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Memorandum

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to: William R. Davis
Associate Area Counsel (Denver)
(Large Business & International)

from: Barbara A. Felker
Branch Chief, Branch 3
Associate Chief Counsel (International)

USParent	=
State A	=
X CFC1	=
Y CFC4	=
Y CFC5	=
USCorp2	=
X CFC2	=
X CFC3	=
Country X	=
Country Y	=
Tax Authority	=
Percent 1	=
Percent 2	=
Percent 3	=
Percent 4	=
Percent 5	=
Percent 6	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=

subject: Foreign Tax Redeterminations With Respect to Pre-1987 Accumulated Profits

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

ISSUE

Whether additional amounts of creditable foreign income tax paid in 2007 with respect to pre-1987 accumulated profits of X CFC3 and its Country X subsidiaries for taxable years 1994 through 1999 should be accounted for by adjusting the foreign corporations' relevant annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes or their pools of post-1986 undistributed earnings and post-1986 foreign income taxes, which were established beginning in 2001.

CONCLUSION

Under the provisions of Internal Revenue Code section 902(c)(6), Treas. Reg. §§1.902-1(a)(10) and 1.902-1(a)(13), and Temp. Treas. Reg. §1.905-5T, a foreign tax redetermination with respect to a taxable year prior to the first taxable year taken into account in computing the post-1986 undistributed earnings and post-1986 foreign income taxes of the Country X controlled foreign corporations (CFCs) is not taken into account by adjusting the corporations' pools of post-1986 foreign income taxes and post-1986 undistributed earnings. Instead, the additional foreign taxes paid must be accounted for by adjusting the CFCs' annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes. Because the CFCs' pre-1987 accumulated profits were eliminated in connection with the CFCs' deemed liquidations as the result of check-the-box entity classification elections in 2010, no portion of those earnings has been or will ever be included in the taxable income of USParent's consolidated group. Accordingly, no portion of the CFCs' pre-1987 foreign income taxes, including the additional amounts paid in 2007 with respect to taxable years 1994-1999, are eligible to be deemed paid. Because all such taxes were paid with respect to taxable years when X CFC3 and its Country X subsidiaries were not CFCs, any such taxes paid by any Country X subsidiary below the third tier in the qualified group are ineligible to be deemed paid for the additional reason that section 902(b)(2) limits credits for foreign income taxes paid by fourth-, fifth-, and sixth-tier corporations to taxes paid with respect to post-1997 taxable years in which the corporation was a CFC.

FACTS

USParent, a domestic corporation incorporated in State A, files a consolidated return on a calendar year basis using the accrual method of accounting. USParent owns 100 percent of X CFC1, which was incorporated in Country X in 2002.

Immediately before the 2010 transactions at issue, USParent owned 100 percent of Y CFC4, which owned 100 percent of Y CFC5. Y CFC4 and Y CFC5 are Country Y corporations. USParent owned Percent 1 and Y CFC5 owned Percent 2, in total comprising 100%, of USCorp2, a member of USParent's consolidated group since it was acquired together with the Country Y CFCs in 2002.

In 2001, prior to being acquired by USParent, USCorp2 had acquired Percent 3 (more than 10% and less than 50%) of the voting stock of X CFC2, a Country X corporation. As a result, X CFC2 and its wholly-owned Country X subsidiaries became noncontrolled section 902 corporations (as defined in section 904(d)(2)(E)) in 2001. In 2002, USParent indirectly acquired the remaining voting stock of X CFC2. Accordingly, X CFC2 and its wholly-owned Country X subsidiaries became CFCs, as defined in section 957(a), in 2002. X CFC2 was subsequently renamed X CFC3. Immediately before the 2010 transactions at issue, USCorp2 directly owned Percent 4 (more than 10%) of the voting stock of X CFC3. X CFC3 was also a member of a qualified group, as defined in section 902(b)(2), through a chain of ownership: USParent wholly owned X CFC1, which owned Percent 5 of the voting stock of X CFC3. Y CFC5, a second-tier CFC of USParent, owned the remaining Percent 6 (more than 10%) of X CFC3's voting stock.

