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to: Cynthia M. Bergmanis, Appeals Team Case Leader
(Appeals)

from: Christopher J. Bello, Branch Chief, CC:INTL:6

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subject: Extraterritorial income exclusion and subpart F income inclusion

This Chief Counsel advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUE

Whether the extraterritorial income (ETI) exclusion under section 114 applies for purposes of determining the amount of income inclusions under section 951(a)(1)(A)(i) (subpart F income inclusions).

SUMMARY

The ETI exclusion for purposes of determining Taxpayer's subpart F income inclusions is zero. The amount of any ETI exclusion under section 114(b) is determined under subpart E of part III of subchapter N. However, for purposes of Taxpayer's subpart F inclusions, the gross and taxable income of its controlled foreign corporations (CFCs) must, except as otherwise distinctly expressed, ignore the provisions of subchapter N. Absent such distinct expression (see the next paragraph), the amount of any ETI exclusion in computing Taxpayer's subpart F inclusions with respect to its CFCs is, therefore, zero.

If anything, Congress distinctly expressed an intent to deny the ETI exclusion to CFCs. The foreign sales corporation (FSC) provisions (repealed and replaced by the

ETI Act[1]) determined the taxable incomes of two persons pursuant to section 925(a), the FSC and "a person described in section 482" (the related supplier). There was no requirement that the related supplier be domestic. Thus, FSC benefits were available to determine the taxable income of a CFC with regard to its transactions with a related FSC. See § 5(c)(3)(C) of the ETI Act. By contrast, with the repeal of the FSC provisions, Congress substituted a territorial exclusion along the lines found in many European tax systems. The ETI exclusion is available to persons who otherwise would have included, and been taxable with regard to, the excluded amounts. Congress afforded a domestication election pursuant to section 943(e)(2)(B), and addressed the effect of the election for pre-October 1, 2000, earnings and profits pursuant to section 5(c)(3)(C) of the ETI Act, to enable access to the ETI exclusion by certain foreign corporations substantially all the gross receipts of which are foreign trading gross receipts. Taxpayer's CFCs were eligible, but did not make domestication elections.

FACTS

Taxpayer is a domestic corporation and a U.S. shareholder (within the meaning of section 951(b)) with respect to four subsidiaries each of which is a CFC within the meaning of section 957(a). The four CFCs are the only partners in a foreign entity that is treated as a partnership for U.S. tax purposes.

Taxpayer manufactures personal property in the United States and sells the property to the foreign partnership. The foreign partnership resells the property to unrelated customers outside the United States.[2] Each partner's distributive share of the foreign partnership's income derived from the sales is treated as subpart F income earned by the partner under sections 952 and 954, and generally results in a subpart F income inclusion to the Taxpayer. For purposes of calculating Taxpayer's subpart F income inclusions with respect to the partners' income, Taxpayer claims that ETI exclusions should be taken into account.

LAW AND ANALYSIS

A. The ETI Exclusion Provisions

1) In general

Section 114 provides an exclusion from gross income for ETI, in part, as follows:

> (a) Exclusion. – Gross income does not include extraterritorial income.

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[1] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000).

[2] No issue is raised, and we express no opinion, regarding the substantive qualification of the partnership's gross receipts as foreign trading gross receipts under section 942.

> (b) Exception. – Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.
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> (e) Extraterritorial Income. – For purposes of this section, the term “extraterritorial income” means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.

Section 941(a)(1) generally defines qualifying foreign trade income (QFTI) as:

> with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of [certain amounts].

Section 942(a)(1)(A) defines foreign trading gross receipts (FTGR), in part, as:

> gross receipts of the taxpayer which are from the sale, exchange, or other disposition of qualifying foreign trade property.

Section 943(a) defines qualifying foreign trade property (QFTP).

2) The domestication election and related rules

Section 943(e)(1) provides in relevant part:

> An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty.

Section 943(e)(2) defines an applicable foreign corporation as:

> any foreign corporation if –
> (A) such corporation manufactures, produces, grows, or extracts property in the ordinary course of such corporation’s trade or business, or
> (B) substantially all of the gross receipts of such corporation are foreign trading gross receipts.

