be needed. For example, an approach based solely on relative values, as determined under a discounted cash flow

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outstanding and 1,000,000 shares of Class A stock outstanding (and the initial conversion ratio was one share of Class B for 1,000,000 shares of Class A), under the Existing Regulations, each of the 1,000,001 shares of CFC stock outstanding generally would be treated as having equivalent rights to distributions and the Class B stock may be allocated only 1/1,000,001 of CFC’s Subpart F income in a given year. It is assumed that the Valuation Rule of the Proposed Regulations is intended to correct the Existing Regulations and change this result.

<sup>34</sup> Prop. Treas. Reg. § 1.951-1(e)(3)(ii). If the values of two classes are “substantially” the same, they are treated as a single class, as in the Existing Regulations. *Id.* § 1.951-1(e)(3)(ii). See Prop. Reg. 1.951-1(e)(6), Examples 3 and 4, for an illustration of the operation of this rule assuming given valuations.

<sup>35</sup> Prop. Treas. Reg. § 1.951-1(e)(3)(iii).

<sup>36</sup> Treas. Reg. § 1.1502-32(c)(2)(ii)(A); *cf.* Treas. Reg. § 1.704-1(b)(3).

methodology, may give undue weight to the likelihood of speedy return of capital, and fail to give proper consideration to a shareholder's more uncertain claim on earnings.

Moreover, valuation of stock that is not traded on an established securities market is an inexact science. The cases referred to in the Preamble as examples of valuation methodologies are very complex and involve the weighing of factors, which are less specific than the factors used in Treas. Reg. § 1.1502-32(c).<sup>37</sup> None of these authorities apply to comparative valuations of more than one class of stock. Adding to the degree of difficulty in this regard are the special rules that must be applied under the Proposed Regulations, including the requirement that restrictions or other limitations on distributions be ignored in determining the proper allocation of a CFC's earnings and profits, and the fact that valuations must be completed as of the end of each year.<sup>38</sup>

Although there is precedent for the approach in the Proposed Regulations, we note that in other contexts the Code limits valuation of stock or debt instruments to publicly traded instruments.<sup>39</sup> Further, the valuation approach advocated in the Proposed Regulations would be open to manipulation, with taxpayers relying on a multitude of permitted valuation factors (e.g., lack of liquidity, minority interest) and structures<sup>40</sup> to assign a relatively low value to the class of stock held by United States shareholders who desire to avoid Subpart F income. Thus, in the event a special rule for stock with discretionary distribution rights is retained, we urge the Treasury Department and the IRS to consider an alternative approach that focuses more closely on the agreed economic sharing among the owners of the CFC, similar to the general "fallback" rule advocated in section V.2 below.

Further, except to the extent actual distributions affect the value of stock, the Valuation Rule does not appear to take into account the effect of actual distributions. We question whether it would be appropriate to allocate earnings and profits to more than one class of stock in a year in which all earnings and profits are actually distributed on a single class of stock. The effect could be that a United States shareholder with no economic right to the earnings of a CFC for a given year is allocated a pro rata share of such CFC's Subpart F income for such year. By contrast, we note that under Treas. Reg. § 1.1502-32(c), any actual distributions are taken into account before any further earnings and profits are allocated for a given taxable year.

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<sup>37</sup> *Framatome Connectors USA, Inc. v. Commissioner*, 118 T.C. 32 (2002), *aff'd* 2004-2 U.S.T.C. (CCH) ¶ 50,364 (2d Cir. Sept. 13, 2004) (summary mem.) (valuing stock for purposes of determining whether foreign corporation was a CFC); Rev. Rul. 59-60, 1959-1 CB 237 (listing factors to be used for valuing privately held stock for estate tax purposes).

<sup>38</sup> Prop. Treas. Reg. § 1.951-1(e)(5).

<sup>39</sup> See I.R.C. §§ 1273(b)(3), 1274, 1296. *But cf.* Treas. Reg. § 1.7701(l)-3(c)(2)(i) (in a fast-pay arrangement, the "benefited shareholders" are treated as issuing financial instruments directly to the fast-pay shareholders for cash equal to the fair market value of the fast-pay stock at the time of issuance).

<sup>40</sup> See *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145 (May 20, 2003).

### 3. Special Rules Ignoring Redemptions and Certain Restrictions on Distributions

#### a. Background

The Proposed Regulations contain special rules ignoring redemptions and certain restrictions on distributions for purposes of measuring the earnings and profits allocable to different classes of stock.<sup>41</sup>

For example, where a CFC had outstanding common and non-voting preferred shares and where the board of directors generally had the power to redeem the preferred stock at any time, the Proposed Regulations would ignore the redemption of the preferred stock. Where the terms of the preferred and common shares of a CFC provide that so long as the preferred stock remains outstanding, no dividends may be paid on the common stock, the Proposed Regulations would ignore the restriction on distributions to the common stock. Specifically, under Prop. Treas. Reg. § 1.951-1(e)(4), the redemptions of the preferred stock would not be counted in computing the hypothetical distributions of earnings and profits to which the preferred stockholder would be entitled. Prop. Treas. Reg. § 1.951-1(e)(5) would then provide that the prohibition on distributions with respect to the common stock while the preferred stock was outstanding would be disregarded. The net result would be that the preferred stockholder would receive a hypothetical distribution for purposes of Prop. Treas. Reg. § 1.951-1(e)(3)(i) limited to the stated dividend on the preferred shares, and the remainder of the current year earnings would be hypothetically distributed to the common shareholder. These two special rules are illustrated in Examples 7 and 6, respectively, of the Proposed Regulations.<sup>42</sup>

#### b. Comments on Ignoring Redemptions and Restrictions on Distributions

The following paragraphs contain our comments on the provisions of the Proposed Regulations that would ignore redemptions and restrictions on distributions.

##### i. Ignoring Redemptions

Prop. Treas. Reg. § 1.951-1(e)(4) states that no amount shall be considered distributed with respect to a class of stock to the extent the distribution would constitute “a distribution in redemption of stock . . . , as a distribution in liquidation, or as a return of capital.” As previously stated, we recommend that entitlement to distributions that economically represent a return *of* capital not be taken into account for purposes of determining the manner in which shareholders have agreed to share the economic earnings of a corporation. Thus, we urge that distributions in redemption or in liquidation that represent a return of capital be ignored for purposes of the pro rata share rules. Distributions in redemption or in liquidation that represent a return *on* capital, however, are properly within the ambit of the Proposed Regulations.

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<sup>41</sup> Although not explicitly stated, these rules appear to be intended to address a type of structuring described in TAM 200437033.

<sup>42</sup> Although these new rules would have required the taxpayer in TAM 200437033 (the “TAM”).

Example 3. CFC has outstanding preferred and common stock. The preferred stock was issued for \$50 and must be redeemed 5 years from the date of its issuance for \$100. CFC has \$100 of earnings and profits each year for 5 years.

