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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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TAM-106310-97

Taxpayer's Name:

Taxpayer's Address:

Year(s) Involved:

Date of Conference:

Country A =

Date B =

Date C =

Date D =

Year E =

FC =

Parent =

Subsidiary =

Purchaser =

"This document may not be used or cited as precedent. Section 6110 (j)(3) of the Internal Revenue Code."

ISSUES

1. For purposes of determining the amount of a deemed dividend under section 1248 of the Internal Revenue Code with respect to a post-1986 sale of stock of a controlled foreign corporation ("CFC"), may a U.S. shareholder of the CFC determine its ratable share of the CFC's earnings and profits ("E&P") accumulated for the year of the sale without reducing such E&P by the amount of a post-sale distribution to the purchaser of the stock during the same taxable year of the CFC?

2. Is a domestic corporation that receives a section 1248 deemed dividend with respect to a post-1986 sale of stock of a CFC thereby entitled to a deemed-paid credit for foreign taxes paid by the CFC prior to 1987 if the domestic corporation already claimed credit for such foreign taxes under former section 902 prior to 1987, but the CFC has undistributed pre-1987 E&P as computed under section 964?

FACTS

Parent is a domestic corporation. Subsidiary is a CFC (as defined in section 957(a)) that is incorporated in Country A. Prior to 1976, Subsidiary qualified as a less developed country corporation under former section 902(d). Parent acquired 100 percent of the stock of Subsidiary prior to 1962 and continued to hold 100 percent of such stock until the sale that is the subject of this technical advice memorandum.

Parent and Subsidiary each file income tax returns on the basis of a calendar year. Subsidiary keeps its books in the FC, the currency of Country A. Subsidiary's functional currency (as defined in section 985(b)) is the FC. During the relevant years, the FC lost value relative to the U.S. dollar.

For purposes of this technical advice memorandum, it is assumed that all of Subsidiary's income is general limitation income described in section 904(d)(1)(I) and that none is subpart F income (as defined in section 952).

Pre-1987 transactions

During 1976 through 1986, Subsidiary generally earned a profit and paid foreign income taxes to Country A. Subsidiary regularly paid dividends to Parent. With respect to each dividend, Parent claimed credit under section 902, prior to that section's amendment by the Tax Reform Act of 1986, for foreign taxes deemed paid. Subsidiary's E&P were computed in FCs (under the rules of section 1.964-1(a) through (c) of the regulations) and translated into U.S. dollars at the spot rate in effect on the date of the dividend. The foreign taxes deemed paid also were translated from FCs into U.S. dollars as of the date of the dividend.

During 1986, Parent included Subsidiary's undistributed accumulated E&P as of December 31, 1985 in gross income as a consent dividend (within the meaning of section 565). Such E&P were deemed to be distributed to Parent in cash and immediately recontributed to Subsidiary as paid-in capital. Parent claimed credit under former section 902 for all foreign taxes paid by Subsidiary through December 31, 1985 for which Parent had not

previously claimed credit. Consistent with the method used for actual dividends, Subsidiary's E&P were computed in FCs. Both E&P and foreign taxes deemed paid were translated into U.S. dollars at the spot rate in effect on the date the E&P were deemed distributed.

Subsidiary made a cash distribution to Parent during 1986 that was initially treated as a dividend entitling Parent to credit under section 902 for foreign taxes deemed paid. The taxpayer and the examiner have agreed that such cash distribution will be treated as a return of capital for purposes of this technical advice memorandum.

Post-1986 transactions

On Date B, Subsidiary made a cash distribution to Parent. On Date C, Parent sold all the stock of Subsidiary to Purchaser for a price in excess of Parent's basis in the stock. On Date D, Subsidiary made a cash distribution to Purchaser. Dates B, C, and D were all within Year E, which was a year subsequent to 1986. Subsidiary's total E&P for Year E (prior to distributions) were greater than the amount of either of the two distributions paid during Year E, but less than the sum of such distributions.

Pursuant to section 1248, Parent treated its gain on the sale of the stock of Subsidiary as a dividend to the extent of Subsidiary's undistributed post-1975 E&P. (E&P earned prior to 1976 while Subsidiary qualified as a less developed country corporation were disregarded.) Parent claimed credit under section 902 for foreign taxes deemed paid with respect to the section 1248 deemed dividend.

In order to measure the amount of gain treated as a deemed dividend under section 1248, Parent computed its ratable share of Subsidiary's E&P for Year E based on Subsidiary's total E&P for Year E without reduction for the post-sale distribution during Year E. If Parent had reduced the total E&P by the amount of the post-sale distribution prior to computing its ratable share, the effect would have been to reduce the amount of the deemed dividend paid out of Subsidiary's post-1986 undistributed earnings, which in turn would have reduced the amount of post-1986 foreign income taxes deemed paid by Parent.

