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

April 18, 2001

Number: **200130007**
Release Date: 7/27/2001
CC:INTL:Br2:KMKogan
TL-N-3070-99
UILC: 952.05-00
952.05-04

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR THEODORE LEIGHTON
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MANHATTAN (GROUP 4) (CC:LM:FSH:MAN:4)
Attn: Alise Alair

FROM: VALERIE A. MARK
ASSISTANT TO THE BRANCH CHIEF, CC:INTL:Br2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 22, 1999. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp A
Division B
Sub 1
Sub 2
Country M
Amount L
Amount M

Amount N
Amount O
Amount P
Amount Q
Amount R
Year T
Year U
Year V
Year W
Date X
Date Y
Date Z

ISSUE

Whether the chain deficit rule of section 952(c)(1)(C) allows the Shipping Subsidiaries to offset their foreign base company shipping income with Sub 1's Year U and Year V deficits in earnings and profits.

CONCLUSION

Section 952(c)(1)(C) permits Sub 1's Year U and Year V deficits in earnings and profits that are attributable to the foreign base company shipping income category of Sub 1 from those years to offset the foreign base company shipping income of the Shipping Subsidiaries in Year U and Year V. The portion of Sub 1's deficits in earnings and profits that is attributable to the foreign base company shipping income category is determined for each year by multiplying the deficit for that year by the ratio of the net loss, if any, in Sub 1's foreign base company shipping income category to Sub 1's total net loss for that year. Further factual development is necessary, however, to determine whether Sub 1 in fact incurred deficits attributable to foreign base company shipping income during those years.

FACTS

Based on your memorandum and additional information provided to us by the International Examiner, we understand the facts to be as follows:

Corp A is a domestic corporation engaged, through its domestic and foreign subsidiaries, in the shipping business.

Prior to Date Z, Corp A owned directly all of the stock of Sub 1, a Country M corporation engaged in the shipping business. Sub 1 owned directly all of the stock of

Sub 2, a Country M corporation, and approximately 20 other Country M corporations that were engaged in the shipping business ("Shipping Subsidiaries").

Sub 1's taxable year is the calendar year.

Dividend Note.

On or around Date Y, Sub 1 declared a dividend of Amount L payable to its sole shareholder, Corp A. In satisfaction of this obligation, Sub 1 issued a note ("Dividend Note") in the same amount to Corp A payable over a period of five years (i.e., Year T through Year W) at an Amount M annual rate of interest. Sub 1 made regular payments of principal and interest to Corp A on the Dividend Note while it was outstanding.

Reorganization.

On or around Date Z, Corp A reorganized its foreign operations in part to take advantage of the chain deficit rule in section 952(c)(1)(C). Consistent with this purpose, Corp A moved all of its Country M subsidiaries (i.e., Sub 1, Sub 2, and the Shipping Subsidiaries) into a single straight chain of ownership with Sub 1 at the top of the chain and each of the other entities somewhere in the chain below Sub 1. Corp A also appears to have caused Sub 1 to dispose of its shipping business assets. As a result of the reorganization, Sub 1 began to function solely as a holding company for Corp A's other Country M subsidiaries.

Management Agreement.

Prior to the reorganization of Corp A's foreign operations, a number of agreements were entered into by various members of the Corp A group. The first agreement, the Management Agreement, was signed by Sub 1, Sub 2, and approximately 14 of the Shipping Subsidiaries ("Contracting Subsidiaries") on Date X. Under this agreement, Sub 1 agreed to "arrange for the appointment of [Sub 2] as manager[] of certain of [Sub 1's and the Contracting Subsidiaries'] operations and to perform services for the [Contracting Subsidiaries] and [Sub 1]." The services that Sub 2 agreed to perform for the Contracting Subsidiaries and Sub 1 pursuant to this agreement consisted of the following:

(1) Provide planning, supervision and advisory services in respect of the whole operations of Sub 1 and the Contracting Subsidiaries.