Analysis. Assume that under section 305(b)(4) and (c), \$10 is deemed distributed on the preferred stock each year. Even though these amounts are only payable upon redemption of the preferred stock, however, we suggest that they be taken into account under the Proposed Regulations.

In light of the fact that the accruing dividend on the preferred stock in the preceding example is treated as a dividend for federal income tax purposes, we believe these amounts, and other deemed distributions under section 305, are appropriate in applying the hypothetical distribution rule. This result may not be absolutely clear in light of the Proposed Regulations' direction to ignore redemptions. While this could be clarified easily, other situations present more difficult problems.

Example 4. Assume the same facts as Example 3, except that the preferred stock participates in the corporate growth of CFC to a significant extent (e.g., through participation in dividends on the common stock), such that the preferred stock is not treated as preferred stock for purposes of section 305(b)(4).

Analysis. As a result of the change in assumed facts, no amount is deemed distributed on the preferred stock. Again, it seems that the amount payable upon redemption of the preferred stock would be ignored under the Proposed Regulations. It is not clear to us that this is the appropriate result. On the other hand, a rule that would achieve the appropriate result will not be easily crafted. For example, it also would seem inappropriate to require some economic accrual of the redemption premium for purposes of the pro rata share rules, when this approach is not required under section 305.<sup>43</sup>

We note that commentators on the fast-pay stock regulations raised similar concerns regarding the appropriateness of treating all redemptions as returns of capital, regardless of whether they are treated as dividends under section 302(d).<sup>44</sup> While the recharacterization resulting from an application of the fast-pay stock regulations is significantly different from the effect of applying the pro rata share regulations, we believe that treating all redemptions as

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<sup>43</sup> Moreover, it is not entirely clear whether the facts in this example would cause the preferred stock and the common stock to fall under the special rules for stock with discretionary distribution rights, since decisions by the CFC's board of directors to make other distributions may leave insufficient funds available to make the required distributions in redemption of the preferred stock.

<sup>44</sup> See New York State Bar Ass'n Tax Section, *Report on Proposed Treasury Regulations 1.7701(l)-3* (May 13, 1999) ("[I]n the case of redemption transactions, a well-wrought and integrated series of provisions already protects the fisc from the type of mischaracterization of amounts received that animated the issuance of the [Fast-Pay Stock] Notice and the Proposed Regulations. As a result, the Committee believes that it would be unwise and inappropriate to override the rules and principles of *Section 302* by applying the Proposed Regulations to redemption transactions. Instead, the Committee recommends that the Proposed Regulations, when finalized, contain an explicit statement to the effect that stock will not be considered to be fast-pay stock merely because the parties intend to redeem such stock in the future in a transaction qualifying as a distribution pursuant to *Sections 302(d)* and *301*.").

returns of capital for purposes of the pro rata share rules has the potential to yield anomalous results. For example, a common shareholder may have a significant Subpart F inclusion when the amount of the inclusion is determined under the hypothetical distribution rule without regard to a potential redemption of outstanding preferred stock (that would be treated as a dividend), while a preferred stockholder may have significant dividend income when the actual redemption of his preferred stock is treated as a dividend under sections 302(d) and 301.<sup>45</sup> While this result may be considered appropriate with respect to the common stockholder, it may be considered inappropriate given that the allocation of subpart F income to the common stockholder does not preclude the preferred stockholder from recognizing dividend income. Thus, we recommend that additional consideration be given to providing an exception to the rule ignoring redemptions, where to do otherwise would result in double inclusions of income or other similar anomalies in situations that are unlikely to be abusive (i.e., when the preferred stockholder is not a tax-indifferent party).

## ii. Ignoring Restrictions on Distributions

The Proposed Regulations disregard “any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation to a United States shareholder, other than currency . . . restrictions . . . imposed under the laws of a foreign country as provided in section 964(b).”<sup>46</sup> The Proposed Regulations provide a non-exclusive list of such restrictions:

- An arrangement that restricts the ability of the CFC to pay dividends on a class of shares 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 CFC that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; and
- An arrangement that conditions the ability of the CFC to pay dividends to its shareholders on the financial condition of the CFC.

The Preamble specifically states, “This rule applies in all cases, including cases where the restriction or limitation is the result of an arrangement between unrelated parties or an arrangement that has a non-tax motivated business purpose and economic substance.”

Prop. Treas. Reg. §1.951-1(e)(5)(iii) provides a narrow exception to the definition of restrictions to be ignored. It provides that

The right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate . . . or otherwise) with respect to a class of stock the distribution of which is a condition precedent

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<sup>45</sup> *But see* Prop. Treas. Reg. § 1.302-5 (treating a shareholder whose stock redemption is treated as the receipt of a dividend as recognizing a loss from the disposition of the redeemed stock under certain circumstances).

<sup>46</sup> Prop. Treas. Reg. § 1.951-1(e)(5)(ii).

to a further distribution of earnings and profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation . . . under paragraph (e)(5) of this section.

This exception would clearly cover the common case of a fixed dividend that is periodically payable on preferred stock and that must be paid before dividends may be paid on common stock. It is not clear, however, whether it would apply in other situations in which a return on capital is not separately stated or paid periodically.

Example 5. CFC has outstanding two classes of stock, Class A and Class B. United States shareholder X contributed \$50 to CFC in exchange for the Class A. United States shareholder Y contributed \$100 to CFC in exchange for the Class B. Pursuant to the terms of the Class A, CFC will distribute its first \$60 of cash flow to Y (as, when and if such cash flow is generated). All other distributions will be made equally on Class A and Class B.

Analysis. It is not entirely clear whether the requirement that CFC distribute its first \$60 of cash flow to Y represents a restriction on distributions under the Proposed Regulations. (It also is not clear whether such a distribution should be treated as a redemption under the Proposed Regulations.) This requirement does limit the amount that may be distributed to X, but because the amount distributed (\$60) exceeds the amount necessary to reduce the amount of Y's unreturned capital down to a level that is equal to X's unreturned capital (\$50), the amount of such excess (\$10) may ultimately represent a fixed, preferential return on Y's capital. The amount is not, however, paid periodically and, because the amount of the preferential distribution does not exceed the amount invested, it does not clearly represent a return on capital. If the requirement to make this preferential distribution were ignored, then it would appear under the Proposed Regulations that each of X and Y would have a 50% pro rata share of CFC's Subpart F income. This seems to us to be the wrong answer. The \$10 return on Y's capital should not be disregarded.

The goal of the present rule, as well as the rule ignoring redemptions and liquidations, appears to be to distinguish distributions that economically represent a return *of* capital from distributions that economically represent a return *on* capital when calculating a shareholder's pro rata share. We agree that the federal income tax rules for determining when a corporation has distributed earnings and profits may not always provide an appropriate guide.<sup>47</sup> We are concerned, however, that even as modified by the Proposed Regulations, these federal income tax rules may not properly distinguish between returns *of* and returns *on* capital.<sup>48</sup> We believe

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<sup>47</sup> It is noted that redemptions reduce a corporation's earnings and profits. See I.R.C. § 312(n)(7) ("in a redemption to which section 302(a) applies . . . the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of such corporation . . . attributable to the stock so redeemed.").

