OFFICE OF
CHIEF COUNSEL

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

May 31, 2000

Number: **200036016**
Release Date: 9/8/2000
CC:INT:B2
TL-N-6298-99
UILC: 955.02-01

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Kenneth A. Hochman
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FROM: Phyllis Marcus, Chief
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SUBJECT:

This memorandum responds to your memorandums dated October 7, 1999, November 12,1999, and November 19, 1999 in the above-captioned case. 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

Company A =
Company B =
Company C =
Year D =
Year E =
Year F =
Date G =
H business =
Years in question =

ISSUES

1. Whether Company A can utilize the Treas. Reg. §1.955A-3(c)(2)(ii) group excess deduction provision of the related group election to reduce its overall taxable income for tax years in which it did not file a written election.

2. Whether Company A's consent to the Treas. Reg. §1.955A-3 related group election of its parent corporation in Year D serves as a related group election by Company A in Year E and subsequent years.

3. Whether Company A can utilize in Year F and subsequent years, the Treas. Reg. §1.955A-3(c)(2)(ii) group excess deduction provision of the related group election to reduce its overall taxable income by making its initial related group election in Year F, a taxable year beginning after the repeal of the section 954(b)(2) exclusion for reinvested shipping income.

CONCLUSION

1. Company A cannot utilize the group excess deduction provision of the related group election to reduce its overall taxable income for tax years in which it did not file a written election.

2. Company A's consent to the election of its parent corporation in Year D does not constitute an election by Company A in Year E and subsequent years.

3. Company A cannot utilize the group excess deduction by making a related group election that would first be effective in Year F, a year after the repeal of the section 954(b)(2) exclusion for reinvested shipping income.

FACTS

Company A and its subsidiaries are diversified international companies engaged in H business. Company A is a wholly owned domestic subsidiary of Company B, a domestic corporation. Company C is a foreign holding company that holds the stock of a number of foreign subsidiaries. Company C was wholly owned by Company B. On Date G, a date after the repeal of section 954(b)(2), Company A purchased from Company B the stock of Company C. Company C and its subsidiaries are controlled foreign corporations (CFCs) under section 957 of the Code. Company A is a US shareholder within the meaning of section 951(b) of the Code.

In Year D, a year before the repeal of section 954(b)(2), Company B, as the U.S. shareholder of Company C and its subsidiaries involved in shipping, made the Treas. Reg. §1.955A-3 related group election, thus aggregating the investment in foreign base company shipping operations of these shipping CFCs. Company A, at the time, owned a controlling interest in several of the CFCs of the related group and consented, within the meaning of Treas. Reg. §1.955A-3(b)(v), to the election by Company B.

After Company A purchased the stock of Company C from Company B on Date G, it owned all but one of the CFCs of Company B's prior related group. In years immediately thereafter, Company A used the related group election and group excess

deduction provisions in computing the CFCs foreign base company shipping income, even though Company A made no related group election.

In Year F, approximately 4 years after Company A acquired the stock of Company C, Company A began attaching to its U.S. federal income tax return (Form 1120), a Treas. Reg. §1.955A-3 election (related group election), listing its CFCs involved in shipping and stating that the CFCs' foreign base company shipping income is computed pursuant to that election. See Treas. Reg. §1.955A-3(d)(1). Company A's related group calculations included the use of the group excess deduction in calculating the foreign base company shipping income of those CFCs. Treas. Reg. §1.955A-3(c)(2).

For the years in question, Company A represents that it has no foreign base company shipping income resulting from a decrease in qualified investments in foreign base company shipping operations.

BACKGROUND

The subpart F provisions enacted in 1962 severely limited the general rule of deferral until repatriation. Congress provided for immediate taxation of certain categories of income, but allowed continued deferral for other classes of income. Shipping income was partially favored under the subpart F regime, as Congress was encouraging investment in foreign shipping operations. Pursuant to section 954(b)(2), recognition of foreign base company shipping income was deferred to the extent such income was reinvested in foreign base company shipping operations. This limited opportunity for deferral ended in 1987, when Congress repealed section 954(b)(2).

Section 954(b)(2), repealed by Public Law 99-514, section 1221(c)(1) (1986), provided that foreign base company income does not include foreign base company shipping income to the extent that the amount of such income does not exceed the increase for the taxable year in qualified investments in foreign base company shipping operations of the controlled foreign corporation. Under the statutory framework in place between 1962 and 1987, the exclusion for reinvested shipping income applied only to invested income that was "qualified".

Qualified investments in foreign base company shipping operations are defined in section 955(b)(1) as investments in:

(A) any aircraft or vessel used in foreign commerce, and
(B) other assets which are used in connection with the performance of services directly related to the use of any aircraft or vessel.

