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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CAROL B. MCCLURE
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FROM: Barbara A. Felker
Chief, CC:INTL:Br3

SUBJECT:

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LEGEND

USparent =
$A =
year X =

ISSUE

Whether interest received in year X by domestic subsidiaries of USparent on loans to affiliated controlled foreign corporations ("CFCs") is foreign oil and gas extraction income ("FOGEI").

CONCLUSION

The interest received in year X by the domestic subsidiaries on loans to the CFCs would likely be treated under section 904(d)(3)(C) of the Internal Revenue Code as either general limitation income or passive income to the extent allocable to income of the affiliated CFCs in those separate categories. The interest income will not be FOGEI in the taxpayer's hands on the basis that it is attributable under the section 904(d)(3)(C) look-though rules to FOGEI income of the CFCs, because the section 907(c)(3)(A) FOGEI look-through rule does not apply to interest. To the extent the interest income is treated as general limitation income under the section 904(d)(3)(C) look-through rules, it would qualify as FOGEI only in the unlikely event that it could qualify as interest on working capital under Treas. Reg. §1.907(c)-1(f)(3). To the extent the interest is treated as passive income under the section 904(d)(3)(C) look-through rules, section 907(c)(1) expressly excludes it from FOGEI.

FACTS

Certain domestic subsidiaries of USparent lend money to affiliated CFCs that are engaged in activities that generate FOGEI. The domestic subsidiaries are "United States shareholders" of the affiliated CFCs as defined in section 951(a) of the Code. The loans are made for various purposes, including to fund the CFCs' plant construction and oil and gas extraction operations and, presumably, to provide the CFCs with working capital. In year X, four USparent domestic subsidiaries received interest payments, totaling approximately $A, on their loans to certain affiliated CFCs. USparent included the interest income in FOGEI.

LAW AND ANALYSIS

In 1975, Congress enacted section 907 of the Code which provides special foreign tax credit rules for foreign oil income.[1] Section 907(a) imposes an annual limit on the amount of foreign taxes paid on FOGEI that can be credited under section 901 against the U.S. tax liability of U.S. taxpayers. The limitation is a certain percentage of FOGEI. The percentage limitation for corporate taxpayers for year X was the highest U.S. corporate tax rate for the year. Foreign taxes paid on FOGEI in excess of the section 907(a) limitation are not deductible as taxes or as royalties but may be carried back for two years or forward for five years subject to the

[1]Tax Reduction Act of 1975, 89 Stat. 54, P.L. 94-12, §601.

section 907(a) limitation in the year to which the taxes are carried. Pursuant to section 904(d)(1), section 907 is applied separately to each separate category of income, including passive income defined in section 904(d)(2)(A) and "general limitation" income described in section 904(d)(1)(I).

For year X, FOGEI is defined in section 907(c)(1) of the Code as foreign source taxable income from the extraction of oil and gas and from the sale or exchange of assets used by the taxpayer in that extraction activity. FOGEI does not include income attributable to processing, transporting or distributing oil and gas or their primary products or to the disposition of assets used in those activities. That income is foreign oil related income ("FORI"). Section 907(c)(2); Treas. Reg. §1.907(c)-1(c). In 1993, Congress revised section 907(c)(1) to provide that FOGEI "does not include any dividend or interest income which is passive income (as defined in section 904(d)(2)(A)."[2] That revision is effective for tax years beginning after December 31, 1992, and applies in year X.

Also included within the definition of FORI are dividends and interest received "from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902 [of the Code] ... to the extent such dividends [or] interest ... is attributable to" FORI. Section 907(c)(3)(A).[3] The Code specifically provides that the look-through rule for interest does not apply to include such interest in FOGEI. Section 907(c)(3). Accordingly, section 907(c)(3) is not applicable here in our analysis of whether USparent was correct to treat the interest payments from the CFCs as FOGEI. [4]

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[2]Omnibus Budget Reconciliation Act of 1993, 107 Stat. 312, 504-505, P.L. 103-66, §13235(a)(1)(A).

[3]Interest is included within the definition of FORI even though "taxes are [not] deemed paid by the taxpayer under section 902" with respect to interest. The reference in section 907(c)(3)(A) to the deemed paid credit under section 902 operates only to identify those corporations in which the taxpayer has the requisite stock ownership for dividends and interest to qualify for the look-through rule.

[4]The conference report accompanying the 1993 amendments to sections 904(d)(2)(A) and 907(c)(1) provides that "the conferees intend that dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902 are classified as FOGEI and FORI, respectively, to the extent attributable to FOGEI or FORI." H.R.Rep. No. 213, 103d Cong., 1st Sess. 1337 (1993). This statement apparently was intended to reflect existing law, since in 1993 Congress did not amend the look-through rule of section 907(c)(3). However, to the extent this statement suggests the conferees believed the look-through rule applied to characterize interest from a foreign subsidiary as FOGEI, it conflicts with the plain language of the Code which specifically precludes application of the look-through rule to include interest payments in FOGEI.

