OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

May 4, 2000

Number: **200032008**
Release Date: 8/11/2000
CC:INTL:Br3
TL-N-5739-99
UILC: 861.11-01
904.09-00
1502.91-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, ILLINOIS DISTRICT

FROM: Barbara A. Felker
Chief, CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated December 28, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

date a =
w% =
year b =
year c =
year d =
USParent =

USSub1 =
USSub2 =
FSub1 =
x% =
y% =
dividend exclusivity
period =
FSub2 =
$b =
m% =

ISSUE

Whether, after issuance of the preferred stock in USSub1 on date a, USParent must include USSub1 in determining its foreign tax credit limitation on an affiliated group basis.

CONCLUSION

It appears that issuance of the preferred stock was effective to disaffiliate USSub1 for purposes of section 1504(a) of the Internal Revenue Code, since the preferred stock represented more than 20% of the total voting power of all of the outstanding USSub1 stock. Similarly, section 904(i) of the Code and Treas. Reg. §1.904(i)-1 would not require USParent to include USSub1 in its determination of its foreign tax credit limitation on an affiliated group basis after the issuance of the preferred stock. In addition, it is also likely that section 864(e) and Treas. Reg. §1.861-11T(d)(6) would not require USParent to include USSub1 in its determination of its foreign tax credit limitation on an affiliated group basis, since the voting power alternative qualification test of that regulation was not met. However, final resolution of this issue is dependent upon determining whether USParent retained 80% or more of the value of all of the outstanding stock of USSub1 after issuance of the preferred stock, the alternative qualification test under Treas. Reg. §1.861-11T(d)(6). This memorandum does not address additional issues that may be presented with respect to the effects of the capitalization and recapitalization of FSub1.

FACTS

Prior to date a in year c, USParent owned w% of the outstanding stock, all common stock, of each of USSub1 and USSub2. USSub1 and USSub2 together owned all of the stock of FSub1, a foreign corporation. FSub1 owned all of the stock of FSub2, a foreign corporation. During the time USSub1 and USSub2 held their stock in FSub1, USSub1 contributed most of FSub1's paid-in-capital, although USSub2 owned most of the stock. USParent, USSub1 and USSub2, along with other affiliated companies, filed a consolidated U.S. income tax return for year b, a calendar year.

A few days before date a, USSub1 and USSub2 entered into a recapitalization under which USSub1 exchanged its x% interest in FSub1 for all of FSub1's Class A common stock and USSub2 exchanged its y% interest in FSub1 for all of FSub1's Class B common stock. The new Classes A and B common stock entitled USSub1 and USSub2 to different dividend and liquidation rights. USSub1, as owner of the Class A common stock, was entitled to receive all ordinary dividends and other distributions paid by FSub1 and 10% of capital distributions during the dividend exclusivity period. Any subpart F income inclusions would also be attributable to USSub1 as the owner of the Class A stock under section 951 of the Code. USSub2, as owner of the Class B common stock, was entitled during the dividend exclusivity period to 90% of capital distributions, and 100% of liquidating distributions less the greater of 10% of the amount available for distribution to members of the company in the winding up or the amount by which dividends received by FSub1 from FSub2 exceeded the distributions previously paid to USub1. That greater amount would be paid to USub1. The terms of the common stock did not specify what the dividend and liquidation rights of USSub1 and USSub2 would be after the dividend exclusivity period. The Class A stock carried the right to elect two directors. The Class B stock carried the right to elect up to three directors.

On date a, USSub1 issued $b of voting preferred stock to unrelated purchasers. This preferred stock represented more than 20% of the voting power of all of the outstanding stock of USSub1.