Section 943(e)(4)(B)(i) provides, with respect to a domestication election:

> For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

The ETI Act, which codified the ETI exclusion provisions described above, also provides a number of uncodified transition rules, including certain rules regarding domestication elections. Specifically, section 5(c)(3) of the ETI Act addresses the effect of the domestication election for pre-October 1, 2000, earnings and profits of certain foreign corporations. Section 5(c)(3)(A) of the ETI Act provides, in relevant part:

> In the case of a foreign corporation to which this paragraph applies-
> (i) earnings and profits of such corporation accumulated in taxable years ending before October 1, 2000, shall not be included in the gross income of the persons holding stock in such corporation by reason of section 943(e)(4)(B)(i); and
> (ii) rules similar to the rules of clauses (ii), (iii), and (iv) of section 953(d)(4)(B) shall apply with respect to such earnings and profits.

Section 5(c)(3)(B) of the ETI Act provides, with respect to a FSC:

> This paragraph shall apply to any controlled foreign corporation (as defined in section 957) if—
> (i) such corporation is a FSC (as so defined) in existence on September 30, 2000;
> (ii) such corporation is eligible to make the election under section 943(e) by reason of being described in paragraph (2)(B) of such section; and
> (iii) such corporation makes such election not later than for its first taxable year beginning after December 31, 2001.

Section 5(c)(3)(C) of the ETI Act provides, with respect to a non-FSC CFC:

> such corporation shall (notwithstanding any provision of section 943(e)) be treated as an applicable foreign corporation for purposes of section 943(e), if—

(i) such corporation is in existence on September 30, 2000;
(ii) as of such date, such corporation is wholly owned (directly or indirectly) by a domestic corporation (determined without regard to any election under section 943(e));
(iii) for each of the 3 taxable years preceding the first taxable year to which the election under section 943(e) by such controlled foreign corporation applies –
    (I) all of the gross income of such corporation is subpart F income (as defined in section 952), including by reason of section 954(b)(3)(B); and
    (II) in the ordinary course of such corporation's trade or business, such corporation regularly sold (or paid commissions) to a FSC which on September 30, 2000, was a related person to such corporation;
(iv) such corporation has never made an election under section 922(a)(2) (as in effect before the date of the enactment of this paragraph) to be treated as a FSC; and
(v) such corporation makes the election under section 943(e) not later than for its first taxable year beginning after December 31, 2001.

The preceding sentence shall cease to apply as of the date that the domestic corporation referred to in clause (ii) ceases to wholly own (directly or indirectly) such controlled foreign corporation.

3) Regulations

Congress enacted the ETI exclusion provisions to replace the FSC provisions with a regime that complied with the World Trade Organization's (WTO) rulings concerning FSCs. H.R. Rep. No. 106-845, at 9-19 (2000). At the time of enactment, Congress expected that published guidance would be issued under the ETI exclusion provisions. The legislative history states:

> The Committee recognizes that there may be a gap in time between the enactment of the bill and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill.

S. Rep. No. 106-416, at 18 (2000). The ETI exclusion provisions were repealed in 2004 before regulations were issued thereunder.[3]

B. Dividends Received Deduction and Earnings & Profits Rules

Section 245(c)(1)(A) provides:[4]

> In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to 100 percent of any dividend received from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC. . . .

Section 1248(c) provides that, in general, earnings and profits of any foreign corporation for any taxable year shall be determined according to rules substantially

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[3] The ETI exclusion provisions were generally repealed effective for transactions after 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357 § 101(a) and (b), 118 Stat. 1418, 1423-24 (2004).
[4] The full text of section 245(c) provides:

> (c) Certain dividends received from FSC.--
> (1) In general. In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to—
> (A) 100 percent of any dividend received from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC, and
> (B) 70 percent (80 percent in the case of dividends from a 20-percent owned corporation as defined in section 243(c)(2)) of any dividend received from another corporation which is distributed out of earnings and profits attributable to effectively connected income received or accrued by such other corporation while such other corporation was a FSC.
> (2) Exception for certain dividends.-- Paragraph (1) shall not apply to any dividend which is distributed out of earnings and profits attributable to foreign trade income which—
> (A) is section 923(a)(2) nonexempt income (within the meaning of section 927(d)(6)), or
> (B) would not, but for section 923(a)(4), be treated as exempt foreign trade income.
> (3) No deduction under subsection (a) or (b).-- No deduction shall be allowable under subsection (a) or (b) with respect to any dividend which is distributed out of earnings and profits of a corporation accumulated while such corporation was a FSC.
> (4) Definitions. -- For purposes of this subsection—
> (A) Foreign trade income; exempt foreign trade income. The terms “foreign trade income” and “exempt foreign trade income” have the respective meanings given such terms by section 923.
> (B) Effectively connected income. The term “effectively connected income” means any income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States and is subject to tax under this chapter. Such term shall not include any foreign trade income.
> (C) FSC. The term “FSC” has the meaning given such term by section 922.
> (5) References to prior law. Any reference in this subsection to section 922, 923, or 927 shall be treated as a reference to such section as in effect before its repeal by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.