At the time of its acquisition by USParent in 2002, X CFC2 had an ongoing dispute with Tax Authority with respect to the Country X tax liabilities of X CFC2 and its wholly-owned Country X subsidiaries for their foreign calendar taxable years 1994-1999. In 2006, X CFC3, as successor to X CFC2, and Tax Authority agreed to settle the outstanding audit issues relating to the tax liability of the X CFC2 group for taxable years 1994-1999 for a payment by X CFC3 of Amount 1, of which Amount 2 was payment of income tax liability. These amounts were paid in mid-2007. Agreed reductions in the amounts of loss carryovers arising from the settlement agreement also increased the Country X tax liabilities of X CFC3's Country X group for taxable years 2000 and 2001.

In November and December 2010, a number of Country X CFCs that were wholly-owned by X CFC3 each filed Form 8832 to elect to be treated as disregarded entities, as provided in Treas. Reg. §301.7701-3(c). Later in December 2010, X CFC3 filed Form 8832 to elect to be treated as a partnership, and then X CFC1 filed Form 8832 to elect to be treated as a disregarded entity. As described below, after the resulting deemed liquidations, X CFC1 was treated as a disregarded entity owned by USParent, and X CFC3 was treated as a foreign partnership owned by USParent, Y CFC5, and USCorp2 for U.S. tax purposes. The other electing Country X corporations that were directly or indirectly wholly-owned by X CFC3 were treated as disregarded entities owned by X CFC3.

USParent and Exam agree that, as a result of the 2010 entity classification elections, each lower-tier entity wholly owned by X CFC3 was deemed to have liquidated into X CFC3 in a nontaxable section 332 liquidation, requiring, under section 381(a), X CFC3 to succeed to and take into account all of the lower-tier entities' earnings and profits

(E&P) and foreign income taxes. Treas. Reg. §§301.7701-3(g)(1)(iii) and 301.7701-3(g)(2)(i) and (ii); sections 381(a)(1), 381(c)(2), and 367(b)(1); Treas. Reg. §1.367(b)-7. Pursuant to Treas. Reg. §1.367(b)-7(d), the post-1986 undistributed earnings and the associated post-1986 foreign income taxes of those liquidating Country X subsidiaries that were members of X CFC3's qualified group were combined with the post-1986 undistributed earnings and post-1986 foreign income taxes of X CFC3. Pursuant to Treas. Reg. §1.367(b)-7(e), X CFC3 also succeeded to the pre-1987 accumulated profits and pre-1987 foreign income taxes of the liquidating Country X subsidiaries, but these amounts continued to be maintained in pre-pooling annual layers and were not combined with each other or with the pre-pooling annual layers of X CFC3. Treas. Reg. §1.367(b)-7(e)(1)(ii).

USParent and Exam further agree that X CFC3 was next deemed to have liquidated into USCorp2, X CFC1, and Y CFC5 in a taxable section 331 liquidation, resulting in an amount of sale gain, which is calculated under section 1248, being recharacterized as a dividend to each of USCorp2, X CFC1, and Y CFC5. The portion of the gain treated as a dividend is the E&P attributable to the X CFC3 stock that were accumulated during the post-2001 taxable years when X CFC3 and its Country X subsidiaries were CFCs, which did not include any portion of the pre-1987 accumulated profits of X CFC3 or its Country X subsidiaries. See sections 964(e) and 1248(a) and Treas. Reg. §§301.7701-3(g)(1) and 1.1248-1(a). Pursuant to section 3 of Notice 2007-9, 2007-1 C.B. 401, the portion of the gain on the X CFC3 stock that was recharacterized as a dividend under sections 964(e) and 1248(a), but not the remainder of the capital gain realized by X CFC1 and Y CFC5, was eligible for the section 954(c)(6) exemption from foreign personal holding company income for purposes of subpart F. Each of USCorp2, X CFC1, and Y CFC5 was eligible to compute an amount of foreign taxes deemed paid with respect to the section 1248(a) deemed dividend resulting from the deemed sale of X CFC3. See sections 902(a), 902(b), 1248(a), and 964(e).