(2) Provide or contract for all general administrative office and support services necessary for the operations of Sub 1 and the Contracting Subsidiaries.

(3) Seek vessels suitable for purchase by the Contracting Subsidiaries, negotiate the terms of any such purchases, and supervise the delivery of vessels to the Contracting Subsidiaries, provided that Sub 2 could enter into a binding commitment on the part of Sub 1 or any of the Contracting Subsidiaries with any third party in respect of the purchase of a vessel only after receiving express authority from Sub 1 or the Contracting Subsidiary to do so.

(4) Determine vessels suitable for sale by the Contracting Subsidiaries and negotiate the terms, arrange and complete such sale, provided that Sub 2 could enter into a binding commitment on the part of Sub 1 or any of the Contracting Subsidiaries with any third party in respect of the sale of a vessel only after receiving express authority from Sub 1 or the Contracting Subsidiary to do so.

(5) Seek business opportunities and negotiate the terms of any such business opportunities, provided that Sub 2 could enter into a binding commitment on the part of Sub 1 or any of the Contracting Subsidiaries with any third party in respect of such a business opportunity only after receiving express authority from Sub 1 to do so.

(6) If requested by a Contracting Subsidiary, negotiate, arrange, complete and supervise the chartering or other employment of its vessel and, in such instance, enter into an agreement substantially upon the terms stated in a Commercial Management Agreement (described below).

(7) Negotiate all borrowing arrangements of Sub 1 and the Contracting Subsidiaries and supervise the implementation of such arrangements, provided that Sub 2 could enter into a binding commitment in respect of any borrowing or financing on behalf of Sub 1 or any of the Contracting Subsidiaries after receiving express authority from Sub 1 and such Contracting Subsidiary to do so.

(8) Liaise with and instruct the secretary of Sub 1 in connection with such officer's obligations and duties.

(9) If requested by a Contracting Subsidiary, provide customary technical management services and, in such instance, enter into an agreement substantially upon the terms stated in a Technical Management Agreement (described below).

(10) Keep separate books, records and accounts relating to all the activities of Sub 1 and each of the Contracting Subsidiaries and, at the end of each month, provide to Sub 1 an analysis of the previous month's trading and operational results as well as an intended budget for the operations of each of the vessels in the forthcoming month.

(11) Operate such bank accounts and in such names as Sub 1 may require subject to the control of Sub 1.

(12) Enter into, make and perform all contracts, agreements and other undertakings as, in the opinion of the Sub 2, may be necessary or advisable or incidental to the carrying out of the objectives of the Management Agreement.

(13) Review, supervise and monitor the performance of all parties providing technical or commercial management or general management services to the Contracting Subsidiaries.

Submanagement Agreement.

A second agreement, the Submanagement Agreement, was signed by Sub 2 and Division B, a division of Corp A, on Date X. Under this agreement, Division B became obligated to perform the following services that Sub 2 had agreed to perform for Sub 1 and the Contracting Subsidiaries under the Management Agreement:

(1) Provide such planning, supervision and advisory services in respect of Sub 1 and the Contracting Subsidiaries as may be requested by Sub 2.

(2) Provide or contract for all general administrative office and support services necessary for accounting and data processing services for Sub 2, Sub 1, and the Contracting Subsidiaries.

(3) Provide such advice or support services as may be requested by Sub 2 with respect to closings on sales and purchases of vessels and loan arrangements and supervise the delivery of the vessels to the Contracting Subsidiaries.

(4) Keep separate books, records and accounts relating to all the activities of Sub 2, Sub 1, and each of the Contracting Subsidiaries and, at the end of each month, provide to Sub 2 an analysis of the previous quarter's trading and operational results as well as an intended budget for the operations of each of the vessels in the forthcoming month.

(5) Operate such bank accounts and in such names as Sub 2 may require subject to the control of Sub 2.

(6) Subject to the instructions of Sub 2, enter into, make and perform all contracts, agreements and other undertakings which, in the opinion of Division B, are necessary or advisable or incidental to the carrying out of the objectives of the Submanagement Agreement.