Such term includes, but is not limited to, investments by a controlled foreign corporation in stock or obligations of another controlled foreign corporation which is a related person (within

the meaning of section 954(d)(3)) and which holds assets described in the preceding sentence, but only to the extent that such assets are so used.

Under this previously existing statutory framework, pursuant to Treas. Reg. §1.955A-3, a controlled foreign corporation could calculate its qualified investments on an individual basis or in conjunction with other controlled foreign corporations that qualified as "related persons". Any qualified investment would be treated separately unless the taxpayer elected the aggregate approach. The regulation provides this election through which a taxpayer can choose to consolidate its qualified investments with those of related persons.

> Treas. Reg. §1.955A-3(a) provides, in general, that if a United States shareholder elects the benefits of section 955(b)(2) with respect to a related group...of controlled foreign corporations, then an investment in foreign base company shipping operation made by one member of such group will be treated as having been made by another member to the extent provided in paragraph (c)(4) of this section, and each member will be subject to the other provisions of paragraph (c) of this section. An election once made shall apply for the taxable year for which it is made and for all subsequent years unless the election is revoked or a new election is made to add one or more controlled foreign corporations to election coverage. For the manner of making an election under section 955(b)(2), and for rules relating to the revocation of such an election, see paragraph (d) of this section. For rules relating to the coordination of sections 955(b)(2) and 955(b)(3), see paragraph (e) of this section.

Thus, a U.S. shareholder was eligible to make the election only with respect to a related group of CFCs. Those covered under the election were also entitled to a pro rata share of any group excess deduction. See Treas. Reg. §1.955A-3(c)(2). However, an election as to qualified investments by related persons (related group election) was a prerequisite to use of the group excess deduction.

The most direct and obvious consequence of the repeal of section 954(b)(2) was that taxpayers could no longer exclude foreign base shipping income by making qualified investments in foreign base shipping operations. The concept of "qualified investments" became prospectively obsolete in that taxpayers could no longer except shipping income from subpart F, and the sum total of excluded income from qualified investments could no longer be increased. However, as a result of the repeal of section 954(b)(2), the previously excluded income was not subject to immediate recognition, and section 955 continues to recognize this income only when withdrawn from foreign base company shipping operations. Therefore, an accounting of a CFC's previously excluded income from qualified investments continues to be necessary, and the concept of "qualified investments" retains significance for this limited purpose.

Analysis

1. Whether Company A can utilize the Treas. Reg. §1.955A-3(c)(2)(ii) group excess deduction provision of the related group election to reduce its overall taxable income for tax years in which it did not file a written election.

Company A cannot utilize the group excess deduction provision of the related group election to reduce its overall taxable income for tax years in which it did not file a written election.

On Date G, a date within Year E, Company A acquired the stock of Company C and its subsidiaries. Company A made no related group election until Year F. Even though Company A had not made a related group election, it computed the income of its CFCs on a group basis and used the group excess deduction provisions of the related group election to compute the foreign base company shipping income of its CFCs for Year E and subsequent years. During the first five years after acquiring the stock of Company C, Company A added 8 CFCs to its related group computation, but still neglected to make a related group election.

A US shareholder cannot use the group excess deduction provision in calculating foreign base company shipping income without having made a related group election. Treas. Reg. § 1.955A-3(d) provides that a U.S. shareholder shall make an election under this section to treat two or more controlled foreign corporations as a related group for a group taxable year and subsequent years by filing a statement to such effect with the return for the taxable year within which or with which such group taxable year ends. The statement shall include:

i) the name, address, taxpayer identification number, and taxable year of the United States shareholder;

ii) the name, address, and taxable year of each controlled foreign corporation which is a member of the related group and is to be subject to the election; and

iii) a schedule showing the calculations by which the amounts described in this section have been determined for the taxable year for which the election is first effective. With respect to each subsequent taxable year to which the election applies, a new schedule showing calculations of such amounts for that taxable year must be filed with the return for that taxable year.

A valid related group election made in the time and manner provided by Treas. Reg. §1.955A-3(d) is a prerequisite to use of the group excess deduction. Since no election whatsoever was made for Year E, and none was made until Year F, use of the group excess deduction in Company A's computation of the CFCs' foreign base shipping income during the years before Year F is invalid regardless of whether Company A was otherwise eligible to make a valid related group election for those years (see Issue 3).

2. Whether Company A's consent to the Treas. Reg. §1.955A-3 related group election of its parent corporation in Year D serves as a related group election by Company A in Year E and subsequent years.

Company A's consent to the election of its parent corporation in Year D, a year before the repeal of section 954(b)(2) was effectuated, has no effect on Company A and does not constitute an election by Company A in Year E or subsequent years.

By consenting to the election, Company A may have enabled Company B, its parent, to make an election under Treas. Reg. §1.955A-3 that would otherwise have been invalid. Company B controlled Company A, which held controlling interests in some of the CFCs that were the subject of Company B's election.