Finally, USParent and Exam agree that X CFC1 was next deemed to have liquidated into USParent in a section 332 liquidation, resulting in USParent including in income as a deemed dividend the all E&P amount with respect to the stock of X CFC1. See Treas. Reg. §§1.367(b)-3(b)(3)(i). The deemed dividend was considered paid out of the E&P with respect to which the deemed dividend was determined. Treas. Reg. §§1.367(b)-2(d) and -2(e)(2).

USParent and Exam agree that USParent properly excluded the pre-1987 accumulated profits of X CFC3 and X CFC3's Country X subsidiaries, including those accumulated in 1994-1999, in computing the amounts of recharacterized sale gain arising from the section 331 deemed liquidation of X CFC3 that were treated as dividends in the hands of USCorp2, X CFC1, and Y CFC5 under sections 964(e) and 1248(a). Accordingly, none of those earnings were included in the taxable income or E&P of USCorp2, X CFC1, and Y CFC5 in connection with the deemed section 331 liquidation of X CFC3, or in the computation of the all E&P amount USParent included in income on the deemed section 332 liquidation of X CFC1. Because the deemed section 331

liquidation of X CFC3 was not subject to section 381(a), none of those pre-acquisition earnings carried over to, or were otherwise taken into account by, USCorp2, X CFC1 or Y CFC5.

In computing its deemed paid foreign tax credit under section 902 for taxable year 2010 with respect to the liquidating distributions from X CFC3 and X CFC1, USParent included in X CFC3's general category post-1986 foreign income taxes Amount 3 of taxes that X CFC3 paid in taxable year 2007 to Tax Authority that were related to the settlement by X CFC3 of the Country X tax liabilities of X CFC3 and its wholly-owned Country X subsidiaries relating to taxable years 1994-1999. On its U.S. tax return for 2010, USParent claimed a total deemed paid credit of Amount 4, of which Amount 5 is derived from taxes paid in 2007 to Tax Authority with respect to X CFC3's Country X group's taxable years 1994-1999.

You requested advice as to whether USParent properly included in the Country X CFCs' post-1986 foreign income taxes pools, and claimed deemed-paid foreign tax credits in connection with deemed dividends and inclusions from post-1986 undistributed earnings for, the additional amounts of creditable income tax paid to Country X in 2007 with respect to the Country X CFCs' pre-1987 accumulated profits for their 1994 through 1999 taxable years. Although not discussed in this advice, adjustments to E&P included in the computation of the Country X CFCs' post-1986 undistributed earnings may also affect the computation of foreign taxes deemed paid by USParent and USCorp2 in connection with deemed dividends or inclusions out of those post-1986 undistributed earnings.

LAW AND ANALYSIS

A. Foreign Taxes Deemed Paid Under Section 902(a)

Section 901(a) provides that, if the taxpayer chooses to have the benefits of Subpart A – Foreign Tax Credit, the tax imposed by Chapter 1 shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960.

Section 901(b) states that, subject to the limitation of section 904, a domestic corporation is allowed to claim a credit under section 901(a) for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.

Under section 902(a), a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as the amount of such dividends (determined without regard to section 78), bears to such foreign corporation's post-1986 undistributed earnings.

Treas. Reg. §1.1248-1(d) provides that if a 10-percent domestic corporate shareholder includes an amount in its gross income as a dividend under section 1248(a) upon a sale or exchange of stock in a first-tier foreign corporation, the foreign tax credit provisions shall apply in the same manner and subject to the same conditions and limitations as if the first-tier corporation on such date distributed to the domestic corporation as a dividend that portion of the amount included in gross income which does not exceed the E&P of the first-tier corporation attributable to the stock under Treas. Reg. §1.1248-2 or §1.1248-3, as the case may be. In addition, Treas. Reg. §1.367(b)-2(e)(2) provides that the all E&P amount income inclusion is treated as a dividend for purposes of the Internal Revenue Code.

Accordingly, USParent and USCorp2 were entitled to compute an amount of foreign taxes deemed paid under section 902 with respect to the income inclusions on the deemed liquidations of X CFC1 and X CFC3, respectively.