<sup>48</sup> Also, as discussed at section V.1 below, we note that there is considerable overlap between a targeted rule ignoring restrictions on distributions and the fast-pay stock regulations under Treas. Reg. § 1.7701(l)-3. If this targeted rule were retained, some coordination between the two sets of rules is recommended.

the government and taxpayers may be better served through the provision of specific examples illustrating the application of the pro rata share rules to certain common business arrangements. We also urge the inclusion of a general “fallback” rule that sets out the principles to be applied in unusual cases.<sup>49</sup>

#### **IV. Coordination with Other Pro Rata Share Rules/Stock Ownership Rules**

##### **1. Stock Ownership Rules**

Pursuant to section 951(a)(1)(A), a United States shareholder is required to include in income his pro rata share of a CFC’s Subpart F income. For this purpose, a shareholder’s pro rata share is determined by reference to shares of a CFC’s stock *directly or indirectly* owned by such person (through the application of section 958(a)).<sup>50</sup> Thus, the first step in determining a United States shareholder’s pro rata share of Subpart F income is to identify the stock directly or indirectly owned by the shareholder.

Section 958(a) provides rules for determining the direct and indirect ownership of CFC stock. Under section 958(a)(2), stock held by a foreign entity is treated as indirectly owned “proportionately” by its shareholders, partners, or beneficiaries. If the shareholder, partner, or beneficiary is itself a foreign entity, the stock indirectly owned by the entity is treated as actually owned by such entity, for purposes of again applying this indirect ownership rule. In this manner, indirect stock ownership flows through a chain of foreign entities until it is attributed to an individual or a domestic corporation, domestic partnership, domestic trust, or domestic estate.

Treas. Reg. § 1.958-1(c)(2) provides that, in general, a person’s proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate is determined “on the basis of all the facts and circumstances in each case.” More specifically the regulations state:

in determining a person’s proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section 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 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.<sup>51</sup>

Once a United States shareholder’s direct and indirect stock ownership has been determined, Subpart F income is then allocated to that stock in accordance with the pro rata share rules. As set forth above, under the Existing Regulations, pro rata shares generally are determined under the hypothetical distribution rule based upon relative entitlements to distributions of earnings and profits. The Proposed Regulations would provide certain special rules for purposes of determining the amount of earnings and profits distributable on a class of stock under the hypothetical distribution rule. Since the pro rata share determination is made only after indirect ownership has been established, however, we are concerned that the Proposed

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<sup>49</sup> See section V.2.

<sup>50</sup> See I.R.C. § 951(a)(2)(A).

<sup>51</sup> Treas. Reg. § 1.958-1(c)(2).

Regulations may achieve little unless changes also are made to integrate the indirect stock ownership regulations with the pro rata share regulations.

Example 6. A CFC has outstanding one class of stock, which is wholly-owned by a non-U.S. limited partnership that is treated as a foreign partnership for U.S. federal tax purposes (FPSHP). USGP is a U.S. domestic partnership that serves as FPSHP's sole general partner. FLP is a non-U.S. corporation that serves as FPSHP's sole limited partner.

FLP contributes funds to FPSHP in exchange for limited partner units, and USGP contributes funds to FPSHP in exchange for general partner units. Pursuant to the terms of FLP's limited partner units, FLP is entitled to a fixed return on its invested capital and a relatively small percentage interest in all other profits and losses of FPSHP. Pursuant to the terms of USGP's general partner units, USGP is entitled to all other profits and losses of FPSHP. FPSHP is required to distribute all of its available cash to FLP until FLP has received distributions equal to the amount of its invested capital and its fixed return. Thereafter, distributions will be made in accordance with relative percentage interests in profits and losses.

FPSHP uses the funds contributed to it to make a capital contribution to CFC. CFC, in turn, loans these funds back to USGP, in exchange for USGP's obligation to repay this loan with interest at a rate significantly in excess of FLP's fixed return.

Analysis. The amount of CFC stock indirectly owned by USGP under section 958(a) is unclear. Query whether, under Treas. Reg. § 1.958-1(c)(2), the amount of CFC stock indirectly owned by USGP will depend upon the relative amount of FPSHP's income that is available to be distributed to USGP (as opposed to the income required to be distributed to FLP). The special pro rata share rules contained in the Proposed Regulations have no impact upon this determination.

We note that, like the Existing Regulations, Treas. Reg. § 1.958-1(c)(2) has not been amended in nearly 40 years and provides limited guidance with respect to common international business arrangements, especially those involving partnerships. We strongly urge amendments be made to Treas. Reg. § 1.958-1(c)(2) to address modern business arrangements. We further suggest that amendments to Treas. Reg. § 1.958-1(c)(2) to integrate the determination of indirect ownership with the Proposed Regulations be treated as a priority in conjunction with the finalizing of the Proposed Regulations themselves. We note that, unlike the Proposed Regulations, the changes to the indirect ownership rules will have to take account of the fact that these rules apply to foreign corporations, partnerships, trusts and estates.

## 2. Section 956 Inclusions

As described previously, a United States shareholder's section 956 inclusion generally is determined based upon the lesser of (i) such shareholder's pro rata share of the CFC's current

and accumulated earnings and profits (with some modifications) and (ii) the excess of (a) such shareholder's pro rata share of the CFC's average investment in United States property for the year, over (b) the amount of the shareholder's section 956 previously taxed earnings. Because a section 956 inclusion is effectively a deemed dividend, once the amount of a shareholder's section 956 inclusion is determined, the shareholder is permitted to reduce the amount of his required income inclusion (i.e., the amount of the deemed dividend) by the amount of earnings and profits that could have been actually distributed to him as a dividend without tax under Subpart F ("Subpart F income previously taxed earnings").<sup>52</sup>

As a result of the interrelationship between the computations required under section 956 and the pro rata share rules under section 951(a)(2), we suggest that it would be appropriate in making section 956 determinations to follow the section 1248 rules, which incorporate by reference the pro rata share rules for purposes of determining a shareholder's pro rata share of a CFC's current and accumulated earnings and profits.<sup>53</sup> Under the section 1248 rules, consistent with section 956(b), a shareholder's pro rata share of a CFC's current earnings and profits is determined by applying the hypothetical distribution rule after taking into account actual distributions for such year.