similar to those applicable to domestic corporations. Section 1248(d) provides for exclusions from a foreign corporation's earnings and profits for purposes of the section. Section 1248(d)(5)[5] provides that one of those exclusions is:

> Earnings and profits of the foreign corporation attributable to foreign trade income of a FSC (as defined in section 922) other than foreign trade income which—
> (A) is section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)), or
> (B) would not (but for section 923(a)(4)) be treated as exempt foreign trade income.

Section 312 provides rules for determining earnings and profits. Treas. Reg. § 1.312-6(b) provides, in relevant part:

> Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts.

C. The Subpart F Provisions

Section 951 provides that a U.S. shareholder of a CFC must include certain amounts in gross income. Section 951(a)(1)(A) provides, in part:

> If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends . . . his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year.

[5] The American Jobs Creation Act of 2004 redesignated former section 1248(d)(6) as section 1248(d)(5) effective for taxable years of foreign corporations beginning after 2004, as well as for the taxable years of U.S. shareholders with or within which such taxable years of the foreign corporations end. Pub. L. No. 108-357 § 413(c)(22) and (d)(1), 118 Stat. 1418, 1509-10 (2004).

Former section 951(c) (which was also previously designated as section 951(e)) provided:

> The foreign trade income of a FSC and any deductions which are apportioned or allocated to such income shall not be taken into account under this subpart.

The U.S. shareholder must include in income the shareholder's pro rata share of the CFC's subpart F income. Section 952(a)(2) defines "subpart F income," in part, as including the foreign base company income (FBCI) (as determined under section 954) of a CFC. FBCI includes foreign base company sales income (FBCSI) as defined in section 954(d). FBCSI includes income derived from the sale of property purchased from a related person. Under Treas. Reg. § 1.952-1(g), a CFC's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a)(2) to the extent the item of income would have been income in such category if received by the CFC directly. Accordingly, in this case the partners' distributive shares of the income derived from the foreign partnership's sale of property purchased from Taxpayer are FBCSI.

Treas. Reg. § 1.952-2(a), (b), and (c) provide rules for determining gross income and taxable income for purposes of a CFC's subpart F income as follows:

> (a) Determination of gross income. – (1) In general. – Except as provided in subparagraph (2) of this paragraph, the gross income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 61 and the regulations thereunder.
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> (b) Determination of taxable income. – (1) In general. – Except as provided in subparagraph (2) of this paragraph, the taxable income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 63.
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> (c) Special rules for purposes of this section. – (1) Nonapplication of certain provisions. – Except where

> otherwise distinctly expressed, the provisions of subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Internal Revenue Code shall not apply and, for taxable years of a controlled foreign corporation beginning after March 3, 1997, the provisions of section 103 of the Internal Revenue Code shall not apply.

Thus, for purposes of a U.S. shareholder's subpart F income inclusion, Treas. Reg. § 1.952-2(a)(1) and (b)(1) generally provide that the gross income and taxable income of a CFC shall "be determined by treating such foreign corporation as a domestic corporation." However, those general rules are subject to the special rules of Treas. Reg. § 1.952-2(c)(1), which provides, among other things, that, except where otherwise distinctly expressed, subchapter N, "shall not apply" for purposes of determining a CFC's subpart F income.

Section 964(a) provides in relevant part that, for purposes of subpart F,

> the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary.

For this purpose, Treas. Reg. § 1.964-1(a)(1) directs the foreign corporation to determine earnings and profits (or deficit thereof) by

> (i) preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders;
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> (ii) Making the adjustments necessary to conform such statement to [accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates]; and
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> (iii) making the further adjustments necessary to conform such statement to [certain U.S. tax accounting principles].