Parent then translated Subsidiary's post-1986 E&P pool, which was maintained in FCs, into U.S. dollars at the spot rate in effect on the deemed dividend date. With respect to Subsidiary's pre-1987 E&P, Parent computed annual E&P accounts (prior to distributions) in U.S. dollars using the section 964 rules (section 1.964-1(a) through (e) of the regulations) that were in effect prior to 1987. Due to the declining value of the

FC relative to the U.S. dollar, the amounts of the E&P accounts computed using the section 964 rules exceeded the amounts of the E&P accounts (after translation into U.S. dollars) computed for purposes of the foreign tax credits that Parent had claimed under section 902 with respect to the pre-1987 dividends paid (including the consent dividend). Parent reduced the U.S. dollar accounts computed under section 964 by the U.S. dollar amounts of the pre-1987 dividends paid. Parent then converted the balance remaining for each year into FCs at the spot rate in effect on January 1, 1987.

In computing the amount of the deemed paid credit under section 960 with respect to the section 1248 deemed dividend, Parent converted the amounts of the foreign taxes paid by Subsidiary during each year prior to 1987 from FCs into U.S. dollars at the exchange rates in effect on the dates the taxes were paid. Such U.S. dollar amounts were greater than the amounts for which credit had already been claimed under section 902 prior to 1987, because the latter had been converted into U.S. dollars at the exchange rates in effect when the dividends with which they were associated had been paid, at a time when the value of the FC relative to the U.S. dollar had declined.

APPLICABLE LAW

Section 1248.

Under section 1248(a), which was added to the Code in 1962, if a U.S. person who meets the stock ownership requirements of section 1248(a)(2) sells stock in a foreign corporation, a portion of the gain recognized on the sale or exchange must be included in the U.S. person's gross income as a dividend. The amount of the deemed dividend is limited to the E&P of the foreign corporation that are attributable to the stock sold and that were accumulated in taxable years beginning after December 31, 1962 and during the period or periods the stock was held by the U.S. person while the foreign corporation was a CFC.

Section 1248(c) provides the general rule that, except as provided in section 312(k)(4), for purposes of section 1248, the E&P of any foreign corporation for any taxable year are determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary. Section 1248(d) provides that certain amounts shall be excluded from E&P for purposes of section 1248. One such amount is E&P of a less developed country corporation under former section 902(d). Section 1248(d)(3).

Section 1248(a) expressly states that the amount of E&P attributable to the stock sold is to be determined under

regulations prescribed by the Secretary. Regulations were adopted at the end of 1964. Section 1.1248-2 of the regulations provides rules for determining the E&P attributable to the stock of foreign corporations in "simple" cases, and section 1.1248-3 provides rules for "complex" cases. If a foreign corporation was a less developed country corporation for any taxable year beginning after December 31, 1962, the rules for complex cases apply. See section 1.1248-2(c)(3), 1.1248-3(a)(1).

Subject to certain special rules not applicable here, section 1.1248-3(b) provides that the E&P accumulated for each taxable year of the foreign corporation are the E&P for such year computed in accordance with the rules prescribed in section 1.964-1, reduced by the amount of distributions made by the corporation during the taxable year.

For taxable years beginning prior to January 1, 1987, the E&P computed in accordance with the rules prescribed in section 1.964-1(a) through (e) (the "full section 964 method") were stated in U.S. dollars, based on the annual change in the foreign corporation's net worth, using a U.S. dollar balance sheet that took into account certain unrealized exchange gains and losses. However, section 986(b)(1), which was enacted as part of the Tax Reform Act of 1986, now requires that, for purposes of determining the federal income tax of any shareholder of any foreign corporation, the E&P of such corporation must be determined in the corporation's functional currency. Pursuant to a transition rule published in Notice 88-70, 1988-2 C.B. 369, pre-1987 E&P accounts based on the full section 964 method were required to be translated into the foreign corporation's functional currency (if not the U.S. dollar) as of the first day of the first taxable year of the corporation beginning after December 31, 1986, at the spot rate in effect on that date and to remain in such functional currency for all post-1986 federal income tax determinations.

Section 986(b)(2) provides that when the E&P determined under section 986(b)(1) are distributed, deemed distributed, or otherwise taken into account in determining the federal income tax of a U.S. person, such E&P shall (if necessary) be translated into U.S. dollars using the appropriate exchange rate. Section 989(b)(2) provides that the appropriate exchange rate in the case of a section 1248 deemed dividend is the spot rate on the date the deemed dividend is included in income.