Because a section 956 inclusion is intended to be a surrogate for a dividend distribution, and because a shareholder's pro rata share of the current and accumulated earnings and profits of a CFC is intended to measure the amount of the CFC's earnings and profits that are available for distribution to the shareholder, we suggest that a United States shareholder's pro rata share of a CFC's investment in United States property for a given year be determined based upon the relative amount of current and accumulated earnings and profits allocated to that shareholder as described in the preceding paragraph. Despite the statute's reference to a shareholder's pro rata share of an investment in United States property *for a given year*, we urge that such pro rata share not be determined solely based on current year items.

Example 7. A CFC has outstanding two classes of stock, common and preferred, each of which is owned by a separate United States shareholder. The preferred stock is entitled to a fixed dividend of \$50 each year. The common stock is entitled to any remaining distributions (when, as and if declared by the CFC's board of directors). For the first year of its operations, the CFC has \$100 of earnings and profits, \$50 of Subpart F income and makes a \$50 distribution to the preferred stockholder (and no other distributions). CFC has an average investment in United States property for the year of \$100.

Analysis. The first step in determining the common and preferred stockholders' section 956 inclusions is to determine the pro rata shares of CFC's Subpart F income for the year. Under the hypothetical distribution rule, \$50 of CFC's earnings and profits would be distributed to the preferred stockholder and \$50 would be distributed to the common stockholder. Consequently, each

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<sup>52</sup> See I.R.C. §§ 951(a)(1)(B), 959(a)(2); see also Treas. Reg. § 1.959-1(c).

<sup>53</sup> Cf. Treas. Reg. § 1.1248-3(c)(4), (d)(6).

stockholder's pro rata share of CFC's Subpart F income would be 50%, and each stockholder would be required to take into account a \$25 Subpart F inclusion.

The next step in determining the stockholders' section 956 inclusions is to take into account actual distributions. Again, \$50 was distributed to the preferred stockholder. Because the preferred stockholder took into account a \$25 Subpart F inclusion, only \$25 of this amount would be treated as a dividend and the remainder would be a distribution of Subpart F income previously taxed earnings.

The stockholders' section 956 inclusions may now be determined. After taking into account the distribution to the preferred stockholder, CFC has \$50 of earnings and profits, and \$25 of such amount has been included in income of the common stockholder as a Subpart F income inclusion. CFC has an investment in United States property for the year equal to \$100.

The common stockholder's section 956 inclusion is equal to the lesser of (i) his pro rata share of the current and accumulated earnings and profits of CFC and (ii) the excess of (a) his pro rata share of CFC's average investment in United States property for the year, over (b) the amount of his section 956 previously taxed earnings. For this purpose, the common stockholder's pro rata share of current and accumulated earnings and profits of CFC (after taking into account distributions) should be \$50. CFC's average investment in United States property for the year was \$100, and the common stockholder's pro rata share of this average investment should be 100% (same as the common stockholder's relative share of the CFC's current and accumulated earnings and profits, \$50/\$50 or 100%). Thus, the common stockholder's pro rata share of CFC's average investment in United States property for the year should be \$100. The common stockholder has no section 956 previously taxed earnings. Consequently, the common stockholder generally would have a \$50 section 956 inclusion for the year. The amount of this section 956 inclusion would be reduced, however, by the amount of the common stockholder's Subpart F income previously taxed earnings of \$25.

The preferred stockholder's section 956 inclusion is equal to the lesser of (i) his pro rata share of the current and accumulated earnings and profits of CFC and (ii) the excess of (a) his pro rata share of CFC's average investment in United States property for the year, over (b) the amount of his section 956 previously taxed earnings. For this purpose, the preferred stockholder's pro rata share of current and accumulated earnings and profits of CFC (after taking into account distributions) should be zero. Consequently, the preferred stockholder should have no section 956 inclusion for the year.

As demonstrated by the preceding example, the calculations required under section 956 can be extremely complicated.<sup>54</sup> We believe the Proposed Regulations' replacement of the

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<sup>54</sup> We have ignored the additional complications raised by changes in a CFC's capital structure or sale of stock in a CFC.

reference to “increase in earnings invested in United States property” in the Existing Regulations with a reference to “amount determined under section 956” leaves the task of producing workable and understandable rules under section 956. In light of the current attention to the pro rata share rules, we urge the Treasury Department and the IRS to undertake to publish Proposed Regulations or other guidance that demonstrates the manner of making the relevant pro rata share determinations under section 956.

### 3. E&P Limitation

#### a. General

Under section 952(c)(1)(A) and the regulations thereunder, a United States shareholder’s pro rata share of a CFC’s Subpart F income for any year cannot exceed that shareholder’s pro rata share of the CFC’s earnings and profits for such year.<sup>55</sup> For this purpose, a shareholder’s pro rata share is determined under the principles of the Existing Regulations.<sup>56</sup> It is noted that when a CFC has outstanding both preferred and common stock, the E&P Limitation generally has the effect of first reducing the amount of Subpart F income allocable to the common stock.

Example 8. A CFC has outstanding two classes of stock, common and preferred, and each class is owned by a separate United States shareholder. The preferred stock is entitled to an annual fixed dividend of \$50. After payment of the preferred stock dividend, all further dividends are distributable on the common stock. CFC has \$100 of Subpart F income for its first year of operations (all in a single section 904(d) basket), but due to losses from unrelated operations, only \$50 of earnings and profits for such year.

Analysis. The preferred stockholder’s pro rata share of CFC’s earnings and profits is equal to the amount of such earnings and profits that would be distributed on the preferred stock in the event CFC distributed all of such earnings and profits (\$50) for such year. If CFC distributed all of its earnings and profits for the year, and made no other distributions for such year, 100% (\$50/\$50) of such earnings and profits would be distributed on the preferred stock. Consequently, under the Existing Regulations (and under the Proposed Regulations), all of CFC’s Subpart F income (\$100) for the year generally would be allocated to the preferred stockholder; however, because the Subpart F income would exceed the preferred stockholder’s pro rata share of CFC’s earnings and profits (\$50), the preferred stockholder’s Subpart F inclusion will be limited to \$50 for the year. The common stockholder will have no Subpart F inclusion for the year.

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<sup>55</sup> Treas. Reg. § 1.952-1(c)(1); *see also* I.R.C. § 952(c)(1)(A).

<sup>56</sup> Treas. Reg. § 1.952-1(c)(2)(iii).

b. Recapture

A CFC is required to maintain accounts, reflecting the amount of its Subpart F income in each foreign tax credit category that has been subject to the E&P Limitation.<sup>57</sup> In any future year in which its earnings and profits exceed its Subpart F income, the CFC is required to compute and account for an additional amount of Subpart F income (generally, up to the total amount of Subpart F income previously eliminated by the E&P Limitation).<sup>58</sup> The additional Subpart F income will be treated as arising from each separate foreign tax credit basket to which the E&P Limitation was allocated on a proportionate basis (i.e., some portion of each recapture account will be “recharacterized” as Subpart F income). The regulations state, “The United States shareholder must include his pro rata share (determined under the rules of § 1.951-1(e)) of each recharacterized amount in income as subpart F income in such separate [basket] for the taxable year.”<sup>59</sup>

Example 9. Assume the same facts from Example 8. In the next year, CFC has no Subpart F income and \$200 of earnings and profits (all in a single section 904(d) basket).