(7) Provide such advice with respect to corporate affairs as may be requested by Sub 2.

Commercial Management Agreements and Technical Management Agreements.

Finally, on Date X, each of the Contracting Subsidiaries entered into a Commercial Management Agreement and a Technical Management Agreement with Division B. Pursuant to each Commercial Management Agreement, Division B agreed to perform the following services for the relevant Contracting Subsidiary (referred to in the agreement as the "Owner"):

(1) Subject to the Owner's consent, negotiate contracts for the employment of a vessel and keep the Owner fully informed of the vessel's movements.

(2) Appoint port agents and arrange for bunkers and other variable voyage services and for loading and discharging cargo.

(3) Cause to be remitted from the paying party directly to the account nominated by the Owner of a vessel without setoff, any freight, hire, demurrage and other amounts due under contracts of employment of a vessel and take such actions as reasonably may be necessary to enforce such payment obligations.

(4) Attend to the processing and issuance of all cargo documents including bills of lading for and on behalf of an Owner of a vessel in accordance with the instruction of the Owner.

(5) Keep the Owner of a vessel informed at all times of all claims, disputes, and suits which may be asserted in connection with the contracts of employment for a vessel and, in accordance with instructions of the Owner, use its best efforts to settle and deal with such claims, disputes, and suits.

Pursuant to each Technical Management Agreement, Division B agreed to perform the following services for the relevant Contracting Subsidiary (referred to in the agreement as the "Owner"):

(1) Provide nautical superintendence such as arranging the supervision and control of safety equipment and moorings, providing instructions and updates on navigation, arranging for assistance and support to the vessel in case of emergencies, arranging for necessary salvage and towage in connection with the vessel, and undertaking such measures as are reasonably necessary to prevent or mitigate damages when an escape or discharge of oil or other substance from the vessel occurs or threatens to occur and causes or threatens to cause pollution damage.

(2) Provide technical superintendence such as arranging for and supervising the maintenance, installation and repair of all aspects of the vessel and its equipment and monitoring the vessel's performance.

(3) Engage and provide ship's personnel, ensuring that the vessel is always properly manned.

(4) Arrange for purchase and forwarding of ship's provision and catering stores, and the placing of contracts in relation thereto.

(5) Unless expressly instructed otherwise by the Owner of a vessel, enter into, carry out and terminate at its discretion contracts for stores, lubrication oils, equipment, parts and the provision of services to the vessel.

(6) Arrange for competitive insurance acceptable to the Owner of a vessel.

Compensation.

The Management Agreement provided that Sub 1, on behalf of the Contracting Subsidiaries, would pay the following fees to Sub 2 as remuneration for its performance of services under the Management Agreement:

(1) For any vessel for which Sub 2 was a technical manager: Amount N per month.

(2) For any vessel for which Sub 2 was a commercial manager: Amount R of the gross revenues related to such vessel.

(3) For any vessel for which Sub 2 was supervising others for either a technical or commercial management: Amount O per month.

(4) For all other services: an amount equal to Sub 2's cost plus Amount P per month per vessel.

The Submanagement Agreement provided that Sub 2 would pay Division B as remuneration for its performance of services under the Submanagement Agreement Amount Q per month per vessel.

The Commercial Management Agreement for each Contracting Subsidiary provided that the Contracting Subsidiary would pay Division B as remuneration for Division B's performance of services under such Commercial Management Agreement a chartering commission of Amount R of the gross revenues generated by the charter.

The Technical Management Agreement for each Contracting Subsidiary provided that the Contracting Subsidiary would pay Division B as remuneration for Division B's performance of services under such Technical Management Agreement a fixed monthly fee of Amount N.

Bookkeeping Entries of Sub 1.

During the years at issue, Sub 1 appears to have booked a series of accounts receivable representing amounts owed by the Contracting Subsidiaries under the various management contracts. Schedules listing these payments are entitled "Management Fee Expense Due Sub 1." Each of these schedules contains the following statement: "The foreign vessels pay Sub 1 who pays Corp A management fees for accounting and technical services that Corp A performs on behalf of the foreign vessels."