If the seller does not hold the stock of the foreign corporation on each day of the taxable year of the sale, the seller's share of the foreign corporation's E&P accumulated for such taxable year is a pro rata share (based on the ratio of the number of days during the year the stock was held by the seller

to the total number of days in the year) of any E&P remaining after the total E&P for the year is reduced by the amount of distributions during the year. See sections 1.1248-3(c) and -3(d).

Rev. Rul. 71-388, 1971-2 C.B. 314, provides that, for purposes of determining the portion of gain on the sale of a CFC's stock that is reportable as dividend income under section 1248, the CFC's E&P for the year of the sale must be reduced by a post-sale dividend distribution to the buyer during the same year. This holding is based on sections 1.1248-2(d)(1) and -2(e)(2), which provide rules for simple cases that are similar to the rules for complex cases provided in section 1.1248-3.

The last sentence of Rev. Rul. 71-388 states parenthetically that the E&P of a CFC are not decreased by the amount of gain from the sale of the CFC's stock that is treated as a dividend under section 1248. Rev. Rul. 83-182, 1983-2 C.B. 149, suspended that part of Rev. Rul. 71-388 temporarily.

If the E&P were not decreased by the amount of gain treated as a dividend under section 1248, a subsequent distribution by the CFC to the new owner might have been treated as a dividend out of E&P that had already caused a dividend inclusion to the seller under section 1248. The new owner also might have claimed entitlement to foreign tax credits for taxes paid by the CFC with respect to the dividend, even if the seller had already claimed credit for the same taxes. To address this potential double counting problem, Congress enacted section 959(e) as part of the Deficit Reduction Act of 1984 to provide that E&P included in a seller's gross income as a dividend by reason of section 1248(a) become previously taxed income ("PTI") for purposes of section 959(a). As PTI, such E&P are not includible in the gross income of the buyer of the stock and do not give rise to deemed-paid foreign tax credits when subsequently distributed to the buyer.

As part of the Tax Reform Act of 1986, Congress amended section 959 further to clarify in section 959(d) that distributions excluded from gross income under section 959(a) reduce E&P at the time of distribution.

Rev. Rul. 90-31, 1990-1 C.B. 147, now provides, based on sections 959(e) and 959(d), that, under the facts described in Rev. Rul. 71-388, E&P are decreased at the time of the actual distribution of the PTI amount attributable to the section 1248 dividend. Thus, Rev. Rul. 90-31 modified the last sentence of Rev. Rul. 71-388 and made Rev. Rul. 83-182 obsolete. Rev. Rul. 90-31 also clarifies that the new owner is not entitled to a foreign tax credit with respect to the PTI amount when such amount is actually distributed. Rev. Rul. 90-31 does not address

the computation of the amount of the section 1248 deemed dividend.

Sections 902 and 960.

Section 1.1248-1(d)(1) of the regulations provides that if a domestic corporation includes an amount in gross income as a dividend under section 1248, the foreign tax credit provisions of sections 901 through 908 apply in the same manner and subject to the same conditions and limitations as if the amount had been distributed to the domestic corporation as an actual dividend. Section 1.1248-1(d)(2) provides that no credit shall be allowed with respect to taxes not actually paid or accrued. See also section 902(c)(4)(A) (referring to taxes "paid by the foreign corporation"). Thus, the domestic corporation is entitled to a deemed-paid credit under section 902 with respect to foreign taxes actually paid or accrued by the CFC. A similar credit is provided under section 960 for foreign taxes associated with amounts that are included in a U.S. shareholder's gross income under section 951(a).

The purposes of the deemed-paid credit are (i) "to protect a domestic parent from double taxation of its income" and (ii) "to equalize treatment between domestic corporations that operate through foreign subsidiaries and those that operate through unincorporated foreign branches." United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 139-40 (1989).

Section 902 was significantly amended by the Tax Reform Act of 1986 with respect to taxable years beginning after December 31, 1986. Section 902(c) provides definitions and certain special rules for calculating deemed-paid taxes on the basis of multi-year pools of earnings and taxes. Any dividend paid in a post-1986 taxable year is treated as made first out of the foreign corporation's post-1986 undistributed earnings to the extent thereof and then out of pre-1987 earnings. Section 902(c)(6)(B). Section 902(c)(6)(A) provides that credits with respect to actual or deemed distributions in a post-1986 taxable year out of pre-1987 earnings are determined under the law in effect prior to 1987.