D. Discussion

1) Treasury Regulation § 1.952-2(c)(1)

Section 114, the provision that authorizes the ETI exclusion from gross income, is located in subchapter B. For purposes of determining a CFC's subpart F income, subchapter B is not excluded under Treas. Reg. § 1.952-2(c)(1). Section 114(b) and (e) define the ETI exclusion amount by specific reference to QFTI and FTGR. The logic of section 114 is as follows: If a taxpayer has gross income attributable to FTGR, then the taxpayer shall exclude that portion of such gross income that constitutes QFTI. Thus, the taxpayer must apply the provisions of sections 941 through 943 (for example, to determine whether it has QFTP, FTGR, and QFTI) before it can determine whether section 114 is applicable.

Sections 941 through 943, the application of which is a necessary prerequisite to a potential application of section 114 in this case, are located in subchapter N. Treas. Reg. § 1.952-2(c)(1) unambiguously states that the provisions of subchapter N "shall not apply" for purposes of calculating a CFC's subpart F income. As a result, FBCSI cannot be characterized as FTGR or as QFTI. Because the application of subchapter N is a sine qua non with respect to the potential applicability of section 114, and because subchapter N does not apply for purposes of calculating a CFC's subpart F income, an ETI exclusion cannot be calculated and claimed in connection with determining a CFC's subpart F income, and thus, is not taken into account in determining a U.S. shareholder's subpart F income inclusion.

Taxpayer disagrees with the foregoing analysis and puts forth several interrelated arguments in support of its position. First, Taxpayer argues that Treas. Reg. § 1.952-2(c)(1) renders the subchapter N provisions inapplicable only if the provisions are "operative" as opposed to merely "definitional." Taxpayer then concludes that sections 941 through 943 are definitional provisions only and, therefore, do not apply in this case. We see nothing in the plain language of Treas. Reg. § 1.952-2(c)(1) that suggests a distinction between operative and definitional rules, nor are we aware of any authority in support of Taxpayer's conclusion that sections 941 through 943 should be considered definitional, rather than operative, in this context.

Second, Taxpayer argues that the qualifying condition "[e]xcept where otherwise distinctly expressed" in Treas. Reg. § 1.952-2(c)(1) is satisfied because section 114 is in subchapter B, which does apply for purposes of calculating subpart F income. Specifically, Taxpayer argues that the placement of section 114 in subchapter B (rather than in subchapter N) is a distinct expression of legislative intent that Treas. Reg. § 1.952-2(c)(1) would not preclude the reduction of gross income by ETI exclusions. We believe Taxpayer's characterization of the location of section 114 in subchapter B as a distinct expression of a legislative intent to override Treas. Reg. § 1.952-2(c)(1) assigns a meaning to that phrase hardly in line with its plain meaning. While the location undoubtedly is a distinct expression of legislative intent that the ETI tax benefit be an exclusion from gross income (as opposed to, for example, a deduction or credit), it cannot reasonably be viewed as a distinct expression regarding the applicability of Treas. Reg. § 1.952-2(c)(1).

Third, Taxpayer relies on PLR 8517025 (the PLR). The PLR considered the same question at issue in this case, but in the predecessor domestic international sales corporation (DISC) context. The description of the facts in the PLR is limited, but the relevant facts seem to be materially similar to those in the present case. Namely, a domestic company sold goods to a CFC, which resold the goods. The PLR addresses whether DISC commissions could be paid and deducted by the CFC with respect to its resales. Unlike the ETI exclusion provisions, which are located in both subchapters B and N, the DISC provisions are located solely in subchapter N. The PLR focuses on the fact that the administrative pricing methods under section 994(a) apply in lieu of section 482. The PLR then summarily concludes that

> section 994(a) of the Code will be viewed as an express exception to section 1.952-2(a)(1) [sic] of the regulations, and thus [the CFC] will not be precluded from deducting commissions paid to D under section 994(a)(1) or (2) for the purpose of determining [its] taxable income under subpart F of the Code.

Taxpayer argues that, because Treas. Reg. § 1.952-2(c)(1) was determined to be inapplicable in the DISC context in that case, the same result should obtain in the ETI exclusion context in this case.

We disagree that the PLR supports Taxpayer's position in this case. First, the PLR is not precedential or authoritative with respect to this case. The penultimate sentence of the PLR provides: "This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent."