Analysis. On these facts, there will be recapture income of \$50 determined at the CFC level. The preferred stockholder’s pro rata share is determined based upon the amount of the CFC’s earnings and profits that would be distributed on the preferred stock in the event that the CFC distributed all of its earnings and profits for the year.<sup>60</sup> If CFC distributed all of its earnings and profits for the year, \$50 of the CFC’s \$200 of earnings and profits would be distributed on the preferred stock. Consequently, the preferred stockholder’s pro rata share of the recapture income is 25%, and the preferred stockholder would have a \$12.50 Subpart F inclusion for the year. The common stockholder also would have a \$37.50 Subpart F inclusion for the year.

As demonstrated by the preceding example, use of the annual pro rata share determination for recapture income can yield results that are not necessarily reasonable or fair.<sup>61</sup> In the first year, the preferred stockholder had a Subpart F inclusion that was exactly equal to his

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<sup>57</sup> § 1.952-1(f)(1).

<sup>58</sup> § 1.952-1(f)(2)(ii).

<sup>59</sup> The reference to “*The*” United States shareholder makes the application of this regulatory provision somewhat uncertain. It is not entirely clear whether a CFC must maintain a recapture account with respect to each of its shareholders, who then may be required to take into account an amount of recapture income, or whether this is a CFC-level account that is then allocated among shareholders in the year of recapture. We believe the latter approach may be the better reading of the regulations, but as described below, we question whether this is appropriate as a policy matter.

<sup>60</sup> *See*. § 1.951-1(e).

<sup>61</sup> Foreign tax credit calculations and the high-tax exception of section 954(b)(4) may further complicate matters. For example, the high-tax exception is applied after the E&P Limitation, and thus the relative amount of taxes paid or accrued with respect to a CFC’s Subpart F income may increase as a result of an application of the E&P Limitation. The result may be that the preferred stockholder is not required to take into account a Subpart F inclusion at all, because such Subpart F income is treated as having been subject to a high rate of foreign taxes. *See* Treas. Reg. § 1.954-1(d)(4)(iii) (example). Recapture income, however, may not benefit from the high-tax exception (even if all of the original Subpart F income would have so benefitted). *Id.* § 1.954-1(a)(7).

share of the CFC's earnings and profits. In the next year, the CFC had no Subpart F income, yet the preferred stockholder was again called upon to take into account a Subpart F inclusion.<sup>62</sup> Moreover, intervening changes in capital structure may affect pro rata shares.

Example 10. Assume the same facts from Example 8 and Example 9, except that at the beginning of the second year, CFC issues a second class of preferred stock ("Class 2 Preferred") that is entitled to a fixed dividend of \$50 per year after payment of the \$50 fixed dividend on the first class of preferred stock ("Class 1 Preferred"). Class 2 Preferred stock is owned by a separate United States shareholder.

Analysis. The Class 1 Preferred stockholder's pro rata share of recapture income is determined as described in the previous example. There does not appear to be any limitation on the allocation of recapture income to the Class 2 Preferred stockholder, and so such stockholder's pro rata share of the recapture income is determined based upon the amount of the CFC's earnings and profits that would be distributed to him in the event the CFC distributed all of its earnings and profits for the year. If CFC distributed all of its earnings and profits for the year, \$50 of the CFC's \$200 of earnings and profits would be distributed on the Class 2 Preferred Stock. Consequently, the Class 2 Preferred stockholder would be required to take into account a Subpart F inclusion of \$12.50 ( $\$50/\$200$ , multiplied by \$50 of recapture income) for such year. The common stockholder would now be required to take into account only \$25 of the recapture income.

### c. Alternative Recapture Rule

An alternative to the annual pro rata share computation system for recapture income would be to require the CFC to maintain a recapture account with respect to each shareholder. Given the computation of the E&P Limitation under the pro rata share rules with respect to each shareholder, the more appropriate approach for recapture income, we suggest, is on a shareholder-by-shareholder basis. We urge the Treasury Department and the IRS to consider amending the regulations or providing additional guidance with respect to the use of the pro rata share determination for purposes of allocating recapture income among shareholders in a manner that results in the burden of recapture being aligned more closely with the benefit of the E&P Limitation. Tracking potential recapture income on a shareholder-by-shareholder basis is in our view the best means of accomplishing this goal. However, we note that additional complexity would result and special consideration would need to be given to the effects of changes in stock ownership or capital structure.

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<sup>62</sup> On an aggregate basis over its two year operating history, the CFC had \$250 of earnings and profits and \$100 of Subpart F income. The preferred stockholder's pro rata share of this Subpart F income, determined on an aggregate basis, would be equal to 40 percent (the amount of earnings and profits distributable to such stockholder (\$100), divided by the total amount of the CFC's earnings and profits (\$250)). Thus, the preferred stockholder's Subpart F inclusion in the first year (\$50) exceeded the amount it would have been required to take into account if its pro rata share had been determined on an aggregate basis. The requirement to take into account an additional Subpart F inclusion in the second year thus may be viewed by the preferred stockholder as excessive.

#### 4. Qualified Deficits

An accumulated deficit in a CFC's earnings and profits from a specified, "qualified activity" may limit a shareholder's Subpart F inclusion for a later year. Under section 952(c)(1)(B)(iv), the limitation is effectively determined on a shareholder-by-shareholder basis. A shareholder's pro rata share of a deficit is determined (i) at the close of the taxable year in which it arose and (ii) at the close of the taxable year for which it would be used. Whichever computation yields the smaller share is then used to determine the limitation applicable to the United States shareholder.

For purposes of determining a shareholder's pro rata share of a deficit (for each of the relevant years), section 952(c)(1)(B) states that "rules similar to the rules under section 951(a)(2)" are applicable. Thus, the principles of the Existing Regulations, which apply for purposes of section 951(a)(2), generally also have application for purposes of section 952(c)(1)(B). Since the Existing Regulations indicate that a shareholder's pro rata share is determined under the hypothetical distribution rule with reference to distributions of earnings and profits, it is not entirely clear how these rules are to be applied for purposes of determining a shareholder's share of a deficit in earnings and profits.

One possibility would be to allocate a deficit for the year the deficit arises based upon the manner in which the deficit reduces earnings and profits otherwise available for distribution to shareholders, and then to determine the pro rata share for the year in which the deficit is to be used based upon the shareholders' pro rata shares of Subpart F income from the qualified activity for such year (without taking into account the Qualified Deficit).

Example 11. A CFC (CFC) has outstanding two classes of stock, common and preferred, and each class is owned by a separate United States shareholder. The preferred stock is entitled to an annual fixed dividend of \$50. After payment of the preferred stock dividend, all further dividends are distributable on the common stock. CFC has \$100 of earnings and profits for its first year of operations, before taking into account a loss of \$50 from a given qualified activity. Thus, for the year, CFC has \$50 of earnings and profits. CFC has no Subpart F income for the year.