Under the law in effect prior to 1987, a CFC's accumulated profits were calculated year by year and were matched with the foreign taxes paid (or accrued) each year. The amount of the foreign taxes deemed paid with respect to a dividend paid out of accumulated profits for a particular year was computed under the following formula:

$$\text{Taxes deemed paid} = \text{Foreign income taxes paid on or with respect to accumulated profits for taxable year} \times \frac{\text{Dividends paid out of accumulated profits for taxable year}}{\text{Accumulated profits for taxable year in excess of foreign income taxes}}$$

For purposes of this formula, the CFC's accumulated profits for a taxable year were equal to the sum of the CFC's E&P for such year plus the foreign income taxes imposed on or with respect to the gains, profits, and income to which such E&P are attributable. Section 1.902-3(e) (formerly section 1.902-1(e)).

Under pre-1987 law, annual accounts of accumulated profits and foreign income taxes were maintained in foreign currency for purposes of section 902. See section 1.902-3(g)(1) (formerly section 1.902-1(g)(1)) (providing that E&P may be determined under the rules provided by section 1.964-1 exclusive of paragraphs (d) and (e) thereof (the "partial section 964 method")). Accumulated profits distributed as a dividend, and a ratable portion of the CFC's foreign income taxes, were translated into U.S. dollars at the spot rate in effect on the distribution date. See Bon Ami Co. v. Commissioner, 39 B.T.A. 825 (1939) (holding that deemed-paid foreign taxes should be translated at the exchange rate prevailing when the dividend is declared). See also section 1.902-3(g)(1) (formerly section 1.902-1(g)(1)). Distributions out of pre-1987 accumulated profits, and the associated foreign income taxes, continue to be determined and translated into U.S. dollars under pre-1987 law for purposes of section 902. Section 1.902-1(a)(10)(ii).

Different rules applied in computing E&P and deemed-paid taxes for purposes of determining a deemed-paid foreign tax credit under section 960 for foreign taxes associated with amounts that were included in a U.S. shareholder's gross income under section 951(a) prior to 1987. Annual accounts of E&P were maintained in U.S. dollars under the full section 964 method described above. Foreign taxes were translated into U.S. dollars at the exchange rates in effect when the taxes were paid or accrued. Section 1.964-1(d)(i).

If there was a combination of actual dividends and section 951(a) inclusions for the same pre-1987 taxable year, it was necessary to compute two sets of E&P and foreign taxes accounts: one under the rules that applied for purposes of section 902 and the other under the rules that applied for purposes of section 960. See TAM 9023006 (Feb. 28, 1990). However, apart from some general discussion in TAM 9023006, which did not present this issue for decision, no guidance has ever been issued as to how the two sets of accounts should be coordinated.

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As noted above, the amount of a section 1248 deemed dividend (the numerator in the fraction set forth above) was based on annual E&P accounts computed in U.S. dollars under the full section 964 method. Pursuant to the transition rule published in Notice 88-70, supra, such E&P accounts were required to be translated into the CFC's functional currency (if not the U.S. dollar) as of the first day of the first taxable year of the CFC beginning after December 31, 1986 at the spot rate in effect on that date.

It is the position of the Service that, for purposes of determining the amount of the deemed-paid foreign tax credit associated with a section 1248 deemed dividend under pre-1987 law, the accumulated earnings and foreign income tax accounts (the denominator and the multiplicand of the fraction set out above) are properly computed in accordance with the method that was used for a section 960 credit. See G.C.M. 37133 (May 24, 1977) (E&P denominator of section 1248 credit fraction determined under section 960 method); G.C.M. 37839 (January 31, 1979) (foreign tax multiplicand determined under section 960 method for purposes of former section 963 where both terms of fraction also determined under section 960 method); cf. section 1.905-5T(b)(1) (foreign taxes deemed paid under section 902 with respect to section 1248 deemed dividend translated into U.S. dollars at rate of exchange for date of payment of foreign taxes). This position is based on the principles of proportionality and consistency: because the amount of the section 1248 deemed dividend is computed by reference to section 964 E&P (which applies to the section 960 credit), the denominator and the multiplicand should likewise be determined under the method that applies to the section 960 credit, so that the percentage of foreign taxes deemed paid matches the percentage of accumulated earnings deemed distributed.

RATIONALE

Issue 1.

Examiner's position. The examiner's position is that Rev. Rul. 90-31 modifies Rev. Rul. 71-388 only with respect to whether the accumulated E&P of a CFC are decreased by the amount of gain from the sale of its stock that is treated as a dividend under section 1248. Accordingly, the examiner applied the methodology set forth in Rev. Rul. 71-388 and reduced Subsidiary's E&P for Year E by the amount of the distribution to Purchaser on Date D. Finally, in calculating Parent's foreign taxes deemed paid in connection with the section 1248 deemed dividend, the examiner included all of Subsidiary's E&P and foreign taxes accrued for Year E in the closing balances of Subsidiary's post-1986 undistributed earnings and post-1986 foreign income taxes pools.