Second, the analysis of the PLR is not relevant to the present case. The DISC and ETI exclusion provisions differ materially with respect to the provision on which the PLR's conclusion is based. Under section 994(a) (i.e., the distinct expression according to the PLR), "a person described in section 482" (referred to in Treas. Reg. § 1.994-1(a)(3) as the related supplier) is permitted to pay a DISC a commission, which the related supplier can then deduct as an expense. In contrast, the ETI exclusion involves only a single party – a taxpayer that excludes a portion of its own gross income. In other words, the DISC tax benefit affected two parties (one earning commission income and the other deducting the corresponding commission expense) whereas the ETI exclusion affects only one party. The two persons/two taxable incomes aspect of the DISC regime, which forms the basis for the PLR's determination that section 994(a) is a distinct expression for purposes of Treas. Reg. § 1.952-2(c)(1), is not present under the ETI exclusion regime. So even if the PLR were precedential and correct, it would be inapposite.[6]

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[6] We also note that the analysis of the PLR is inconsistent with Taxpayer's position in at least one material respect. The DISC provisions themselves do not provide for commission expense deductions, only the commission payments. The reason that commission payments may be deducted by related suppliers is that they are deductible as ordinary business expenses under section 162. Under Taxpayer's theory of the present case, the PLR should have concluded that Treas. Reg. § 1.952-2(c)(1) did not

Taxpayer has asserted additional arguments in support of its position. We find these arguments similarly unpersuasive. Their common thread is that we should disregard the fact that any ETI exclusion that is potentially available under section 114 is entirely dependent on the application of the rules in sections 941 through 943. Absent application of those rules, the ETI exclusion amount must be zero.

2) The ETI exclusion statutory framework

As explained above, the ETI exclusion provisions do not contain a distinct expression that the carve-out of subchapter N contained in Treas. Reg. § 1.952-2(c)(1) does not apply. If anything, the statutory framework of the ETI exclusion provisions reflects an intent to deny the ETI exclusion to CFCs. Also as discussed above, the DISC provisions determined the taxable incomes of two persons pursuant to section 994(a) – the DISC and its related supplier. The FSC provisions contained materially similar rules in section 925(a). See also Temp. Treas. Reg. § 1.927(d)-2T. As reflected in the transition rule provided in section 5(c)(3)(C) of the ETI Act, FSC benefits could be claimed by a CFC that transacted with a related FSC. Neither the DISC nor the FSC provisions required that the related supplier be a domestic person or otherwise be subject to Federal income tax.

In contrast, the ETI exclusion provisions replaced the two person/two taxable income paradigm under the predecessor regimes with a materially different territorial system based on the European model requiring, as a threshold matter, that the person claiming the tax benefit be subject to tax in the first instance.

a. The plain language of section 941(a)(1)

The ETI exclusion may be claimed only with respect to QFTI. Section 941(a)(1) defines QFTI by reference to the relationship between the gross income and the taxable income of a single taxpayer. Thus, under the statutory structure, in this case the ETI exclusion may be computed only with respect to sales income subject to U.S. taxation in

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preclude the DISC commission deduction because section 162 is an operative rule located outside of subchapter N and the DISC provisions located within subchapter N are merely definitional rules. On the contrary, the PLR disregarded the relevance of the location of section 162 altogether and focused only on the location of the DISC provisions. The PLR provides:

> Subchapter N includes sections 861 through 999 of the Code. Therefore, unless otherwise distinctly expressed, the gross receipts or combined taxable income methods [sic] of section 994(a) does not apply in calculating the taxable income of C for purposes of section 952.

So even if the PLR were relevant here, it would support Examination's position that the location of section 114 (similar to the location of section 162) does not require us to disregard the plain language of Treas. Reg. § 1.952-2(c)(1) with respect to subchapter N.

the hands of the person that earned such sales income.[7] The statutory structure is consistent with the intent to exclude ETI from "U.S. gross income" expressed by Congress in the House Ways and Means Committee Report (House Report):

> It is the Committee's intent and belief that the exclusion of extraterritorial income from U.S. gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports.

H.R. Rep. No. 106-845, at 17 (2000).

And it is consistent with the intent expressed in the Report of the Senate Finance Committee (Senate Report):

> The legislation modifies the general rule of U.S. taxation by fundamentally amending the definition of gross income. Under the Code, the definition of "gross income" defines the outer boundaries of U.S. income taxation. The bill excludes income derived from certain activities performed outside the United States, referred to as extraterritorial income, from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income.