Analysis. Ignoring the loss from its qualified activity, CFC would have had \$100 of earnings and profits, and if all such earnings and profits had been distributed at the end of the year, such earnings and profits would have been distributed \$50 to the preferred stockholder and \$50 to the common stockholder. In light of its loss from a qualified activity, however, CFC only has \$50 of earnings and profits. If CFC distributed all of such earnings and profits at the end of its year, all \$50 would have been distributed to the preferred stockholder. Consequently, it may be argued that the common stockholder's pro rata share of the qualified deficit is \$50 for the year in which the deficit arose (and the preferred stockholder's pro rata share is \$0), since the loss affected only the amount distributable to the common stockholder.

Although this approach may entail complexity in some cases due to, among other things, changes in a CFC's capital structure, we believe this complexity is simply a function of the statutory formulation of the qualified deficit rule.<sup>63</sup> We note that further complexity arises in the event that a CFC has no current or accumulated earnings and profits. In such case, it may be argued that the deficit should be shared in the manner that the shareholders share losses of their invested capital (i.e., common shareholders suffer the first losses).

A shareholder's pro rata share of a Qualified Deficit must be determined both in the year the deficit arose and the year the deficit is to be used. In contrast to the proposal for determining a shareholder's share of a deficit in the year it arose, we suggest a shareholder's share of a deficit for the year it is to be used be determined based upon the shareholder's pro rata share of the *Subpart F income* that may be reduced by the Qualified Deficit. We believe this approach generally yields appropriate results.

Example 12. Assume the same facts from Example 11. Further assume that in the next year, CFC earns \$100 of Subpart F income from the same qualified activity with respect to which it had a deficit in the preceding year, and CFC has \$100 of earnings and profits for the current year.

Analysis. The preferred stockholder's pro rata share of CFC's Subpart F income for the year generally would be \$50 (i.e., the amount that bears the same ratio to CFC's Subpart F income as the amount that would have been distributed to the preferred stockholder bears to CFC's earnings and profits for the year). Since the preferred stockholder's pro rata share of the deficit in the year it arose was \$0, the preferred stockholder has no limitation on its Subpart F inclusion. By contrast, the common stockholder's share of the deficit in the year the deficit arose was \$50. However, the amount of the deficit that the common stockholder may take into account is determined based upon the lesser of the common stockholder's pro rata share in (i) the year the deficit arose or (ii) the year the deficit is to be used. Determining the common stockholder's share of the deficit for the year it is to be used based upon the common stockholder's pro rata share of Subpart F income for such year, the common stockholder's share of the deficit for such year also would be \$50 (\$50/\$100 of earnings and profits would be distributed to the common stockholder, multiplied by \$100 of Subpart F income). Consequently, the common stockholder would have a \$50 Qualified Deficit that he could use to offset his \$50 pro rata share of Subpart F income for the year.

As may be seen from this discussion, there is a need for specific rules which address the allocation of Qualified Deficits among shareholders. The Proposed Regulations, which will be effectively incorporated by reference into the rules for allocating Qualified Deficits, provide no guidance on these important determinations and, in our view, perpetuate the uncertainty that exists under current law.

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<sup>63</sup> Difficult transition problems also may arise with respect to CFCs that were in existence prior to the enactment of the Qualified Deficit rules in their present form.

In this context, one possible approach to the allocation of deficits among shareholders would be to modify the Proposed Regulations to include a “fallback” rule similar to the one advocated below, which seeks to determine (based upon all facts and circumstances) the manner in which the shareholders have agreed to share the profits/losses of a corporation. We believe that such a “fallback” rule, although certainly not a substitute for specific guidance on the allocation of Qualified Deficits, may provide at least a conceptual framework for making these determinations.

5. Section 1248/367(b)

a. Pro Rata Share Rules Are a Two-Way Street

Section 1248 requires that gain recognized on the sale or exchange of certain stock in a foreign corporation be recharacterized as a dividend to the extent of the earnings and profits attributable to such stock. If a foreign corporation has more than one class of stock outstanding, the amount of earnings and profits attributable to each class of stock is to be determined in accordance with the principles of the Existing Regulations.<sup>64</sup> In addition, under certain circumstances, section 367(b) requires a United States person to take into account either the “section 1248 amount” or the “all earnings and profits amount” with respect to the stock of a foreign corporation. Both of these amounts are determined under the principles of section 1248, which incorporate the pro rata share rules of the Existing Regulations.<sup>65</sup>

While taxpayers generally seek to avoid current inclusions under section 951, the recharacterization of gain as a dividend under section 1248 or the recognition of dividend income under section 367(b) may be beneficial in some cases. For example, an amount recharacterized as a dividend under section 1248 may permit a corporate taxpayer to claim deemed-paid foreign tax credits under section 902.<sup>66</sup> In addition, an individual taxpayer who does not satisfy the long-term holding period requirement for a reduced rate of capital gains taxation will favor the recharacterization of his or her gains as dividends, if such dividends would be “qualified dividends” eligible for a reduced rate of taxation.<sup>67</sup> In this context, pro rata share rule may be either detrimental or beneficial to a particular taxpayer. It is important that these rules achieve a consistent balance.

b. Section 1248

As indicated immediately above, upon a sale of stock in a corporation that has multiple classes of stock outstanding, the amount of earnings and profits attributable to such stock must be computed under Treas. Reg. § 1.1248-3. This regulation generally requires that the earnings and profits of the corporation accumulated for each taxable year after December 31, 1962 be allocated to each block of stock on an annual basis. The aggregate amount of such annual allocations is the section 1248 amount attributable to such stock.<sup>68</sup> In the case of a corporation

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<sup>64</sup> See Treas. Reg. § 1.1248-3(c)(4), (d)(6).

<sup>65</sup> See § 1.367(b)-2(d)(3).

<sup>66</sup> See § 1.1248-1(d).

<sup>67</sup> See I.R.C. § 1(h)(11)(C).