Parent's position. Parent agrees that, under a literal reading of section 1.1248-3(b)(3) of the regulations, the methodology set forth in Rev. Rul. 71-388 would be applicable and, accordingly, Subsidiary's E&P for Year E would be reduced by the amount of the distribution to Purchaser prior to computing Parent's ratable share of such E&P. However, Parent contends that applying the regulation would be inappropriate here, because the result is inconsistent with legislative provisions enacted after the regulation was adopted in 1964. Further, in determining Parent's foreign taxes deemed paid in connection with the section 1248 inclusion, Parent included in Subsidiary's post-1986 undistributed earnings and taxes pools only a pro rata portion of the E&P and taxes accrued by Subsidiary for Year E. Under Parent's position, a larger portion of Subsidiary's post-1986 undistributed earnings pool would be included in the section 1248 dividend amount, and a larger portion of Subsidiary's post-1986 foreign income taxes would be deemed paid by Parent.

Analysis. We conclude that section 1.1248-3(b)(3) of the regulations applies in determining Parent's section 1248 deemed dividend amount. The regulation was issued under a specific grant of authority and it implements the statute in a reasonable manner that is not inconsistent with subsequent legislative changes. Accordingly, in determining Parent's ratable share of Subsidiary's E&P for purposes of section 1248, Subsidiary's E&P for Year E must first be reduced by the amounts of the Year E distributions to Parent and Purchaser. Parent's section 1248 deemed dividend amount must then be determined and treated as creating a PTI account pursuant to section 959(e). The distribution to Purchaser on Date D is treated as a distribution of PTI, to the extent thereof.

Parent contends that, to be consistent with Rev. Rul. 90-31 and section 959(e), Subsidiary's E&P for Year E must be calculated for purposes of section 1248 as of Date C (the date of Parent's sale of the Subsidiary stock to Purchaser) without reduction for Subsidiary's subsequent distribution to Purchaser on Date D. Parent argues that if the E&P for the year of the sale is reduced by the amount of the post-sale distribution to the buyer (prior to computing the section 1248 dividend amount), the application of section 959(e) to create a PTI account in the amount of the section 1248 dividend would create an anomaly, because the post-sale distribution to the buyer would be paid first out of PTI, which would be inconsistent with the assumption in Rev. Rul. 71-388 that the distribution would be characterized as a dividend taxable to the buyer.

We agree that the distribution in Rev. Rul. 71-388 is described as a dividend to the buyer. However, Rev. Rul. 71-388 was issued prior to the enactment of section 959(e), at a time

when the same E&P arguably could have been treated as a dividend to both the seller and the buyer. Further, the holding in Rev. Rul. 71-388 is based on the regulations described above, which provide that, for purposes of determining the amount of a section 1248 deemed dividend, the foreign corporation's E&P accumulated for the year of the sale must be reduced by the amount of distributions during such year. This rule is not limited to distributions that are treated as dividends. In our view, the fact that the distribution to Purchaser on Date D is ultimately determined to be out of PTI and is not treated as a dividend (except that it reduces E&P) does not affect the section 1248 calculation. Rev. Rul. 90-31 confirms that distributions to the buyer of amounts taxed to the seller as a deemed dividend under section 1248 are PTI, but does not modify the ordering rule of section 1.1248-3(b) for determining the amount of the section 1248 deemed dividend.

Parent also argues that allowing post-sale distributions to decrease the amount of E&P available for a section 1248 deemed dividend would be inconsistent with the purpose of section 1248. Parent states that, at the time Congress enacted section 959(e) in 1984, it affirmed that the purpose of section 1248 is to tax the accumulated profits of active foreign corporations upon repatriation. Parent quotes from the General Explanation's discussion of section 1248(i), which was enacted at the same time as section 959(e) to address an abusive situation where taxpayers were taking the position that section 1248 did not apply to certain indirect transfers in which a CFC that was wholly owned by a widely held U.S. corporation issued new shares and paid a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation.

The cited passage explains the need for section 1248(i) as follows: "In the view of Congress, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would undermine the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation." Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 446-47 (1985). According to Parent, allowing post-sale distributions to decrease the amount of E&P available for a section 1248 deemed dividend also would undermine the principle of taxing accumulated E&P upon repatriation. Parent argues that all subpart F inclusions, as well as section 1248 amounts (which Parent contends section 959(e) puts on par with subpart F inclusions), must be calculated before taking into account the effect of distributions.