S. Rep. No. 106-416, at 5 (2000).

Under subpart F of the Code, U.S. shareholders of CFCs are required to include their pro rata share of certain earnings of the CFC in income currently, rather than later when distributed as a dividend. Subpart F requires an income inclusion by U.S. shareholders of a CFC, rather than subjecting the CFC itself to U.S. taxation on its income. Therefore, the ETI exclusion cannot apply to a CFC for purposes of computing subpart F income because the ETI exclusion can be computed only with respect to sales income subject to U.S. taxation in the hands of the person earning such income. See I.R.C. § 941(a)(1). A CFC is not subject to U.S. taxation on its income under subpart F.

In the instant case, the CFCs are not subject to U.S. taxation on the income from sales of products purchased from, and manufactured in the United States by, Taxpayer. Thus, the ETI exclusion cannot be computed with respect to the CFC's sales income.

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[7] Foreign corporations, such as CFCs, can be subject to U.S. taxation only under sections 881 and 882. Neither section applies to the income at issue in this case.

b. Intent to impose territorial regime

The ETI exclusion provisions were intended by Congress to be analogous to a territorial tax system that Congress believed would comply with the WTO requirements. This intent is explicit in the legislative history. For example, the Senate Report provides:

> The Committee notes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by European Union member states. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems.

S. Rep. No. 106-416, at 5 (2000). Similarly, the House Report provides:

> The legislation makes fundamental adjustments to the Code that move the U.S. tax system in the direction of many European tax systems by incorporating certain of the territorial features of those systems…. Under a territorial system, such as those of a number of European countries, only income earned within the borders of the taxing jurisdiction is subject to tax…. In a territorial system, the "exemption method" is used [to avoid double taxation], that is, income earned abroad is simply not subject to tax.

H.R. Rep. No. 106-845, at 13 (2000). The House Report further explains:

> What the Committee is intending to do with this legislation is once again to incorporate elements of a territorial tax system into the U.S. system of worldwide taxation, this time in a manner which does not conflict with WTO rules.
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> *   *   *
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> Indeed, pure territorial tax systems exclude all foreign source income, including export income, from tax. WTO rules do not compel members to adopt pure territorial tax regimes. Accordingly, the United States, like European Union

> countries with territorial tax systems (whether pure territorial systems or partial territorial systems) must be free to elect not to tax certain categories of income.

Id. at 14 and 16.

By its nature, this territorial system is available only to persons that would otherwise have been subject to taxation with respect to ETI. Moreover, denial of the ETI exclusion benefits with respect to subpart F is consistent with the territorial approach. The hypothetical claiming of an ETI exclusion to reduce a subpart F income inclusion would result in a mere deferral of income, as opposed to an exclusion of income. This is because any ETI excluded from the subpart F income calculation would eventually be taxed upon repatriation because the earnings and profits of the U.S. shareholder would not be correspondingly reduced by the ETI exclusion amount. See I.R.C. §§ 312, 964(a), and 1248(c)(1) and Treas. Reg. §§ 1.312-6(b) and 1.964-1.[8] In short, the territorial system is conceptually and mechanically incompatible with deferral under subpart F.

c. Domestication election

Congress recognized that certain non-manufacturing foreign corporations that may have previously been eligible for FSC benefits (such as the CFCs in this case) would be ineligible to benefit from the ETI exclusion under the territorial system. Accordingly, Congress provided the domestication election for a foreign corporation under section 943(e)(2)(B) if substantially all of the corporation's gross receipts are foreign trading gross receipts. The election enables such corporations to claim ETI exclusions, while still being consistent with the territorial system. In addition, the transition rules in section 5(c)(3)(A) and (C) of the ETI Act afforded relief from the effects of section 943(e)(4)(B) for an electing CFC that had pre-October 1, 2000, earnings and profits associated with FSC transactions. Taxpayer's CFCs did not take advantage of the domestication election and thus cannot claim ETI exclusions.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

The discussion above reflects the Chief Counsel's consideration that, under the better interpretation of the plain language of the relevant statutes and regulations, the ETI exclusion for purposes of determining Taxpayer's subpart F inclusions is zero.

[redacted]

[8] Whereas section 1248(d)(5) provides an exclusion from earnings and profits with respect to certain foreign trade income of a FSC, the ETI exclusion provisions contain no analogous rule. Note also that, because the ETI exclusion provisions affect the taxable income of only one person, the special dividends received deduction for distributions from FSCs contained in section 245(c) has no analog in the ETI exclusion provisions. Similarly, the ETI exclusion provisions contain no analog with respect to former section 951(c), which disregarded the foreign trade income of a FSC for subpart F purposes.

[redacted]

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Please contact Branch 6 at (202) 435-5265 if you have any further questions.