Income Earned by Sub 1 and the Shipping Subsidiaries in Year U and Year V.

In Year U and Year V, some of the Shipping Subsidiaries earned foreign base company shipping income within the meaning of section 954(f). During those same years, Sub 1 reported the following income:

(1) management fees from the Contracting Subsidiaries under the Management Agreement;

(2) dividends from entities in which Sub 1 had a less than 10 percent ownership interest;

(3) interest from banks and other financial institutions unrelated to Sub 1;

(4) interest on a loan made by Sub 1 to its parent, Corp A; and

(5) capital gain from the sale of two foreign subsidiaries ("Related Subsidiaries") engaged in the shipping business.[1]

This income was more than offset, however, by interest paid by Sub 1 to Corp A on the Dividend Note and management fees purportedly paid to Sub 2 under the Management Agreement. As a result, Sub 1 incurred deficits in its earnings and profits in Year U and Year V.

LAW AND ANALYSIS

The issues addressed in this memorandum relate to Corp A's claim that deficits Sub 1 incurred in its earnings and profits in Year U and Year V may be used to offset the foreign base company shipping income earned by the Shipping Subsidiaries in those same years under the chain deficit rule in section 952(c)(1)(C).

A. Qualified Chain Deficit Rule.

The chain deficit rule in section 952(c)(1)(C) (hereinafter referred to as the "qualified chain deficit rule" because it is a modified version of the chain deficit rule repealed in 1986[2]) permits a controlled foreign corporation ("CFC") to elect to reduce the amount of its subpart F income for any taxable year that is attributable to a "qualified activity" by the amount of any deficit in earnings and profits of a "qualified

[1]We do not know the extent of Sub 1's interest in the Related Subsidiaries. As a result, we do not know whether they constituted Shipping Subsidiaries. (As defined in this memorandum, Shipping Subsidiaries are entities that are wholly-owned, either directly or indirectly, by Sub 1).

[2]Section 1221(f) of the Tax Reform Act of 1986, P.L. 99-514, repealed prior section 952(d), generally effective for taxable years of foreign corporations beginning after December 31, 1986. Section 1012(i)(25)(A) of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, added new section 952(c)(1)(C), also generally effective for taxable years of foreign corporations beginning after December 31, 1986.

chain member" for a taxable year ending with or within the taxable year of the CFC.[3] This reduction may occur, however, only to the extent the deficit in the earnings and profits of the qualified chain member is attributable to the same qualified activity that generated the subpart F income of the CFC. Section 952(c)(1)(C)(i). For purposes of this rule, the term "qualified activity" is defined generally as any activity giving rise to a particular category of foreign base company income, including foreign base company shipping income. See Section 952(c)(1)(B)(iii).[4]

1. Sub 1 Was a Qualified Chain Member with Respect to the Shipping Subsidiaries.

The term "qualified chain member" is defined, with respect to a CFC, as another corporation created or organized under the laws of the same country in which the CFC is created or organized and that meets one of the following tests: (1) the CFC owns all of the stock of the other corporation (directly or indirectly through one or more corporations other than the common parent), or (2) the other corporation owns all of the stock of the CFC (directly or indirectly through one or more corporations other than the common parent). Section 952(c)(1)(C)(ii). This ownership requirement must have been met at all times during the taxable year in which the deficit arose. Id.

A CFC is defined as any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such foreign corporation is owned (whether directly, indirectly, or constructively within the meaning of section 958) by United States shareholders on any day during the taxable year of such foreign corporation. Section 957(a). The term

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[3]Any reduction in subpart F income under the qualified chain deficit rule may occur only after the application of the limitations in sections 952(c)(1)(A) (current earnings and profits limitation) and 952(c)(1)(B) (accumulated deficit rule). See section 952(c)(1)(C)(iii). You have not asked about, and thus we have not considered, the application of these limitations to the facts of this case.