As support for the foregoing argument, Parent relies on the Taxpayer Relief Act of 1997, which added a sentence to section 951(a)(2) to resolve a potential double counting issue. P.L. 105-34, section 1112(a)(1). Under section 951(a)(2), the amount of subpart F income that is includible by a buyer of stock of a CFC for the year of the acquisition is reduced by a specified percentage of the amount of distributions received by the seller as a dividend with respect to the stock during the year. The new sentence now provides that the seller's section 1248 deemed dividend will be treated as a distribution that reduces the amount of the buyer's subpart F inclusion. Parent argues that this amendment reflects a Congressional purpose to give priority to including year-of-sale earnings in the seller's income under section 1248.

In our opinion, reducing the amount of a section 1248 deemed dividend by the amount of a same-year post-sale distribution is not inconsistent with the purpose of section 1248 or with section 951(a)(2). Since 1962, when section 1248 was enacted in conjunction with subpart F, the purpose of section 1248 has been to ensure that when earnings accumulated by a foreign corporation are repatriated, they will be taxed as ordinary income and not as capital gains:

> Under existing law, through an ordinary taxable liquidation or sale or exchange, it is possible to bring earnings accumulated by a foreign corporation back to this country merely by paying a capital gains tax on such earnings included in the gain. . . .
>
> The bill has as one of its objectives in the foreign income area the imposition of the full U.S. tax when income earned abroad is repatriated. Full U.S. taxation will occur in the case of the ordinary taxable liquidations or sales or exchanges only if the earnings and profits are in effect taxed as dividends (to the extent of any gain) at the time the funds are brought back to the United States. This objective is accomplished by this section of the bill.

S. Rep. No. 1881, 87th Cong., 2d Sess., 1962-3 C.B. 813.

Consistent with the purpose of section 1248, Congress determined in 1984 that section 1248(i) was needed to prevent the shareholders of a widely held U.S. corporation from obtaining capital gains treatment on the exchange of their shares in the U.S. corporation for shares in such corporation's wholly owned controlled foreign corporation, thereby indirectly repatriating the accumulated earnings of the controlled foreign corporation free of taxation at ordinary income rates.

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In contrast to section 1248(i), which was needed to prevent taxpayers from circumventing the purpose of section 1248, section 959(e) was needed only to ensure that amounts included in one taxpayer's gross income as a deemed dividend by reason of section 1248 will not be taxed as dividends again when subsequently distributed to another taxpayer. There is no question as to whether the amounts at issue will be taxed at ordinary income rates. Section 959(e) merely places a section 1248 inclusion on par with a subpart F inclusion for purposes of section 959 and 960(b); it has no effect on the computation of the amount of the section 1248 inclusion.

The last sentence of section 951(a)(2) also was not needed to prevent taxpayers from circumventing the purpose of section 1248. Its purpose was to provide an ordering rule for a situation where there was potential double counting and no definitive guidance, by ensuring that amounts taxed to one U.S. shareholder as a section 1248 deemed dividend will not also be included in another U.S. shareholder's gross income under section 951. This provision reflects a Congressional determination that year-of-sale subpart F earnings that are taxed to the seller under section 1248 should not also be taxed to the buyer under section 951. However, its enactment does not compel the inference that Congress intended to tax year-of-sale non-subpart F earnings to the seller in circumstances involving a post-sale distribution where no double counting issue is presented, much less that Congress intended retroactively to override a longstanding Treasury regulation governing the computation of the section 1248 inclusion.

Parent presents an additional argument based on the fact that other aspects of the section 1248 regulations adopted in 1964 are out of date, specifically section 1.1248-1(d), which sets forth rules for the allowance of deemed paid credits for foreign income taxes paid by first- and second-tier foreign subsidiaries and provides that a domestic corporation's section 1248 gain on sale of a first-tier subsidiary that owns a second-tier subsidiary is prorated based on the amount of E&P in each subsidiary. The 1964 regulation does not include any provisions for third-tier subsidiaries, because deemed paid credits for foreign income taxes paid by third-tier subsidiaries were not available until 1971. Parent says that a literal reading of the regulation suggests that the availability of foreign tax credits with respect to section 1248 inclusions is limited to first- and second-tier subsidiaries. However, because this interpretation would be inconsistent with current law, Parent says it is reasonable to conclude that the section 1248 proration and deemed paid credits would be extended to third-tier foreign corporations. Parent argues that concluding that post-sale distributions should be accounted for before the creation of

inclusions that result in PTI would be as erroneous as disallowing third-tier foreign tax credits in the section 1248 context.

However, the statutory change making deemed paid credits available for taxes paid by third-tier subsidiaries rendered the provisions of section 1.1248-1(d) of the regulations incomplete, rather than erroneous or obsolete. Moreover, we see nothing in the post-1964 changes to the Code or the legislative history thereof that overrides the position taken in section 1.1248-3(b) and Rev. Rul. 71-388 with respect to post-sale distributions in calculating the section 1248 amount. Accordingly, we reject the taxpayer's argument that the 1984 and 1997 statutory changes preclude the Service from applying the regulation as written.