<sup>68</sup> See, e.g., *id.* § 1.1248-3(a)(7) (Example 1).

with multiple classes of stock, the earnings and profits accumulated during any given year are allocated to each class of stock in accordance with the principles of the Existing Regulations.<sup>69</sup> If a foreign corporation has a deficit in earnings and profits for a given year, the deficit must also be allocated among the various classes of stock in accordance the same principles used to allocate positive earnings and profits.

c. Section 367(b)

The pro rata share rules of the Proposed Regulations will also apply for purposes of section 367(b). Under certain circumstances, a shareholder of a foreign corporation must include either the “section 1248 amount” or the “all earnings and profits amount” with respect to the stock of the foreign corporation.<sup>70</sup> The “section 1248 amount” is the “net positive earnings and profits (if any) that would have been attributed to such stock and includible as a dividend under section 1248 . . . if the stock were sold by the shareholder.”<sup>71</sup> The “all earnings and profits amount” is the net positive earnings and profits of the corporation that are attributable to the stock.<sup>72</sup> The amount of earnings and profits attributable to a block of stock is determined in accordance with the principles of section 1248 and thus in accordance with the pro rata share rules of the Existing Regulations.<sup>73</sup> We believe the application of the Proposed Regulations in the section 367(b) context generally presents the same issues that arise in the section 1248 context. In addition, however, all the earnings and profits amount includes earnings and profits of a corporation accumulated prior to the date that such corporation became a CFC and thus may present additional complications.<sup>74</sup>

## V. Potential Alternative Regulatory Approach

As described in sections III and IV above, the Proposed Regulations generally incorporate the provisions of the Existing Regulations but contain additional rules intended to address unusual transactions or transactions considered abusive. We believe the rules set forth in the Proposed Regulations raise a number of technical issues that need to be resolved before the Proposed Regulations are promulgated as final regulations. We also believe the Proposed Regulations generally perpetuate (and in some cases add to) the uncertainty that exists under current law. Consequently, in this section, we present an alternative approach that we believe the government might wish to consider in relation to pro rata share regulations. Under this alternative approach, the pro rata share regulations would be restated to include specific guidance regarding the appropriate manner of determining pro rata shares in certain common situations arising in international business transactions. We believe that a sufficient number of common business arrangements could be covered such that there would be limited need for additional

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<sup>69</sup> § 1.1248-3(c)(4), (d)(6).

<sup>70</sup> §§ 1.367(b)-3(b)(3)(i), 1.367(b)-4(b).

<sup>71</sup> § 1.367(b)-2(c).

<sup>72</sup> § 1.367(b)-2(d)(1).

<sup>73</sup> § 1.367(b)-2(d)(3).

<sup>74</sup> See § 1.367-2(d)(3) (“the all earnings and profits amount is determined without regard to whether the foreign corporation was a controlled foreign corporation at any time during the five years preceding the section 367(b) exchange in question, without regard to whether the shareholder owned a 10 percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a controlled foreign corporation.”).

rules. Nonetheless, because not all possible situations can be contemplated, a general “fallback” rule would be provided for cases falling outside the specific provisions, which could then serve as the conceptual basis for future guidance in the form of revenue rulings.

1. Specific Allocation Rules and Examples

a. Single Class of Stock

In the case of a CFC with only one class of stock outstanding, we suggest that the Proposed Regulations indicate that pro rata shares be determined based upon relative numbers of shares owned. For this purpose, it is recommended that the Proposed Regulations provide guidance on determining whether a CFC has one or more than one class of stock outstanding. For example, voting rights and other attributes that do not affect entitlement to dividends or other distributions generally could be ignored in determining whether a CFC has one or more than one class of stock outstanding.

b. Preferred Stock

We suggest that the pro rata share rules indicate that when a CFC has outstanding a class of preferred shares, pro rata shares be determined based upon allocable shares of earnings and profits.<sup>75</sup> For this purpose, a preferred class of stock would have an allocable share of earnings and profits equal to the amount of its preference in distributions for a given year (taking into account arrearages for prior years that would have existed if the CFC had actually distributed all of its earnings for such years) and its share of any other dividend distributions for the year in the case of participating stock. Special rules take into account any excess of its preference upon redemption or liquidation over the amount paid for the stock. Otherwise, payments in redemption or upon liquidation would be ignored. The rules for preferred stock thus generally would be similar to the rules contained in the Proposed Regulations with the suggested modifications described in section III above.

c. Joint Venture Structures Between Unrelated Parties

We suggest that the pro rata share rules contain specific examples describing their application to partnerships that have elected to be treated as corporations and thus are CFCs. Further, we encourage the Treasury Department and the IRS to consider whether Subpart F income recognized by partnerships may be more appropriately allocable in accordance with the partners’ relative shares of partnership profits as such profits would otherwise have been determined under the rules of subchapter K. We note that taxpayers generally may achieve a similar result under current law simply by placing a domestic partnership on top of a CFC, and using partnership allocations to determine pro rata shares.

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<sup>75</sup> As described previously at note 15, the hypothetical distribution rule of the Existing Regulations may not be completely consistent with the statute it purports to interpret. Nonetheless due to its long history and settled existence, we do not recommend changing this rule. Rather, our approach would be to explain the application of the rule through specific guidance and provide a “fallback” rule based upon, among other things, the same principles.

#### d. Tracking Stock

We suggest that the pro rata share rules also contain specific guidance regarding the determination of a shareholder's pro rata share when the shareholder owns tracking stock. We believe tracking stock structures present unique issues not addressed by the Existing Regulations or the Proposed Regulations. As a result, there may be significant uncertainty regarding the proper manner of determining the pro rata share of an owner of tracking stock under current law. We urge the Treasury Department and the IRS to consider the appropriate manner of determining pro rata shares in such situations.

#### e. Fast-Pay Stock Arrangements Described in Treas. Reg. § 1.7701(I)-3

We strongly urge that the Proposed Regulations include guidance regarding the overlap between the pro rata share rules and the "fast-pay" preferred stock regulations of Treas. Reg. § 1.7701(I)-3. We note that the targets of the fast-pay stock regulations include certain CFC share ownership structures. The IRS's position has been that the fast-pay stock regulations apply to structures involving restrictions on distributions and redemptions taxed as dividends.<sup>76</sup> We also note that in the original notice addressing fast-pay arrangements, the issuance of fast-pay shares by a CFC to a tax-indifferent party was one of the specifically targeted abuses.<sup>77</sup> We believe it would be useful for any forthcoming pro rata share guidance to contain an example of the interaction between the pro rata share rules and the fast-pay regulations in a case where both potentially apply.<sup>78</sup>

### 2. General "Fallback" Rule

As described in the preceding sections of these comments, the Proposed Regulations contain various rules that attempt to ensure that a United States shareholder's pro rata share generally is determined by reference to that shareholder's entitlement to CFC earnings. We are concerned that such rules will undoubtedly produce the wrong result in some cases. Further, we believe that the Valuation Rule is unlikely to provide a workable solution to any problems that may exist with respect to multiple classes of stock with discretionary distribution rights.

Consequently, we believe that the interests of the government and of taxpayers may be better served by providing specific allocation rules for (i) a CFC with a single class of stock, (ii) a CFC that has one or more classes of preferred stock, (iii) CFC joint ventures, (iv) tracking stock arrangements, and (v) fast-pay stock arrangements. As described in section IV.4, we also suggest specific allocation rules be provided for allocations of deficits. We believe that providing such guidance would eliminate much of the uncertainty and opportunity for abuse that exists under current law. Moreover, we believe that if a sufficient number of common business arrangements are covered in revised regulations, there may be limited need for an additional general rule (such as the hypothetical distribution rule or an alternative rule) to govern other situations. However, because of the inevitable creation of new capital structures, and because we

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<sup>76</sup> See TAM 200437033.