[4]Section 952(c)(1)(B)(iii) imposes additional requirements in the case of activities that give rise to foreign personal holding company income or insurance income. Activities that generate foreign personal holding company income are qualified activities for purposes of the qualified chain deficit rule only if such activities are performed by a qualified financial institution (as defined in section 952(c)(1)(B)(vi)) or a qualified insurance company (as defined in section 952(c)(1)(B)(v)). Section 952(c)(1)(B)(iii)(V) and (VI). Similarly, in the case of activities that give rise to insurance income, such activities are qualified activities for purposes of the qualified chain deficit rule only if they are performed by a qualified insurance company (as defined in section 952(c)(1)(B)(v)). Section 952(c)(1)(B)(iii)(V).

"United States shareholder" is defined, with respect to any foreign corporation, as a United States person who owns (whether directly, indirectly, or constructively within the meaning of section 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 951(b). The term "United States person" is defined to include a domestic corporation. Section 957(c) (cross-referencing the definition in section 7701(a)(30)).

During the years at issue, Corp A was a domestic corporation that directly owned all of the stock of Sub 1 and indirectly owned all of the stock of the Shipping Subsidiaries. Sub 1 and the Shipping Subsidiaries were all Country M corporations. Accordingly, Corp A qualified as a United States shareholder with respect to those entities, and all of those entities qualified as CFCs. See sections 951(b), 957(a), and 958(a). Further, Sub 1 wholly-owned, directly or indirectly, each of the Shipping Subsidiaries during each of the years at issue. Accordingly, Sub 1 was a qualified chain member with respect to each of the Shipping Subsidiaries during each of the years at issue. See section 952(c)(1)(C)(ii)(II).

2. Subpart F Income of Sub 1 and the Shipping Subsidiaries Must Be Attributable to the Same Qualified Activity.

There are no regulations under section 952 specifying how to determine deficits in earnings and profits that are attributable to qualified activities. In light of such absence, it is reasonable and appropriate to make this determination by following the generally applicable rules under sections 861 and 904 for allocating expenses to determine a CFC's income and earnings and profits.[5] To the extent the application of these rules results in a net loss in a category of a CFC's subpart F income described in section 952(c)(1)(B)(iii)(I) - (IV) (or, in the case of a qualified insurance company or qualified financial institution, section 951(c)(1)(B)(iii)(V) and (VI)), any deficit in the earnings and profits of the CFC is considered attributable to the qualified activity that, when profitable, generates income in that category in the same proportion that the net loss in that category bears to the total net loss of the CFC for the taxable year.[6]

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[5]For example, these rules are applicable in determining a CFC's net foreign base company income. See Treas. Reg. § 1.954-1(c)(1) (applicable to taxable years of a CFC beginning after November 6, 1995) and Treas. Reg. § 4.954-1(c) (applicable to taxable years of a CFC beginning after December 31, 1986, and on or before November 6, 1995).

[6]Stanford v. Commissioner, 108 T.C. 344 (1997), aff'd. 152 F.3d 450 (5th Cir. 1998), is the only case that has considered, in part, the operation of the qualified chain deficit rule. In that case, the courts considered the issue of whether certain deficits of a CFC

(continued...)

Accordingly, the portion of Sub 1's deficits in its earnings and profits during those years that may be used to offset the foreign base company shipping income of the Shipping Subsidiaries is determined by multiplying the deficit by the ratio of Sub 1's net loss in the foreign base company shipping income category to Sub 1's total net loss. Making this determination in the context of this case is a multi-step process. First, for each of the years in issue, Sub 1's gross income must be examined to determine whether any of it qualifies as foreign base company shipping income within the meaning of section 954(f). Second, the rules for allocating and apportioning expenses to classes of gross income must be applied to determine whether Sub 1 has a net loss in the foreign base company shipping income category and, if so, what portion of Sub 1's deficit is attributable to the net loss in this category for each of those years.

