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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-129782-05

RIN 1545-BE71

Special Rule Regarding Certain Section 951 Pro Rata Share Allocations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to regulations under section 951(a) of the Internal Revenue Code (Code) regarding a United States shareholder's pro rata share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and previously excluded subpart F income withdrawn from foreign base country shipping operations. These proposed regulations are intended to ensure that a CFC's earnings and profits for a taxable year attributable to a section 304 transaction will not be allocated in a manner that results in the avoidance of Federal income tax. These proposed regulations are also intended to ensure that earnings and profits of a CFC are not allocated to certain preferred stock in a manner inconsistent with the economic interest that such stock represents.

DATES: Written or electronic comments and requests for a public hearing must be received by October 24, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129782-05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-129782-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-129782-05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jefferson VanderWolk, (202) 622-3810; concerning submissions of comments and requests for a public hearing, Robin Jones, (202) 622-3521 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 951(a) of the Code relating to the determination of a United States shareholder's pro rata share of a CFC's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and previously excluded subpart F income withdrawn from foreign base country shipping operations.

In general, section 951(a)(1) requires a United States shareholder that owns stock in a CFC to include its pro rata share of such amounts in its gross income. Pro rata share is defined in section 951(a)(2) of the Code as the amount:

(A) Which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day in its taxable year on which the corporation is a CFC it had distributed pro rata to its shareholders an amount which bears the same ratio to its subpart F income for the taxable year, as the part of such year during which the corporation is a CFC bears to the entire year, reduced by

(B) The amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount which bears the same ratio to the subpart F income of such corporation for the taxable year, as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

A CFC's earnings and profits are allocated among different classes of the CFC's stock for the purpose of determining the pro rata share of the CFC's subpart F income or withdrawal of previously excluded subpart F income of a United States shareholder of such CFC under §1.951-1(e). The IRS and Treasury Department are aware of certain transactions in which a CFC's earnings and profits and subpart F income for a taxable year are increased by a deemed dividend arising from a transaction described in section 304, with respect to which taxpayers take the position that the current regulations permit the allocation of earnings and profits between different classes of stock (e.g., common stock and preferred stock) in a manner inconsistent with the economic

interests in the CFC represented by the respective classes of stock. The IRS and Treasury Department believe that such allocations are inconsistent with the policies underlying subpart F. These proposed regulations would provide additional guidance to ensure results that are consistent with such economic interests.

Responding to regulations proposed under section 951 on August 6, 2004, and published in final form in this issue of the **Federal Register** (REG-129771-04), a commentator observed that U.S. shareholders of CFCs sometimes have caused mandatorily redeemable preferred stock with cumulative dividend rights to be issued to (or otherwise acquired by) foreign persons. Relying on the fact that the hypothetical distribution rule does not take into account the time value of money, the parties in these transactions provide a relatively high dividend rate on such stock but forego compounding on the accrued but unpaid dividends, which would generally be required in an arms' length transaction. This would inappropriately deflect subpart F income inclusions with respect to the U.S. shareholder's stock in the CFC. To address this concern, the proposed regulations provide a special allocation rule for such stock which would appropriately discount the amount of earnings and profits allocated to the preferred stock in annual hypothetical distributions.

Explanation of Provisions

A. Earnings and profits from certain section 304 transactions

Section 1.951-1(e) defines pro rata share for purposes of section 951(a) of the Code. Proposed §1.951-1(e)(3)(v) adds a special rule that would modify the

general rule of §1.951-1(e)(3)(i) regarding the allocation of a CFC's current earnings and profits to more than one class of stock. The general rule provides for the allocation of current earnings and profits to different classes of stock on the basis of the respective amounts of such earnings and profits that would be distributed with respect to each class if such earnings and profits were distributed on the last day of the CFC's taxable year on which it is a CFC.

The special rule applies where a CFC has earnings and profits and subpart F income for its taxable year attributable to a transaction described in section 304 of the Code and that transaction is part of a plan a principal purpose of which is to avoid Federal income taxation by allocating the subpart F income resulting from the section 304 transaction disproportionately to a tax-indifferent party. Pursuant to the rule, such earnings and profits will be allocated to each class of stock of the CFC in accordance with the value of such class relative to all other classes.

In the absence of the special rule, the current earnings and profits of a CFC having a class of preferred stock with a fixed return and a class of common stock would be allocated under the general rule on the basis of a hypothetical distribution. Thus, the preferred stock would receive an allocation equal to the amount of the fixed return on the total investment in such stock, and the common stock would receive an allocation of the remainder of the earnings and profits. This result would not reflect the actual economic interest in the CFC of the respective classes of stock in a case where the earnings and profits were artificially inflated as a result of the dividend arising from the section 304

transaction. The amount allocated to the preferred stock in such a case under the general rule would be a significantly smaller percentage of the total than the percentage of the corporation's value represented by the preferred stock.

This is illustrated by the example that would be added to §1.951-1(e)(6) by these proposed regulations. By modifying the allocation of earnings and profits to classes of stock in this limited category of cases, the proposed regulations ensure that the allocation will be consistent with the economic interest in the CFC represented by the respective classes of stock.