<sup>77</sup> Notice 97-21, 1997-1 C.B. 407 (February 27, 1997).

<sup>78</sup> There may be some question whether, once the pro rata share regulations are amended as proposed, it may be necessary also to apply the fast-pay stock regulations to CFCs.

believe it is important to enunciate the general principles to be applied in making pro rata share determinations, we further believe it would be appropriate and helpful for the Treasury Department and the IRS to provide a general “fallback” rule to be applied in cases not covered by the regulations.

Rather than providing a “fallback” rule based solely on the hypothetical distribution rule or relative fair market values of classes of stock (as proposed to be applied in narrow situations governing stock with discretionary distribution rights), we suggest the Proposed Regulations describe certain general principles to be applied in determining pro rata shares, taking into account all facts and circumstances. The principles to be taken into account generally may include those contained in Treas. Reg. 1.1502-32(c) and the rule for determining a “partner’s interest in a partnership” under subchapter K.<sup>79</sup> This rule generally would take into account the manner in which a CFC’s assets would be distributed in the event of a liquidation, and the shareholders’ relative shares of profit and loss upon such an event. We recognize that such a rule entails uncertainty.<sup>80</sup> Nonetheless, we are hopeful that sufficient guidance may be provided in the form of the specific applications described above, that limited reliance would be placed on the facts and circumstances test.<sup>81</sup> If the Treasury Department and the IRS are receptive to suggestions for crafting the specific language of such a facts and circumstances test, we would be delighted to assist with further comments.

## **VI. Effective Date Issues**

The Proposed Regulations are to be effective for taxable years of a CFC beginning on or after January 1, 2005. Thus, where pro rata share allocations are required to be made over several years of a CFC (e.g., for Qualified Deficits or under section 956 or 1248), the Existing Regulations apparently would apply for purposes of allocations for taxable years of a CFC beginning before January 1, 2005, and the Proposed Regulations would apply for purposes of allocations for subsequent taxable years.<sup>82</sup>

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<sup>79</sup> Treas. Reg. § 1.704-1(b)(3).

<sup>80</sup> Cf. New York State Bar Ass’n Tax Section, *Report on Proposed Treasury Regulations 1.7701(l)-3* (May 13, 1999) (advocating legislative amendments to permit a “direct” recharacterization of fast-pay stock arrangements, in order to treat “an amount denominated as a dividend for state-law purposes and paid out of the issuer’s current or accumulated earnings and profits as a tax-free return of capital to the extent such ‘dividend’ constituted a return of the shareholder’s investment as a matter of economic substance,” but noting the significant complexity that could result in attempting to draw such distinctions appropriately).

<sup>81</sup> Special consideration is urged in respect of the effects of stock options. Stock options are treated as exercised for purposes of determining a shareholder’s constructive ownership of CFC stock under section 958(c). They are not treated as exercised for purposes of determining a shareholder’s actual or indirect ownership of CFC stock under section 958(a) and (b), however. Thus, while stock options are outstanding, the (actual and indirect) shareholders of a CFC may have pro rata shares that reflect greater interests in the CFC’s earnings and profits than such shareholders actually possess. We believe it would be helpful for the regulations to provide an illustration of this principle and the effects upon exercise of such options in certain standard situations (e.g., employee stock options).

<sup>82</sup> Because the effective date is stated in terms of taxable years of a CFC, and not in terms of taxable years of a United States shareholder or other taxpayer, we assume that pro rata share determinations required to be made after the effective date with respect to multiple years of a CFC (e.g., under section 1248) are proposed to be made under the Existing Regulations for pre-effective date years and under the Proposed Regulations for post-effective date years.

This “mixed” allocation system (or “lock-in” approach) has the potential for causing hardships, for example, where the taxpayer is determined to have a relatively small share of a deficit in earnings and profits for one year under the Existing Regulations and a relatively large share of earnings and profits for the next year under the Proposed Regulations. In other situations, such a system also has the potential for providing a windfall to taxpayers. Any change in allocation methodology will disrupt taxpayers’ expectations regarding the amount of earnings attributable to shares and thus affect the value of those shares. This may have the potential for uncertain effects under the Valuation Rule, which determines allocations based upon relative values.

In light of the problems associated with a mixed system, we have considered whether transition relief should be available for existing capital structures. We therefore urge that the Treasury Department and the IRS consider a rule that would permit a CFC and its shareholders to continue to apply the provisions of the Existing Regulations so long as the CFC’s capital structure remains static (e.g., the CFC does not issue any new stock). While we believe this approach has some merit, we understand that any decision regarding application of such a transition rule ultimately will depend upon whether such transition relief would grandfather transactions the Treasury Department and the IRS consider abusive.

Because of the potential issues raised by a mixed system, we also considered whether it may be appropriate to permit taxpayers an election to apply the rules of the Proposed Regulations retroactively. We believe that in order for such an approach to be appropriate, there must not be a potential for double inclusions of the same earnings. Thus, such an election arguably should only be permissible when the earlier allocations did not have an effect on the amounts includible in income for any closed years and all United States shareholders agree to report consistently for future years. Finally, we recommend that to the maximum extent possible, the same pro rata share rules apply across all Subpart F and section 367(b)/1248 determinations, and thus any such election to apply the Proposed Regulations retroactively apply across all such determinations. In light of these constraints, such an election may be of limited utility.

Finally, in considering effective date issues under the Proposed Regulations, we reviewed the Treasury Department’s approach when instituting new rules for allocating stock basis adjustments in a consolidated return context under Treas. Reg. § 1.1502-32(c). Under those rules, the Treasury Department decided to adopt a “disposition” approach, pursuant to which all prior year items were required to be recomputed under the new regulations. The preamble to the final regulations under Treas. Reg. § 1.1502-32(c) indicates several reasons for the government’s decision, but also notes:

Although a lock-in approach [i.e., a mixed system] would avoid requiring groups to apply the new rules to prior period adjustments, and may protect taxpayer expectations, the IRS and the Treasury Department understand that few groups determine their stock basis adjustments annually and therefore have any

substantial expectation regarding stock basis before a stock disposition is contemplated.<sup>83</sup>

By contrast to the determination of stock basis adjustments under a consolidated return system, we believe taxpayers are much more likely to have reason to determine pro rata shares annually. Consequently, we believe it would be appropriate to retain the mixed system contained in the Proposed Regulations. Nonetheless, due to the uncertainty that we believe presently exists under various provisions of the Proposed Regulations, and the recommendations for substantial changes in the Proposed Regulations contained in our comments above, we believe that some delay in the proposed January 1, 2005 effective date may be indicated.

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<sup>83</sup> T.D. 8560, 1994-2 C.B. 201, 209.