B. Inclusion of Taxes Paid by Lower-Tier Entities in Foreign Taxes Deemed Paid

Section 902(b)(1) provides that a foreign corporation that owns 10 percent or more of the voting stock of another foreign corporation that is a member of the same qualified group (as defined in section 902(b)(2)) shall be deemed to have paid the same proportion of the lower-tier corporation's post-1986 foreign income taxes as would be determined under section 902(a) if the recipient were a domestic corporation. Section 902(b)(2) defines a qualified group as a foreign corporation with a 10 percent domestic corporate shareholder and any other foreign corporation of which the domestic corporation owns at least 5 percent of the voting stock indirectly through a chain of foreign corporations connected through stock ownership of at least 10 percent of their voting stock, and such other foreign corporation is not below the sixth tier in such chain. However, the term "qualified group" does not include any foreign corporation below the third tier in the chain unless such foreign corporation is a CFC in which the domestic corporation is a United States shareholder (as defined in section 951(b)). Id. In addition, section 902(b)(2) provides that foreign income taxes paid by a member of the qualified group below the third tier are eligible to be deemed paid only if such taxes were paid with respect to periods during which the member was a CFC.

Section 1113(a)(1) of the Taxpayer Relief Act of 1997, P.L. 105-34, amended section 902(b) to extend the tier limit for deemed paid taxes from three tiers to six, effective for taxes of foreign corporations for taxable years of such corporations beginning after August 5, 1997. Accordingly, Treas. Reg. §1.902-1(a)(4)(ii) provides that no foreign income taxes of CFCs below the third tier that were paid or accrued with respect to taxable years beginning on or before August 5, 1997, or during which the foreign corporations were not CFCs, are eligible to be deemed paid.

Accordingly, in connection with the deemed section 332 liquidations of its Country X subsidiaries, under section 381(a) and Treas. Reg. §1.367(b)-7 X CFC3 succeeded to the earnings and taxes of the liquidating Country X subsidiaries as provided therein, but

foreign income taxes paid or accrued by any fourth-, fifth-, or sixth-tier Country X subsidiary are eligible to be deemed paid only to the extent those taxes were paid or accrued with respect to the post-2001 taxable years during which those subsidiaries were CFCs.

C. Classification of Foreign Income Taxes as Post-1986 Foreign Income Taxes or Pre-1987 Foreign Income Taxes

Under section 902(c)(1), the term "post-1986 undistributed earnings" means the amount of the E&P of the foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986, as of the close of the taxable year of the foreign corporation in which the dividend is distributed, and without diminution by reason of dividends distributed during such taxable year.

Section 902(c)(2) provides that the term "post-1986 foreign income taxes" means the sum of the foreign income taxes with respect to the taxable year of the foreign corporation in which the dividend is distributed, and the foreign income taxes with respect to prior taxable years beginning after December 31, 1986, to the extent such foreign taxes were not attributable to dividends distributed by the foreign corporation in prior taxable years.

However, under section 902(c)(3)(A), if the first day on which the requirements of section 902(c)(3)(B) are met with respect to any foreign corporation is in a taxable year of such corporation beginning after December 31, 1986, the post-1986 undistributed earnings and the post-1986 foreign income taxes of such foreign corporation shall be determined by taking into account only periods beginning on and after the first day of the first taxable year in which such requirements are met. Section 902(c)(3)(B) provides that the requirements of section 902(c)(3)(B) are met with respect to any foreign corporation if 10 percent or more of the voting stock of such foreign corporation is owned by a domestic corporation, or the requirements of section 902(b)(2) (relating to the inclusion of the foreign corporation in a chain of foreign corporations constituting a qualified group) are met with respect to such foreign corporation. See also Treas. Reg. §§1.902-1(a)(8), 1.902-1(a)(9), 1.902-1(a)(10), and 1.902-1(a)(13), defining post-1986 foreign income taxes and post-1986 undistributed earnings with reference to the special effective date provisions of section 902(c)(3).