B. Foreign Base Company Shipping Income.

Corp A contends that all of the gross income received by Sub 1 during Year U and Year V constituted foreign base company shipping income within the meaning of section 954(f). Specifically, Corp A claims that Sub 1's income during those years constituted either related services income as defined in Treas. Reg. § 1.954-6(d)(1) or incidental income as defined in Treas. Reg. § 1.954-6(e)(1) and (2)(ii). We do not agree with Corp A's contentions. Based on our review of the information provided in connection with this memorandum, it appears that the only foreign base company shipping income Sub 1 may have received during the years in issue was the capital

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[6](...continued)
could offset the income of a subsidiary CFC under the qualified chain deficit rule. To satisfy the qualified activity requirement, the taxpayer in that case needed to show two things. First, it needed to show that its deficits were attributable to the activities of a qualified financial institution. Second, the taxpayer needed to show that its deficits were attributable to activities that, when profitable, would produce foreign personal holding company income. Both the Tax Court and the Fifth Circuit, using different analyses, determined that the taxpayer failed to show the existence of the first element. Because they determined that the CFC with deficits was not a qualified financial institution, they did not address the second element. Accordingly, the taxpayer was not entitled under the qualified chain deficit rule to use the deficits of its unprofitable CFC to offset the income of its profitable CFC.

In this case, the qualified activity of the subsidiaries is an activity that gives rise to foreign base company shipping income. The issue is whether Sub 1 has deficits attributable to an activity that, if profitable, would generate foreign base company shipping income. Accordingly, the analyses in the Stanford decisions are not directly relevant to the facts of this case.

gain from the sale of the two Related Subsidiaries, although more information will be necessary to confirm this conclusion.

Subpart F income is defined as including foreign base company income, which in turn is defined as including foreign base company shipping income. Sections 952(a)(2), 954(a)(4). In general, foreign base company shipping income consists of several categories of income, including: (1) income derived in connection with the use or lease of any aircraft or vessel in foreign commerce; (2) income derived in connection with the performance of services directly related to the use of any aircraft or vessel in foreign commerce; (3) income incidental to foreign base company shipping operations of the CFC, a related CFC, or an entity in which the CFC owns an interest, and (4) certain dividends and interest received from certain foreign corporations, and gains from the sale of stock or obligations in certain foreign corporations. Treas. Reg. § 1.954-6(b)(1)(i), (ii), (iii), and (v).[7] For purposes of these rules, the term "foreign base company shipping operations" is defined as a trade or business that derives foreign base company shipping income described in categories (1) and (2), supra. Treas. Reg. § 1.954-6(b)(2).

1. Sub 1 Did Not Receive Gross Income from the Use or Lease of a Vessel in Foreign Commerce.

As stated above, foreign base company shipping income includes "gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce." Treas. Reg. § 1.954-6(b)(1)(i). This category consists of (1) income derived from transporting passengers or property by aircraft or vessel in foreign commerce; and (2) income derived from hiring or leasing an aircraft or vessel to another for use in foreign commerce. Treas. Reg. § 1.954-6(c)(1)(i) and (ii).

For purposes of these rules, a "vessel" is generally defined as any water craft or other artificial contrivance capable of being used or intended to be used as a means of transportation on water. Treas. Reg. § 1.954-6(b)(3)(ii). An aircraft or vessel is used in "foreign commerce" to the extent it is used for the transportation of property or passengers: (1) between a port in the United States and a port in a foreign country; (2) between two ports within the same foreign country; (3) between two ports in different foreign countries. Treas. Reg. § 1.954-6(b)(3)(i)(A) and (B). The term "port" means any place (whether on or off shore) where aircraft or vessels are accustomed to load or unload goods or to take on or let off passengers. Treas. Reg. § 1.954-6(b)(3)(iii).

[7]Treas. Reg. § 1.954-6 describes several other categories of foreign base company shipping income, none of which appear to be present in this case. Accordingly, they are not discussed in this memorandum.