Because the section 907(c)(3) look-through rule does not apply, the only basis on which USparent might argue that its interest income qualifies as FOGEI would be to treat the CFC loans as temporary investments generating interest on working capital within the meaning of Treas. Reg. §1.907(c)-1(f)(3).[5] That regulation provides that "FOGEI may include interest on bank deposits or any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated needs of the person that is engaged in the conduct of the activities described in section 907(c)(1) or (2) [of the Code]." It is extremely unlikely that the CFC loans would qualify under this rule, since the loans must be readily convertible into cash to meet the definition of temporary investment or working capital. See Notice 88-22, 1988-1 C.B. 489, 490, and *Alaska Steamship Co. v. Federal Maritime Comm.*, 344 F.2d 810, 823 (9th Cir. 1965). Moreover, to the extent the interest income is passive income, the 1993 statutory revision to the definition of FOGEI that excludes "dividend or interest income which is passive income (as defined in section 904(d)(2)(A))" supercedes Treas. Reg. §1.907(c)-1(f)(3) to prevent the inclusion of the passive interest income in FOGEI.

Under section 904(d)(2)(A), passive income is income "of a kind which would be foreign personal holding company income (as defined in section 954(c))." Under section 954(c)(1)(A), foreign personal holding company income includes interest income.[6] However, "passive income" does not include income that also would fall within any of the other section 904(d) separate categories, any export financing interest, and any high-taxed income. Section 904(d)(2)(A)(iii)(I), (II), and (III).[7] Also, interest received from a controlled foreign corporation in which the taxpayer is a United States shareholder, such as the interest received here by the domestic subsidiaries of USparent from the affiliated CFCs, may not be passive income under the "look-through rule" of section 904(d)(3)(C). This rule provides that interest "shall be treated as income in a separate category to the extent it is

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[5]Issued on March 14, 1991. T.D. 8338, 1991-1 C.B. 115.

[6]The section 904(d) definition of "passive income" does not include a working capital exception. The current separate limitation for passive income replaced the separate limitation for passive interest income. Excluded from the definition of passive interest was interest derived from any transaction which directly related to the taxpayer's trade or business in a foreign country. Section 904(d)(2)(A) of the Code effective for tax years beginning before January 1, 1987. The regulations under prior law, former Treas. Reg. §1.904-4(b), treated certain types of interest on working capital as interest derived from a transaction directly related to the taxpayer's trade or business in a foreign country.

[7]In 1993, concurrent with the revision made to the definition of FOGEI, Congress also deleted section 904(d)(2)(A)(iii)(IV), which provided that passive income for purposes of section 904(d) did not include FOGEI.

properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation in such category." The regulations provide that related person interest expense will be allocated first to passive income of the CFC and then to the CFC's other separate categories. Treas. Reg. §1.904-5(c)(2).

Under the look-through rule of section 904(d)(3)(C) of the Code, the interest payments received here by the domestic subsidiaries of USparent from the affiliated CFCs will be treated as income in a separate category to the extent allocable to income of the affiliated CFCs in that category. The determination would be made with regard to each affiliated CFC. Here, some of the CFCs' income, such as from their oil and gas extraction operations, would be general limitation income as described in section 904(d)(1)(I), so that an allocable part of the interest payments made by those CFCs would be general limitation income. Even though the CFCs' oil and gas extraction operations would generate general limitation FOGEI for the CFCs, however, that characterization as FOGEI does not carry through to interest paid by the CFCs to USparent. As stated above, section 907(c)(3) provides that the look-through rule of section 907(c)(3)(A) for characterizing payments from a CFC as FOGEI for purposes of section 907 does not apply to interest payments. Accordingly, the general limitation interest income could be FOGEI only in the unlikely event that the CFC loans could properly be characterized as temporary investments generating interest on working capital within the meaning of Treas. Reg. §1.907(c)-1(f)(3).[8]

To the extent that the affiliated CFCs' income is passive income as defined in section 904(d)(2)(A) of the Code, the portion of the CFCs' interest payments allocated under the section 904(d)(3)(C) look-through rule to that passive income will be passive income of USparent. Under the 1993 revision to the definition of FOGEI in section 907(c)(1) discussed above, that passive income cannot be FOGEI.

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

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[8]The legislative history to the 1993 amendments to sections 904(d)(2)(A) and 907(c)(1) reflects the House and Conference Committees' understanding that interest income on working capital related to FOGEI would be treated as passive income that would not itself qualify as FOGEI. H.R.Rep. No. 111, 103d Cong., 1st Sess. 716 (1993); H.R.Rep. No. 213, 103d Cong., 1st Sess. 1336-1337 (1993).