Based on the foregoing, we conclude that Subsidiary's E&P for Year E must be reduced by the amount of the distributions to Parent and Purchaser prior to computing Parent's ratable share of the E&P. Because the sum of Subsidiary's distributions to Parent and Purchaser in Year E exceeds Subsidiary's E&P for Year E, a negative ratable share of E&P for Year E is taken into account together with the positive E&P arising in other post-1986 years in determining the extent to which Parent's gain on the sale of the stock of Subsidiary is characterized as dividend income under section 1248. As required by sections 902(c)(1) and 902(c)(2), for purposes of calculating Parent's foreign taxes deemed paid in connection with the section 1248 deemed dividend, the entire amount of Subsidiary's E&P and taxes accrued in Year E (and not just a ratable share thereof) are included in Subsidiary's post-1986 undistributed earnings and post-1986 foreign income taxes as of the end of Year E.

Issue 2.

As explained above, there were different sets of rules prior to 1987 for computing and translating E&P and foreign taxes for actual dividends and deemed inclusions. In the case of actual dividends, annual E&P and foreign tax accounts for purposes of section 902 were computed in foreign currency and translated into U.S. dollars at the rate in effect on the dividend date. In the case of deemed inclusions, annual E&P accounts for purposes of section 960 were maintained in U.S. dollars (using the full section 964 method) and foreign taxes were translated into U.S. dollars at the exchange rates in effect when the taxes were paid or accrued. There was no guidance on how to coordinate the two sets of accounts when there was a combination of actual distributions and deemed inclusions of earnings from the same pre-1987 taxable year of a foreign corporation.

Parent and the examiner agree that Parent's deemed-paid credit with respect to the section 1248 inclusion out of pre-1987 earnings and profits is calculated using the section 960 method. Parent and the examiner also generally agree that Parent is not entitled to a double credit for pre-1987 taxes paid by Subsidiary and that offsets between the two sets of accounts are necessary. The point of disagreement is whether the existence of a double credit should be determined with reference to the number of FCs of tax paid by the foreign subsidiary (which is the basis for both tax accounts) or with reference to the differing amounts of U.S. dollars into which the FCs were translated (which translation occurred at the time of payment in the case of the section 960 tax accounts and upon distribution of the associated earnings in the case of the section 902 tax accounts).

Examiner's position. The examiner's position is that once a deemed-paid foreign tax credit has been claimed by a U.S. corporation for a unit of foreign tax paid by a foreign corporation, no additional credit can be claimed for that same unit of foreign tax under another method that uses a different translation convention. Because Parent had already received credit under section 902 for all foreign taxes paid by Subsidiary through December 31, 1985, the examiner disallowed any additional credit calculated under section 960 for the same taxes. Under the examiner's position, the foreign taxes would be viewed in FCs and the amount of taxes available for credit under section 960 with respect to a deemed inclusion would be reduced by the FC amount of the taxes claimed as credits under section 902.

Parent's position. Parent's position is that because the U.S. dollar amount of Subsidiary's pre-1987 taxes using the translation convention that applied for purposes of sections 960 and 1248 exceeded the U.S. dollar amount of Subsidiary's pre-1987 taxes using the translation convention that applied for purposes of section 902, the section 1248 deemed dividend entitles Parent to a deemed-paid foreign tax credit for the excess of the section 960 dollar tax account over the dollar amount of credit previously claimed under section 902 for each of the pre-1987 years in question. Thus, Parent compares the foreign taxes for purposes of sections 902 and 960 in terms of U.S. dollars.

Analysis. Deemed-paid foreign tax credits are available only for foreign taxes actually paid or accrued. See section 902(c)(4)(A); section 1.1248-1(d)(2). See also H.H. Robinson v. Commissioner, 59 T.C. 53, 74 (1972), aff'd per curiam, 500 F.2d 1399 (3d Cir. 1974). Accordingly, the appropriate method for coordinating the two sets of pre-1987 tax accounts must be the method that ensures that credits are limited to foreign taxes actually paid or accrued. We conclude that the two sets of accounts must be compared in terms of FCs.

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There was no direct correlation between pre-1987 section 902 E&P, which was calculated using a foreign currency profit and loss statement, and section 964 E&P, which was calculated using a U.S. dollar balance sheet. Accordingly, a given distribution (or deemed inclusion) from a particular year's earnings was virtually certain to constitute a different percentage of the year's section 902 profits and section 964 profits, and thus to attract a different percentage of the year's creditable taxes, depending on which section applied. In contrast, both sections based the amount of creditable tax on the foreign currency taxes paid (although different translation conventions applied).