None of the information provided in connection with this memorandum suggests that Sub 1 owned or leased a vessel used by it or anyone else in the transportation of passengers or property in foreign commerce during the years in issue. To the contrary, the facts indicate that during this period, Sub 1 functioned solely as a holding company for Corp A's other Country M subsidiaries. Accordingly, it does not appear that any of Sub 1's gross income during Year U and Year V falls into this category of foreign base company shipping income, nor does Corp A contend that it does.

2. Sub 1 Did Not Receive Income From Services Directly Related to the Use of an Aircraft or Vessel in Foreign Commerce.

Foreign base company shipping income also includes income that is derived from, or in connection with, the performance of services directly related to the use of an aircraft or vessel in foreign commerce. Treas. Reg. § 1.954-6(b)(1)(ii). This category of income consists of income derived from, or in connection with, intragroup services and services for a passenger, consignor, or consignee. Treas. Reg. § 1.954-6(d)(1)(i). Intragroup services are defined as services performed for a person who is the owner, lessor, lessee or operator of a vessel used in foreign commerce, by such person or by a related person, and which fall into at least one of the following categories:

(1) terminal services, such as dockage, wharfage, storage, lights, water, refrigeration, and similar services;

(2) stevedoring and other cargo handling services;

(3) container-related services (including the rental of containers and related equipment) performed either in connection with the local drayage or inland haulage of cargo or in the course of transportation in foreign commerce;

(4) services performed by tugs, lighters, barges, scows, launches, floating cranes, and other similar equipment;

(5) maintenance and repairs;

(6) training of pilots and crews;

(7) licensing of patents, know-how, and similar intangible property developed and used in the course of foreign base company shipping operations;

(8) services performed by a booking, operating, or managing agent; and

(9) any service performed in the course of the actual transportation of passengers or property.

Treas. Reg. § 1.954-6(d)(2)(i) - (ix). Passenger, consignor, or consignee services are defined as services provided by the operator (or person related to the operator) of a vessel in foreign commerce for the passenger, consignor, or consignee. Treas. Reg. §1.954-6(d)(3). They include, for example, categories (1) - (4) and (9) of intragroup services, described supra, as well as the rental of living accommodations and the furnishings of meals, barber shop and other services to passengers aboard vessels, excess baggage, and demurrage, dispatch, and dead freight. Treas. Reg. § 1.954-6(d)(3)(i) - (v). For purposes of these rules, a person is a related person with respect to a CFC if it is a "related person" within the meaning of section 954(d)(3).

Corp A's contention that some of Sub 1's gross income during the years in issue constituted related services income as defined in Treas. Reg. § 1.954-6(d)(1) appears to refer to the management fees ostensibly received by Sub 1 under the Management Agreement. It is unclear from the information provided in connection with this memorandum whether such fees, to the extent they were in fact accrued by Sub 1, constituted compensation for management services that Sub 1 was obligated to perform on behalf of the Contracting Subsidiaries. The only contract to which Sub 1 was a party was the Management Agreement. Under its terms, Sub 1 was obligated to perform a limited number of services. These consisted of arranging for the appointment of persons to manage the operations of the Contracting Subsidiaries, functioning as a conduit for the payment of the Management Fees to these persons from the Contracting Subsidiaries, approving certain actions undertaken by Sub 2 in connection with the Management Agreement (although it is unclear whether Sub 1's approval authority was limited to actions undertaken on Sub 1's behalf only or extended to actions undertaken on behalf of the Contracting Subsidiaries), and occasionally providing funds necessary to the operation of a Contracting Subsidiary's vessel. Sub 1 does not appear to have been obligated to perform any services under the Management Agreement directly related to the use of a vessel in foreign commerce.[8] Accordingly, to the extent that Sub 1 earned income in connection with the Management Agreement, such income appears more like an agency fee or commission from the Contracting Subsidiaries for setting up the contract and performing other obligations unrelated to the use of a vessel in foreign commerce. Accordingly, it does not appear to constitute related services income within the