B. Certain cumulative preferred stock

Proposed §1.951-1(e)(4)(ii) would add a special rule that would determine the hypothetical distribution of earnings and profits with respect to cumulative preferred stock with a mandatory redemption date by reflecting the present value of accrued but unpaid dividends with respect to such stock, determined generally on the basis of the implied annual rate of return on such stock and the length of time between the current year's hypothetical distribution date and the mandatory redemption date. This special rule would apply only if the rate of compounding on the accrued but unpaid cumulative dividends would be less than the appropriate applicable Federal rate and if a distribution on the stock would not be included in the gross income of a United States taxpayer.

Proposed Effective Dates

Sections 1.951-1(e)(3)(v) and 1.951-1(e)(4)(ii) are proposed to apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2006.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because these regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments regarding appropriate rules for determining under section 951 the hypothetical distribution of earnings and profits for cumulative preferred stock that does not have a mandatory redemption date, or that is subject to a shareholder-level agreement, such as a purchase option, to take into account the present value of accrued but unpaid dividends. The IRS and Treasury Department contemplate that if promulgated, such rules would be effective for taxable years of a controlled foreign corporation beginning on or after January 1, 2006.

The IRS and Treasury Department also request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Jefferson VanderWolk of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Par. 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.951-1 is amended by revising paragraphs (e)(3)(v), (e)(4)(ii), (e)(6) Example 9, and (e)(7).

The revisions read as follows:

§1.951-1 Amounts included in gross income of United States shareholders.

* * * * *

(e) * * *

(3) * * *

(v) Earnings and profits attributable to certain section 304 transactions.

For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has more than one class of stock outstanding and the corporation has earnings and profits and subpart F income for a taxable year attributable to a transaction described in section 304, and such transaction is part of a plan a principal purpose of which is the avoidance of Federal income taxation, the amount of such earnings and profits allocated to any one class of stock shall be that amount which bears the same ratio to the remainder of such earnings and profits as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock of the corporation, determined on the hypothetical distribution date.

(4) * * * (i) * * *

(ii) Certain cumulative preferred stock. For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has one or more classes of preferred stock with a mandatory redemption date and cumulative dividend rights, arrearages on which compound at a rate less than an annual compounding at the applicable Federal rate (as defined in section 1274(d)(1)) (AFR) that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date, then, to the extent that-

(A) A distribution with respect to such stock on the hypothetical distribution date would not be includible in the gross income of a citizen or individual resident of the United States, a domestic corporation, or a foreign person as income effectively connected with such foreign person's conduct of a trade or business in the United States; and

(B) Any dividends accruing with respect to such stock during the taxable year of the controlled foreign corporation have not been paid during such taxable year (accrued but unpaid dividends), the amount of earnings and profits that shall be considered to be distributed as part of the hypothetical distribution for purposes of paragraph (e)(3)(i) of this section with respect to such stock shall be equal to the present value of such accrued but unpaid dividends for the taxable year. The present value of such accrued but unpaid dividends for the taxable year is determined for the purposes of this paragraph by discounting such accrued but unpaid dividends for that taxable year from the mandatory redemption date to the hypothetical distribution date using the implied annual rate of return on an investment at par in a share of such stock that is held from the date of issue until the mandatory redemption date, on the assumption that no dividends with respect to the stock are paid prior to redemption.

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(6) * * *

Example 9. (i) Facts. In 2006, FC10, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of common stock and 100 shares of 6-percent, voting, preferred stock with a par value of \$10x per share. All of the common stock is held by Corp H, a foreign corporation which invested \$1000x in FC10 in exchange for the common stock. All of FC10's preferred stock is held by Corp J, a domestic corporation which invested \$1000x

in FC10 in exchange for the FC10 preferred stock. The value of the common stock of FC10 at all relevant times is \$1000x and the value of the preferred stock of FC10 at all relevant times is also \$1000x. In 2006, FC10 borrows \$3000x from a bank and invests \$5000x in preferred stock issued by FC11, a foreign corporation owned by Corp J. FC11, which has no current or accumulated earnings and profits, uses the proceeds to lend \$5000x to Corp J. In 2008, FC10 sells the FC11 preferred stock to FC12, a wholly owned foreign subsidiary of FC11 that has \$5000x of accumulated earnings and profits, for \$5000x in a transaction described in section 304. FC10 repays the bank loan in full. The acquisition and sale of the FC11 preferred stock by FC10 was part of a plan a principal purpose of which was the avoidance of Federal income tax. For 2008, FC10 has \$5000x of earnings and profits, all of which is subpart F income attributable to a deemed dividend arising from FC10's sale of the FC11 preferred stock to FC12.

(ii) Analysis. FC10 has \$5000x of earnings and profits for 2008 attributable to a dividend from a section 304 transaction which was part of a plan a principal purpose of which was the avoidance of Federal income taxation. Under paragraph (e)(3)(v) of this section, these earnings and profits are allocated to the common and preferred stock of FC10 in accordance with the relative value of each class of stock. Thus, for taxable year 2008, \$2500x is allocated to FC10's common stock and \$2500x is allocated to its preferred stock.

(7) Effective dates. Except as provided in paragraphs (e)(3)(v) and (e)(4)(ii) of this section, this paragraph (e) applies for taxable years of a

controlled foreign corporation beginning on or after January 1, 2005. * * *

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/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.