Subsidiary's foreign tax liabilities were determined in FCs and paid in FCs, and the FC liability is the basis for determining allowable credits under both sections 902 and 960. In our view, the only principled way to keep track of pre-1987 taxes previously credited and taxes still available for credit under either section 902 or 960 is in FCs. Thus, when there is an actual dividend or a deemed inclusion out of pre-1987 earnings and taxes are deemed paid, both the section 902 and the section 960 tax accounts should be reduced by the FC amount of taxes deemed paid. See section 1.902-1(a)(10)(iii). When the FC taxes for a particular pre-1987 year are all deemed paid and the tax accounts are thus reduced to zero, no more credits are available with respect to that pre-1987 year, even if earnings remain available to support a distribution or deemed inclusion from that year.

Parent first contends that this position is inconsistent with the requirement established by Bon Ami Co. v. Commissioner, supra, that earnings and taxes be linked and translated on the same basis. Parent argues that the pre-1987 section 902 and section 960 regimes were designed to operate independently and that neither should limit or otherwise change the amount of E&P or tax credit reflected in the operation of the other regime. However, Parent concedes that cross-regime adjustments are necessary to avoid a doubling up of foreign tax credits and, therefore, that credits claimed under one regime operate to limit the credits that would otherwise be available under the other regime. The only point of disagreement is whether the starting point for determining this limit should be a foreign currency amount or a dollar amount, since translations are necessary for purposes of both accounts. The principles of Bon Ami do not assist in the resolution of this problem, much less require the foreign taxes credited under section 902 to be viewed as a U.S. dollar amount of tax for purposes of determining the amount of tax available for credit under section 960.

Parent next contends that viewing the pre-1987 tax accounts in terms of U.S. dollars would be more consistent with the goal

of equalizing the tax treatment of domestic corporations operating abroad through subsidiaries and through branches and with the post-1986 statutory scheme. In support of this contention, Parent points to the General Explanation of the Tax Reform Act of 1986, which cited equalizing the tax treatment of subsidiaries and branches as a major reason for rejecting the Bon Ami translation convention in favor of the historic spot rate translation convention for post-1986 foreign taxes of both branches and subsidiaries. Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 1091 (1987).

We do not find this argument persuasive. The issue of how to coordinate two sets of pre-1987 foreign tax accounts did not exist with respect to taxes of an unincorporated foreign branch. In enacting sections 985-989, Congress recognized, and eliminated for post-1986 taxable years, the problems created by the fact that different computational and translation conventions for determining earnings and taxes applied prior to 1987 for different U.S. tax purposes. Congress did not amend the law applicable to pre-1987 years nor express a view as to how the problem presented herein should be resolved.

Parent also contends that its use of a dollar-based methodology is endorsed by the Service's own pronouncements, namely Notice 88-70, supra, Rev. Rul. 73-182, 1973-1 C.B. 350, and G.C.M. 37133, supra. However, none of these pronouncements addresses the specific question of whether the two sets of pre-1987 foreign tax accounts should be coordinated in foreign currency or in U.S. dollars. Rev. Rul. 73-182 and G.C.M. 37133 do address the coordination of pre-1987 tax accounts when there is a combination of distributions and deemed distributions under two different regimes, and they provide that the accounts must be reduced by the amount of the foreign taxes that are creditable with respect to the first distribution. However, because the section 902 earnings and taxes accounts in each case were assumed to be maintained in U.S. dollars, neither authority addresses the issue presented by this case.

Based on the foregoing, we agree with the examiner that the section 1248 deemed dividend does not entitle Parent to additional credit for any of Subsidiary's pre-1986 foreign taxes. Parent is entitled to credit only for foreign income taxes actually paid by Subsidiary, and Parent has already received credit under section 902 for all such taxes paid prior to 1986. It would not further the purposes of the indirect foreign tax credit to allow any additional credit, because additional credit would neither reduce the amount of any double taxation with respect to Subsidiary's pre-1987 earnings nor make the treatment more comparable to that of an unincorporated foreign branch.

CONCLUSIONS

Issue 1.

For purposes of determining the extent to which Parent's gain on the sale of the stock of Subsidiary is characterized as dividend income under section 1248(a), Subsidiary's E&P for the year of the sale must be reduced by the amounts of both the pre-sale distribution to Parent and the post-sale distribution to Purchaser.

Issue 2.

The section 1248 deemed dividend resulting from Parent's sale of the Subsidiary stock does not entitle Parent to a deemed-paid foreign tax credit for foreign taxes paid by Subsidiary prior to 1986 for which Parent has already received deemed-paid credits under section 902 in connection with actual and consent dividends.

We do not express an opinion on any aspect of Parent's computations other that those specifically addressed above.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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