> An election under paragraph (b)(1)(iii) of this section will not be valid in the case of an election by a U.S. shareholder (the first U.S. shareholder) if-
> (A) The first U.S. shareholder controls a second shareholder,
> (B) The second U.S. shareholder controls one or more controlled foreign corporations, and,
> (C) Any of the controlled foreign corporations are the subject of the election by the first U.S. shareholder, unless the second U.S. shareholder consents to the election by the first U.S. shareholder.

Treas. Reg. §1.955A-3(b)(1)(v).

However, Company A's consent to Company B's election does not serve as the equivalent of an election by Company A. Treas. Reg. §1.955A-3(c)(5) says that an election under Treas. Reg. §1.955A-3 shall have no effect on any other U.S. shareholder or any other controlled foreign corporation. Therefore, the election by Company B, in Year D, has no effect on whether Company A has made an election in Year E and subsequent years.

3. Whether A can utilize in Year F and subsequent years, the Treas. Reg. §1.955A-3(c)(2)(ii) group excess deduction provision of the related group election to reduce its overall taxable income by making its initial related group election in Year F, a taxable year beginning after the repeal of the section 954(b)(2) exclusion for reinvested shipping income.

Company A cannot use the group excess deduction to reduce its overall taxable income by making its initial related group election in Year F, a year after the repeal of section 954(b)(2).

Company A purchased the stock of Company C from Company B in Year E, several years after the repeal of section 954(b)(2). Even though Company A had not made a related group election, it reported its CFCs' foreign base company shipping income as if a group election had been in effect for Year E and subsequent years. In Year F, the fifth tax year after purchasing the stock, Company A made its initial related group election.

A US shareholder cannot make a related group election which is first to be effective after the repeal of section 954(b)(2). During the period when foreign base company shipping income used for qualified investments was excludable from subpart F income, the related group election enabled related taxpayers to work collectively to minimize that income. However, this exclusion for qualified investments in foreign base company shipping income was repealed as part of the Tax Reform Act of 1986.

Section 955(b)(2) arguably is authority for the related group election under Treas. Reg. §1.955A-3. Section 955(b), however, was not repealed along with section 954(b)(2). Section 955(b) is definitional and thus, needed to be retained for purposes of implementing section 955(a), which deals with withdrawal of previously excluded subpart F income from qualified investment.

The retention of section 955(b), however, does not authorize a U.S. shareholder to make a related group election which is first effective subsequent to the section 954(b)(2) repeal. As use of the group excess deduction is predicated upon a valid related group election, the group excess deduction is also unavailable under such circumstances.

In addition, subpart F income generally is computed on an individual corporation basis. Neither section 954(f), nor Treas. Reg. §1.954-6, which provides rules for determining foreign base company shipping income, allows for computing that income on a group basis. Treas. Reg. §1.955A-3 is an exception to the general rule.

Further, a reading of the provisions as a whole leads to the conclusion that Treas. Reg. §1.955A-3 cannot be used to compute foreign base company shipping income by a company making an initial election after the repeal of section 954(b)(2). The title of Treas. Reg. §1.955A-3; “election as to qualified investments by related persons”, clearly demonstrates that the election pertains to “qualified investments”. The concept of “qualified investments” became prospectively obsolete with the repeal of section 954(b)(2). To permit a first time election after the repeal of section 954(b)(2) would contravene the intent of the repeal.

The language found in Treas. Reg. §1.955A-1 also provides guidance in the analysis at hand. Treas. Reg. §1.955A-1(b)(2)(C) explicitly states that a taxpayer’s share of the group excess deduction constitutes excluded subpart F income under section 954(b)(2). This language demonstrates that the group excess deduction is dependent upon the section 954(b)(2) exclusion. As foreign base company shipping income is no longer excludable under section 954(b)(2), the group excess deduction is likewise unavailable to U.S. shareholders who first elect to use the deduction after repeal of section 954(b)(2).

The policy consideration implemented by repeal of section 954(b)(2), current recognition of shipping income earned through a foreign corporation, also suggests the curtailment of the group excess deduction.

> Congress has made a judgment that shipping income is the inherently manipulable type of income rarely subjected to foreign tax that ought to be subject to subpart F when earned through a foreign corporation. The committee believes that as a matter of tax policy that judgment should be given full effect.

H.R. REP. NO. 99-426 at 395 (1985).

The group excess deduction functions by enabling taxpayers to maneuver deductions in order to minimize current taxation. An initial attempt to use the group excess deduction after section 954(b)(2) repeal would frustrate Congress' intent to fully subject shipping income to current taxation and prevent manipulation of such income.

Based upon all of the above, Company A cannot use the group excess deduction for the years in question.

[redacted]

If you have any further questions, please call Mark R. Pollard at (202) 622-3840.

/s/ Phyllis E. Marcus
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(International)