Section 902(c)(6) provides rules with respect to the treatment of distributions out of earnings accumulated in taxable years beginning before 1987 and in post-1986 taxable years before the requirements of section 902(c)(3)(B) are met with respect to the foreign corporation. Section 902(c)(6)(A) provides that, in the case of any dividend paid by a foreign corporation out of accumulated profits (as defined in section 902 prior to amendment by the Tax Reform Act of 1986 (1986 TRA)) for taxable years beginning before the first taxable year taken into account in determining the post-1986 undistributed earnings of such corporation, the pre-1986 TRA version of section 902 applies. Prior to amendment by the 1986 TRA, section 902 provided for the calculation

of deemed-paid taxes on the basis of annual layers of earnings and taxes, rather than on the basis of multi-year pools of earnings and taxes. Section 902(c)(6)(B) and Treas. Reg. §1.902-1(b)(2)(i) provide that dividends paid in post-1986 taxable years shall be treated as made first out of post-1986 undistributed earnings to the extent thereof. Under Treas. Reg. §1.902-1(b)(2)(ii), consistent with the law in effect prior to the 1986 TRA and Treas. Reg. §1.902-3, any dividend in excess of post-1986 undistributed earnings is attributable to pre-1987 accumulated profits for a taxable year to the extent thereof, on a last-in, first-out basis. Under section 902(c)(6)(A) and Treas. Reg. §1.902-1(b)(3), foreign taxes deemed paid with respect to dividends paid out of pre-1987 accumulated profits are computed under section 902 and the regulations thereunder as in effect prior to the effective date of the 1986 TRA.

Treas. Reg. §1.902-1(a)(10)(i) provides that the term "pre-1987 accumulated profits" means the amount of the E&P of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. However, consistent with section 902(c)(6), if the special effective date of section 902(c)(3) and Treas. Reg. §1.902-1(a)(13) applies, pre-1987 accumulated profits also includes any E&P (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and Treas. Reg. §1.902-1(a)(1) through (4) are met with respect to that corporation. Id. Under section 902(c)(6)(A) and Treas. Reg. §1.902-1(a)(10)(ii), the amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902 with respect thereto, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the 1986 TRA.

Treas. Reg. §1.902-1(a)(10)(iii) provides that the term "pre-1987 foreign income taxes" means any foreign income taxes paid, accrued, or deemed paid by a foreign corporation on or with respect to its pre-1987 accumulated profits. Pre-1987 accumulated profits and pre-1987 foreign income taxes are computed and maintained in annual layers in accordance with Treas. Reg. §1.902-3. See Treas. Reg. §1.902-3(b)(2), (e), and (f).

X CFC3 and its wholly-owned Country X subsidiaries first became noncontrolled section 902 corporations in 2001, when USCorp2 met the requirements of a domestic shareholder with respect to X CFC3 under section 902(c)(3)(B) and Treas. Reg. §1.902-1(a)(1). Therefore, the post-1986 undistributed earnings and post-1986 foreign income taxes of the Country X CFCs that were members of X CFC3's qualified group included only earnings and taxes for taxable years beginning on and after January 1, 2001, the first day of the foreign corporations' first taxable year in which USCorp2 met such ownership requirements. Section 902(c)(3); Treas. Reg. §1.902-1(a)(13). E&P accumulated by the qualified group members prior to January 1, 2001, are pre-1987 accumulated profits attributable to taxable years beginning before the first day of the first taxable year in which the ownership requirements were met by USCorp2 with

respect to X CFC3 and the lower-tier corporations became members of a qualified group. Treas. Reg. §1.902-1(a)(10)(i) and (13).

Foreign income taxes paid, accrued, or deemed paid by X CFC3 and its Country X subsidiaries on or with respect to their pre-1987 accumulated profits are pre-1987 foreign income taxes. Treas. Reg. §1.902-1(a)(10)(iii). Accordingly, additional amounts of creditable foreign taxes paid by X CFC3 in 2007 with respect to the pre-1987 accumulated profits of the Country X group for its 1994-1999 taxable years are pre-1987 foreign income taxes. These amounts are definitionally excluded from, and therefore may not be included in, the post-1986 foreign income taxes of X CFC3 or its Country X subsidiaries. Treas. Reg. §§1.902-1(a)(8)(i), 1.902-1(a)(10)(iii), and 1.902-1(a)(13)(i).