For year b, USParent had excess credits for foreign tax credit purposes. For year c and all prior years, most of USParent’s foreign source income and all of its foreign taxes for which it claimed a foreign tax credit resulted from its indirect investment in FSub2. In year b, USParent apportioned m% of its total group interest expense to foreign source income for purposes of its sourcing calculation. For part of year c and all of year d, USParent excluded USSub1 from its consolidated return. Because the effect of the recapitalization of FSub1 was to shift dividend rights from USSub2 to USSub1, the disaffiliation of USSub1 reduced the amount of the USParent group’s assets that were held to produce foreign source income. This reduced the amount of interest expense and other expenses and losses of the USParent group that were allocated and apportioned to reduce foreign source income. In addition, USSub1’s foreign tax credit limitations were calculated by taking into account only its separate income and expenses, so that USSub1's foreign tax credit limitation was not reduced by interest or other expenses and losses of the USParent group.

## LAW AND ANALYSIS

The foreign tax credit limitation is determined on a consolidated group basis for those groups of corporations that are eligible and elect to file consolidated returns, see Treas. Reg. §1.1502-4(d). Section 864(e)(2) of the Code, added by the Tax Reform Act of 1986 (Pub. L. No. 99-514), requires that interest expense be apportioned on the basis of assets rather than gross income. In addition, section 864(e)(1) provides that even if affiliated corporations do not elect to file a consolidated return, taxable income for purposes of the foreign tax credit limitation will "be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation." Whether a particular domestic corporation is considered to be part of an affiliated group for purposes of the consolidated return regulations, or for purposes of section 864(e), will affect the amount of consolidated taxable income and the calculation of the foreign tax credit limitation.

For example, disaffiliation of a corporation holding foreign-source income producing assets can change the total amount of foreign source income of the remaining consolidated group and the disaffiliated corporation. For purposes of asset-based interest expense apportionment, the consolidated group will include its stock in the disaffiliated corporation as an asset held to produce U.S. source dividend income, instead of including the assets of the disaffiliated corporation, which include assets held to produce foreign source income. This will increase the relative amount of the group's U.S. assets and thus the amount of interest expense that is apportioned to U.S. source income. Similarly, the foreign source income in the disaffiliated corporation is not reduced by interest and other expenses and losses of the consolidated group. These effects increase the aggregate amount of the combined entities' foreign source income and foreign tax credit limitations. The issue here is whether USSub1's issuance of preferred stock was effective to remove it from the USParent affiliated group for purposes of calculating the foreign tax credit limitations of USSub1 and the USParent consolidated group.

Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through at least 80% stock ownership with a common parent corporation which is an includible corporation. The 80% stock ownership test requires that the common parent or another includible corporation own directly both 80% of the total voting power and 80% of the total value of the stock of each includible corporation. Here, on date a, USSub1 issued $b of voting preferred stock to unrelated purchasers, representing more than 20% of the voting power of all of the outstanding stock of USSub1. The submitted facts do not indicate there is any restriction on the voting power of the preferred shareholders or on the authority of the directors elected by the holders of the preferred stock, which might indicate that the preferred stock represented less than 20% of the voting power of all of the outstanding stock of USSub1, cf. *Alumax v. Commissioner*, 109 T.C. 133 (1997)(restrictions on powers of directors to run the corporation reduced power of taxpayer's stock below the 80% threshold despite nominal power to elect 80% of board members). Accordingly, issuance of the preferred stock was effective to remove USSub1 from the USParent affiliated group as defined in section 1504(a) and thus to preclude USSub1 from joining in the filing of the USParent group's consolidated return.

Section 904(i) of the Code, which was enacted as part of The Revenue Reconciliation Act of 1989 (Pub. L. No. 101-239), authorizes the Treasury Department to issue regulations requiring the resourcing of income of any member of an affiliated group of includible corporations (as expanded by the legislation) or the modification of the consolidated return regulations, to the extent that such resourcing or modification is necessary to prevent the avoidance of the provisions of subpart A, relating to the foreign tax credit. Specifically, Treasury was authorized to issue regulations to address situations where affiliated entities other than "includible corporations" (as defined in section 1504(b)) are interposed into a chain of corporate ownership to deconsolidate domestic corporations in the chain and, as a result of the deconsolidation, avoid limitations and related rules, including the rules set forth in section 864(e) and the regulations thereunder, on the foreign tax credit. *See* H.R. Rep. 247, 101st Cong., 1st Sess., at 1293 (1989).

