



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

OFFICE OF
CHIEF COUNSEL

October 23, 2002

Number: **200305016**
Release Date: 01/31/2003
UILC: 952.00-00, 954.02-00

CC:INTL:2
GL-133544-02

MEMORANDUM FOR CC:SB:5:LV

FROM: Phyllis E. Marcus, Branch Chief, CC:INTL:2

SUBJECT: U.S. Municipal Bond Interest Earned by a Controlled Foreign Corporation

This Chief Counsel Advice responds to your memorandum dated July 25, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

\$A =
Taxpayer =
Wife =

FC =
FCorp =

ISSUE:

Whether interest earned on U.S. municipal bonds held by a controlled foreign corporation is properly characterized as foreign personal holding company income, and thus, subpart F income.

CONCLUSION:

For the tax years in issue, interest earned on U.S. municipal bonds held by a controlled foreign corporation is foreign personal holding company income, and thus, subpart F income, pursuant to sections 1.952-2(c)(1) and 1.954-2(b)(3) of the Income Tax Regulations.

GL-133544-02

FACTS:

The facts as we understand them are as follows.

Taxpayer is the sole U.S. shareholder of FCorp, a Cayman Islands corporation. During tax years ended December 31, 1998, December 31, 1999 and December 31, 2000, FCorp, (and its predecessor, FC), was a controlled foreign corporation ("CFC"), as defined in Internal Revenue Code ("Code") section 957(a) of the Internal Revenue Code.

During each tax year in issue, FCorp earned approximately \$A interest from U.S. municipal bonds, which was reported on its Forms 1120-F, "U.S. Income Tax Return of a Foreign Corporation."¹ Taxpayer, as the sole U.S. shareholder of FCorp, treated the income as subpart F income of FCorp and reported the income from the deemed distributions of subpart F income on his Federal income tax returns. He then filed amended returns for each tax year reclassifying the deemed distributions as tax-exempt interest and requested a refund of the Federal income tax paid on those deemed distributions. Taxpayer believes he is entitled to refunds for the tax paid on the deemed distributions reported on his Federal income tax returns. He argues that sections 1.952-2(c)(1), 1.954-2(a)(4)(i) and 1.954-2(b)(3) of the regulations, requiring shareholder-level taxation of U.S. municipal bond interest received by a CFC, are invalid because U.S. municipal bond interest is specifically excluded from the definition of "gross income" under section 61(b) of the Code, and foreign personal holding company income under subpart F is determined with reference to gross income. Taxpayer also argues that the above regulations are invalid and beyond the authority of the Secretary.

LAW AND ANALYSIS

A. Subpart F legislative history

In 1962, Congress enacted the subpart F provisions of the Code to address concerns that certain types of moveable income earned by U.S.-controlled foreign corporations organized in tax havens were not subject to tax. The subpart F provisions do not subject CFCs to U.S. tax, but instead limit tax-deferral by including in the current income of U.S. shareholders their pro rata shares of certain types of undistributed income of CFCs in the year the income is earned, whether or not it is actually distributed by the foreign corporations. In effect, these Code

¹ We note that FCorp and Taxpayer each reduced the amount of U.S. municipal bond interest income by certain custodial and investment management fees. We have not been asked to address the appropriateness of such deductions.

GL-133544-02

provisions treat U.S. shareholders as having received a current distribution of subpart F income from CFCs. I.R.C. § 951(a). When the earnings and profits of CFCs are actually distributed to U.S. shareholders, these amounts are not included in the shareholders' gross income (by virtue of having been taxed previously), and therefore are not subject to U.S. tax a second time. I.R.C. § 959.

B. Subpart F generally

Subpart F income encompasses types of income, earned by CFCs, that Congress believed were subject to manipulation, including foreign base company income. I.R.C. § 952(a). "Foreign base company income" includes, among other things, foreign personal holding company income of a CFC. I.R.C. § 954(a). Section 954(c) provides that foreign personal holding company income includes interest income. I.R.C. § 954(c)(1)(A). Section 954(c) does not specifically exclude U.S. municipal bond interest from foreign personal holding company income. In addition, the statutory provisions do not define gross income or net income for subpart F purposes. The regulations under section 952 define gross income and net income using U.S. tax rules for domestic corporations with modifications. Nowhere does the Code require the use of the U.S. tax rules for domestic corporations for computing income of a foreign corporation not subject to tax in the United States.

C. Subpart F treatment of U.S. municipal bond interest income for taxable years prior to March 3, 1997

Prior to 1987, where a CFC realized U.S. municipal bond interest income described in section 103(a), such income did not constitute foreign base company income. See Rev. Rul. 72-527, 1972-2 C.B. 456.