D. Additional Rules with Respect to Foreign Tax Redeterminations

Section 905(c)(1) provides that, in general, if (A) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, (B) accrued taxes are not paid before the date 2 years after the close of the taxable year to which such taxes relate, or (C) any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected. Section 905(c)(1) also provides that the Secretary may prescribe adjustments to the pools of post-1986 foreign income taxes and the pools of post-1986 undistributed earnings under sections 902 and 960 in lieu of the redetermination of U.S. tax required under the preceding sentence. Section 989(c)(4) also authorizes regulations providing for alternative adjustments to the application of section 905(c) that are necessary or appropriate to carry out the purposes of subpart J, relating to foreign currency transactions.

Section 905(c)(2)(A) provides additional rules for taxes not paid within two years. In general, except as provided in section 905(c)(2)(B), in making the redetermination under section 905(c)(1), no credit is allowed for accrued taxes not paid before the date two years after the close of the taxable year to which such taxes relate. Under section 905(c)(2)(B)(i)(I) and (II), any such taxes if subsequently paid are taken into account, in the case of taxes deemed paid under section 902 or section 960, for the taxable year in which paid (and no redetermination shall be made under section 905 by reason of such payment), and, in any other case, for the taxable year to which such taxes relate.

Section 905(c) was amended and sections 905(c)(1) and 905(c)(2) were added by the Taxpayer Relief Act of 1997 (P.L. 105-34, §1102(a)(2)), effective for taxes which relate to taxable years beginning after December 31, 1997. However, under section 902(c)(6) and Treas. Reg. §§1.902-1(a)(10), 1.902-1(a)(13), 1.902-1(b)(2)(ii), and 1.902-1(b)(3), the amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902 with respect to such a distribution, is determined by applying the law in effect prior to the effective date of the 1986 TRA, which did not include the provisions of sections 905(c)(1)(B) and 905(c)(2)(B)(i)(I).

Temporary and proposed regulations published under section 905(c) in 1988, and amended in part in 2007, generally provide that foreign tax redeterminations with respect to post-1986 undistributed earnings are taken into account through prospective adjustments to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes, rather than by redetermining the foreign taxes deemed paid and the U.S. tax liability of the foreign corporation's domestic corporate shareholders. See Temp. Treas. Reg. §§1.905-3T(a)(2) and 1.905-3T(d)(2)(i). Section 905(c)(2)(B) codified this rule with respect to additional payments of creditable foreign taxes that relate to taxable years beginning after December 31, 1997.

Temp. Treas. Reg. §1.905-5T provides rules governing the application of section 905(c) to foreign tax redeterminations occurring in taxable years beginning prior to January 1, 1987, and to foreign tax redeterminations occurring after December 31, 1986, with respect to foreign tax deemed paid under section 902 or section 960 with respect to pre-1987 accumulated profits (as defined in Treas. Reg. §1.902-1(a)(10)(i) to include earnings accumulated in both taxable years beginning before 1987 and post-1986 taxable years beginning before the foreign corporation first had a domestic corporate shareholder eligible to compute foreign taxes deemed paid).

Under Temp. Treas. Reg. §1.905-5T(c), the term "foreign tax redetermination" is defined in Temp. Treas. Reg. §1.905-3T(c) as a change in foreign tax liability that may affect a taxpayer's foreign tax credit, including additional payments of creditable foreign tax. Temp. Treas. Reg. §1.905-5T(d) states that a redetermination of United States tax liability is required with respect to any foreign tax redetermination subject to Temp. Treas. Reg. §1.905-5T.