As discussed above, section 1504(a) of the Code defines an affiliated group as one or more chains of includible corporations connected through 80% stock ownership with a common parent corporation which is an includible corporation. The 80% ownership requirement refers to 80% of both the total voting power and the total value of the stock. Section 904(i) expands the definition of an “includible corporation” to include otherwise non-includible domestic corporations described in section 1504(b), such as life insurance companies, and to apply the constructive ownership rules of section 1563(e) for purposes of section 1504(a). However, it does not operate to treat as an includible corporation an entity such as USSub1 that does not meet the 80% of vote and value affiliation test under those expanded rules.

Similarly, Treas. Reg. §1.904(i)-1, issued in 1995, applies only with respect to includible corporations with respect to which the ownership test is met, or would be met if ownership by non-includible corporations or under the constructive ownership rules counted. Accordingly, section 904(i) and the regulations thereunder do not provide authority to require the inclusion of USSub1 in USParent’s consolidated group following the issuance of the preferred stock, or for considering USSub1’s income, expenses, or assets in determining USParent’s consolidated foreign tax credit limitation.

Section 864(e)(5) provides that the term “affiliated group” will have the same meaning as that term has under section 1504, other than one exception not relevant here, applicable to consolidated returns. However, Treas. Reg. §1.861-11T(d)(6), which was issued under section 864(e), lowers the threshold of this test by providing that a corporation will be considered an includible corporation for purposes of determining the affiliated group for which a combined allocation and apportionment of interest expense must be made if 80% of either the vote <u>or</u> value of all outstanding stock of that corporation is owned directly or indirectly by an includible corporation or by members of an affiliated group.

From the facts that have been developed, it is not clear whether USSub1 is an includible corporation for purposes of section 864(e) of the Code and Treas. Reg. §1.861-11T(d)(6). As discussed above, the issued voting preferred stock represented more than 20% of the voting power of all of the outstanding stock of USSub1. Accordingly, USSub1 would not be an includible corporation under the first alternative qualification test of Treas. Reg. §1.861-11T(d)(6). However, it has not been determined whether that preferred stock represented more than 20% of the value of all outstanding stock of USSub1, the second alternative qualification test of Treas. Reg. §1.861-11T(d)(6). We recommend further factual development to determine whether USParent in fact retained 80% of the value of all of the outstanding stock of USSub1. If it did, the foreign tax credit limitations of both the USParent group and USSub1 must be calculated by allocating and apportioning interest expense as if they were a single corporation.

If you determine that USParent and USSub1 are not affiliated for purposes of the foreign tax credit limitation calculation, we recommend that the allocation of the section 904(c) foreign tax credit carryover accounts be examined to ensure that after the disaffiliation USParent and USSub1 correctly calculated the portion of the USParent group's consolidated unused foreign tax attributable to USSub1. Under Treas. Reg. §1.1502-79(d)(2), this amount would be calculated with reference to the percentage of the group's creditable taxes that were paid or deemed paid by USSub1 in each year. To the extent that dividends and subpart F inclusions from FSub2 were taxable to USSub2 rather than USSub1 in years preceding the disaffiliation, carryovers attributable to unused foreign taxes of FSub2 would remain with the USParent group.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Understand that the field has previously determined that it would be unlikely to ceed in challenging the disaffiliation based on several alternative theories, including characterizing the preferred stock as debt rather than equity; developing a step transaction argument to show that the disaffiliation was part of a larger plan to ultimately reconsolidate and that this plan was improper; investigating whether USSub1 rejoined the consolidated group within 61 months after the first taxable year in which it ceased to be a member of the group, which is prohibited by section 1504(a)(3); and determining whether there is a pattern of abuse of affiliation/disaffiliation. [redacted]

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

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