In 1986, Congress enacted the Tax Reform Act of 1986, which narrowed the exceptions to subpart F income, and added certain other types of income that Congress considered particularly susceptible to manipulation. See T.D. 8216, 1988-2 C.B. 257, 258. Temporary regulations were published in 1988 ("1988 temporary regulations") to conform to revisions to the definitions of "foreign base company income" and "foreign personal holding company income" in the 1986 Act. T.D. 8216, 1988-2 C.B. 257. The 1988 temporary regulations, effective for taxable years beginning after December 31, 1986, preserved the treatment of U.S. municipal bond interest earned by a CFC in that the tax on such income continued to be deferred at the U.S. shareholder level, although potentially subject to the alternative minimum tax. Temp. Treas. Reg. §§ 1.954-2T(a)(1); 1.954-2T(b)(6). The purpose of this rule, as later noted in the Preamble to regulations published as final in 1995 for certain subpart F provisions not including U.S. municipal bond interest income, was to "prevent a person from avoiding the consequences of the

GL-133544-02

alternative minimum tax provisions by investing in tax-exempt obligations described in section 103 through a controlled foreign corporation.” T.D. 8618, 1995-2 C.B. 89, 94.

In light of comments questioning the application of Temp. Treas. Reg. § 1.954-2T(b)(6) and citing the administrative complexity of applying the rule, the regulations published as final in 1995 for certain subpart F provisions reserved on the treatment of U.S. municipal bond interest in the hands of a U.S. shareholder. Proposed regulations were published treating U.S. municipal bond interest as foreign personal holding company income. INTL-75-92, 1995-2 C.B. 480. As a result, the 1988 temporary regulations continued to apply until final regulations were adopted in 1996 (“1996 final regulations”). T.D. 8704, 1997-1 C.B. 154. The 1996 final regulations adopted without amendment the regulations on the subpart F treatment of U.S. municipal bond interest income that were proposed in 1995. T.D. 8704, 1997-1 C.B. 154, adopting without amendment INTL-75-92, 1995-2 C.B. 480.

D. Subpart F treatment of U.S. municipal bond interest for taxable years beginning after March 3, 1997

The 1996 final regulations departed from the prior treatment of interest earned on U.S. municipal bonds. Section 1.954-2(b)(3) of the regulations provides that foreign personal holding company income includes all interest income, including U.S. municipal bond interest as described in section 103. See also Treas. Reg. § 1.952-2(c)(1) providing that section 103 does not apply in determining the gross income and taxable income of a CFC for subpart F purposes. The treatment of U.S. municipal bond interest at the shareholder level, as adopted in the 1996 final regulations, closely parallels the domestic rule and was intended to simplify the interaction of the U.S. municipal bond interest provisions and the alternative minimum tax provisions. INTL-75-92, 1995-2 C.B. 480, 481. The Preamble to the 1995 proposed regulations further explains the parallel with the domestic rule for U.S. municipal bond interest,

The controlled foreign corporation realizes the tax benefit associated with the receipt of interest income described in section 103 because no United States withholding tax is collected on the income when it is paid to the controlled foreign corporation. As in the domestic context, however, this tax benefit is limited to the corporate level and is not retained when the tax-exempt interest is distributed to the United States shareholders or included in their gross income under subpart F.

INTL-75-92, 1995-C.B. 480, 481. As a result of the treatment of U.S. municipal bond interest with regard to deemed distributions of CFCs’ subpart F income to U.S. shareholders, Rev. Rul. 72-527 was obsoleted. T.D. 8704, 1997-1 C.B. 154.

GL-133544-02

The U.S. municipal bond interest income provisions of the 1996 final regulations are effective for taxable years of a CFC beginning after March 3, 1997.

The U.S. municipal bond interest regulations issued under sections 952 and 954 of the Code are interpretive regulations, that is, authority for the promulgation of these regulations derives from the general grant of authority from Congress authorizing the Secretary or his delegate to prescribe rules and regulations necessary for the enforcement of tax laws. I.R.C. § 7805(a). The Supreme Court has supported the principle of deference to agency legal interpretations, and has determined that regulations must be upheld unless they are unreasonable and inconsistent with revenue statutes. See Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948). Taxpayer's argument that regulation sections 1.952-2(c)(1), 1.954-2(a)(4)(i) and 1.954-2(b)(3) are invalid and beyond the authority of the Secretary is not valid in light of the general grant of authority under section 7805(a), the general principle of deference to agency interpretations, and the reasons discussed above. Further, Taxpayer has not even provided any reasons why he believes that the above-cited regulations are inconsistent with subpart F.

E. U.S. municipal bond interest earned by FCorp is includable in Taxpayer's income for taxable years 1998, 1999 and 2000

The subpart F rules apply to determine the tax treatment of foreign personal holding company income deemed distributed to Taxpayer during the years in issue because Taxpayer is a U.S. shareholder of FCorp (previously FC), which is a CFC as defined under Code section 957(a).

The 1996 final regulations, which are effective for taxable years beginning after March 3, 1997, apply to Taxpayer's tax years ended December 31, 1998, December 31, 1999, and December 31, 2000.

Sections 1.952-2(c)(1) and 1.954-2(b)(3) clearly provide that U.S. municipal bond interest described in section 103 is included in foreign personal holding company income of a CFC. Applying these provisions of the 1996 final regulations to the present case, Taxpayer, the sole U.S. shareholder of FCorp (previously FC), is required to include in his income during the taxable years in issue, his pro rata share of FCorp's (previously FC's) subpart F income (to the extent of earnings and profits of FCorp, and FC), including the appropriate amount of U.S. municipal bond interest earned by FCorp (previously FC) as subpart F income.

GL-133544-02

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call _____ if you have any further questions.

By:

PHYLLIS E. MARCUS
Chief, Branch 2
Associate Chief Counsel
(International)