USParent properly excluded the pre-1987 accumulated profits of X CFC3 and its Country X subsidiaries that were accumulated in taxable years beginning before 2002 in calculating the section 1248 amounts of recharacterized sale gain arising from the deemed liquidation of X CFC3 that were treated as dividends in the hands of USCorp2, X CFC1, and Y CFC5, because those E&P were accumulated in taxable years before USParent acquired the stock of the Country X corporations and they became CFCs. Treas. Reg. §1.1248-2. Accordingly, it also excluded these amounts from the computation of the all E&P amount recognized on the deemed liquidation of X CFC1. Treas. Reg. §1.367(b)-7. However, in computing its deemed paid credit under sections 902 and 960 for taxable year 2010 with respect to the liquidating distributions from X CFC3 and X CFC1, USParent included in X CFC3's general category post-1986 foreign income taxes Amount 3 of taxes that X CFC3 paid in taxable year 2007 to Tax Authority that were related to the settlement by X CFC3 for the Country X tax liabilities of X CFC3 and its wholly-owned Country X subsidiaries relating to their pre-1987 accumulated profits for taxable years 1994-1999. USParent then took those taxes into account in computing its deemed-paid credit with respect to the deemed dividends that were calculated solely with respect to the CFCs' post-1986 undistributed earnings accumulated in post-2001 taxable years.

X CFC3 and its Country X group were assessed additional foreign income taxes, and therefore had foreign tax redeterminations, with respect to their pre-1987 accumulated profits for their 1994 through 1999 taxable years. The position that additional payments of tax with respect to pre-1987 accumulated profits may adjust post-1986 foreign income taxes finds no support in the Code, the regulations or sound tax policy. Only additional assessments of tax paid with respect to the X CFCs' 2001 and later taxable years are properly accounted for under section 905(c) and Temp. Treas. Reg. §1.905-3T by adjusting the relevant pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the year those taxes were paid. Section 905(c)(2)(B)(i)(I) and Temp. Treas. Reg. §1.905-3T(d) do not apply to section 902 computations, including the effect of foreign tax redeterminations on the amount of foreign taxes deemed paid, with respect to pre-1987 accumulated profits. Instead, those computations are governed by the law in effect prior to the 1986 TRA. Section 902(c)(6) and Temp. Treas. Reg. §1.905-5T.

E&P accumulated by X CFC3 and its Country X subsidiaries in taxable years beginning before January 1, 2001, are pre-1987 accumulated profits. Under Treas. Reg. §§1.902-1(a)(10)(iii) and 1.902-3(e) and (f), any foreign income taxes of X CFC3 and its Country X subsidiaries that are attributable to pre-1987 accumulated profits, including, but not limited to the additional foreign tax assessments paid in 2007 with respect to taxable years 1994 through 1999, are pre-1987 foreign income taxes. Under sections 902(c)(3) and 902(c)(6), such pre-1987 foreign income taxes must be taken into account under the annual layering rules of Treas. Reg. §1.902-3 and are definitionally excluded from post-1986 foreign income taxes. Under section 902(c)(3) and Treas. Reg. §1.902-1(a)(10)(ii), the amount of a distribution out of any pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902 with respect to such a distribution, are determined by applying the law as in effect prior to the effective date of the 1986 TRA.

The regulations under section 905(c) similarly confirm that foreign tax redeterminations with respect to pre-1987 accumulated profits, regardless of when made, are accounted for by adjusting the foreign corporation's pre-1987 accumulated profits and pre-1987 foreign income taxes for the year or years affected, and not by adjusting the corporation's post-1986 undistributed earnings and post-1986 foreign income taxes pools. Temp. Treas. Reg. §1.905-3T(a)(2) specifically limits the application of the prospective pooling adjustment rules of Temp. Treas. Reg. §1.905-3T(d) to foreign tax redeterminations with respect to post-1986 undistributed earnings.[1] By their terms,

[1] Temp. Treas. Reg. §§1.905-3T, 1.905-4T, and 1.905-5T were published on June 22, 1988, and amended in part by temporary regulations made effective for taxes paid or accrued in taxable years of United States taxpayers beginning on or after November 7, 2007, and taxes paid or accrued by a foreign corporation in its taxable years ending with or within such taxable years of its domestic corporate shareholder. The additional Country X taxes were paid in 2007, prior to the effective date of the 2007 amendments to the section 905(c) temporary regulations. Accordingly, the 1988 temporary regulations, rather than the 2007 temporary regulations, govern the effect of the foreign tax redeterminations at issue here. However, the 2007 amendments made no substantive change to the relevant provisions of the regulations.

these regulations plainly preclude the inclusion in post-1986 foreign income taxes of any additional tax paid with respect to pre-1987 accumulated profits of X CFC3 and its Country X subsidiaries for their taxable years 1994 through 1999. But in any event, as described in detail above, the plain language of sections 902(c)(3) and 902(c)(6) and the final regulations under those sections mandate the same result.

Section 905(c)(2)(B)(i)(I) provides only that additional payments of tax paid by a foreign corporation shall be taken into account in the taxable year in which paid, and no redetermination of U.S. tax shall be made under section 905(c) by reason of such payment. It does not mandate inclusion of pre-1987 foreign income taxes in the post-1986 foreign income taxes pool. Instead, it simply provides that such taxes can only be deemed paid in the year paid or subsequent years, and are not taken into account by redetermining foreign taxes deemed paid (and the U.S. shareholder's U.S. tax) for prior years, including and subsequent to the year or years to which the taxes relate. Here, the required adjustment to the appropriate annual layer of the Country X CFCs' pre-1987 accumulated profits and pre-1987 foreign income taxes did not require a redetermination of U.S. tax under section 905(c), because no portion of those pre-1987 accumulated profits had yet been distributed or otherwise included in USParent's income, and no portion of the pre-1987 foreign income taxes had ever been deemed paid.

The required adjustments to the Country X subsidiaries' pre-1987 foreign income taxes paid with respect to their pre-1987 accumulated profits for taxable years 1994-1999 would have been taken into account in computing USParent's foreign taxes deemed paid only in connection with distributions or inclusions of those pre-1987 accumulated profits in years subsequent to the year in which the additional taxes were paid. And in fact, no portion of the pre-1987 accumulated profits were ever taxable to USParent, because the section 1248 amounts of deemed dividends taken into account in connection with the deemed section 331 liquidation of X CFC3 included only E&P accumulated in the post-2001 years during which the Country X corporations were CFCs. Any pre-1987 accumulated profits of X CFC3 and its lower-tier Country X subsidiaries were eliminated in connection with that liquidation. Accordingly, even if section 905(c)(2)(B)(i)(I) applied to the additional assessments (which under sections 902(c)(3) and 902(c)(6) and the regulations under those sections it clearly does not), USParent would still be precluded from including any pre-1987 foreign income taxes of the Country X CFCs in their post-1986 foreign income taxes pools.[2]

Finally, the conclusion that foreign tax redeterminations with respect to pre-1987 accumulated profits must be taken into account by adjusting the appropriate annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes is entirely consistent with the purpose of the foreign tax credit to alleviate double taxation of

[2] We note that section 905(c)(2)(B)(i)(I) is effective for taxes that relate to taxable years beginning after December 31, 1997. Therefore, in addition to the dispositive reasons laid out above, USParent cannot rely on that section as support for including taxes paid by X CFC3 and its Country X subsidiaries with respect to their pre-1987 accumulated profits for the 1994-1997 taxable years in their post-1986 foreign income taxes pools.

foreign source income. USParent seeks to claim a deemed-paid foreign tax credit for taxes paid with respect to earnings of X CFC3 and its lower-tier Country X subsidiaries that have not been, and will never be, distributed or deemed distributed and subject to tax in the United States. The result USParent seeks, in addition to being squarely contradicted by the statutory and regulatory regime, is flatly inconsistent with the Congressional policy underlying the matching regime established by section 902. See H.H. Robertson v. Commissioner, 59 T.C. 53, 78-79 (1972) (in computing the deemed paid foreign tax credit, accumulated profits of each year must be matched with foreign taxes paid for that year).

Accordingly, the additional amounts of creditable foreign tax paid by X CFC3 in 2007 with respect to its and its Country X subsidiaries' taxable years 1994 through 1999 must be taken into account in the respective CFCs' annual layers of pre-1987 foreign income taxes for the appropriate year. None of these taxes may be added to the CFCs' post-1986 foreign income taxes pools in the year paid. Only taxes paid with respect to 2001 and later taxable years were properly included in the CFCs' post-1986 foreign income taxes pools and deemed paid by USCorp2 and USParent in connection with the deemed liquidations of X CFC3 and X CFC1 in 2010.

Please call CC:INTL:Br3 at (202) 317-6936 if you have any further questions.