[8]In fact, the Commercial Management Agreements and the Technical Management Agreements obligate Division B to perform, on behalf of the Contracting Subsidiaries, many of the types of services described in Treas. Reg. § 1.954-6(d). These contracts were entered into directly between Division B and each Contracting Subsidiary. Sub 1 was not a party to any of them.

meaning of Treas. Reg. § 1.954-6(d)(1) (although it may qualify as foreign base company services income within the meaning of section 954(e)). To confirm these conclusions, you should conduct additional factual development to determine the precise nature of the services Sub 1 performed for the Contracting Subsidiaries, where such services were performed, and whether any fees paid by the Contracting Subsidiaries in return for these services were properly and consistently recorded and accounted for by the relevant parties.

3. Sub 1 Did Not Receive Incidental Income.

The third category of foreign base company shipping income potentially relevant to this case consists of incidental income derived by a CFC in the course of its foreign base company shipping operations, i.e., the active conduct of a trade or business that derives income from the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce or from the performance of services directly related to the use of an aircraft or vessel in foreign commerce. Treas. Reg. § 1.954-6(e)(1). Specifically, this category of foreign base company shipping income is defined by the regulations as including:

(1) gain from the sale, exchange, or other disposition of related shipping assets;

(2) income from temporary investments that are used to meet the working capital requirements of a foreign corporation engaged in foreign base company shipping operations or that are held pursuant to a plan to purchase any tangible asset for use in foreign base company shipping operations;

(3) interest on accounts receivable and evidences of indebtedness that arise from the conduct of foreign base company shipping operations by the CFC or a related person;

(4) income derived from granting concessions to others aboard aircraft or vessels used in foreign commerce;

(5) income derived from stock and currency futures used to hedge risks arising in the conduct of foreign base company shipping operations;

(6) income derived by the lessor of an aircraft or vessel used in foreign commerce from additional rentals of related equipment (such as shipping containers); and

(7) interest derived by the seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel used in foreign commerce.

Treas. Reg. § 1.954-6(e)(2)(i) - (vii).

Related shipping assets are defined in Treas. Reg. § 1.955A-2(b) to include assets used or held for use in connection with the production of income from foreign base company shipping operations. They include, but are not limited to, the following:

(1) money, bank deposits and other temporary investments reasonably required to meet working capital requirements of the CFC in its conduct of foreign base company shipping operations;

(2) accounts receivable and similar evidences of indebtedness which arise form the conduct of foreign base company shipping operations by the CFC or a related party;

(3) amounts held pursuant to a specific plan to purchase a tangible asset for use in foreign base company shipping operations;

(4) amounts paid into escrow to secure payment of charter fees or a debt against an asset used in foreign base company shipping operations;

(5) capitalized expenditures made under a contract to purchase an asset for use in foreign base company shipping operations;

(6) pre-paid expenses and deferred charges incurred in the course of foreign base company shipping operations;

(7) stock acquired and retained to insure a source of supplies or services in the conduct of foreign base company shipping operations; and

(8) currency futures acquired and retained as a hedge against foreign currency fluctuations in connection with foreign base company shipping operations.

Treas. Reg. § 1.955A-2(b)(2)(i) - (viii).

Corp A appears to claim that Sub 1's gross income other than the purported management fees, discussed supra, constituted income derived from temporary investments described in Treas. Reg. § 1.955A-2(b)(2)(i). We do not agree with this position for two reasons. First, in order for Sub 1's income to fall within this category of foreign base company income, Sub 1 must have been engaged in foreign base

company shipping operations. As discussed above, during the years in issue, Sub 1 was not engaged in the use (or hiring or leasing for use) of a vessel in foreign commerce, since it neither owned nor leased vessels described in Treas. Reg. § 1.954-6(b)(3)(ii) upon which it or someone else transported property or passengers in foreign commerce, as that term is defined in Treas. Reg. § 1.954-6(b)(3)(i). Further, Sub 1 did not appear during the years in issue to have been engaged in the performance of services directly related to the use of any aircraft or vessel in foreign commerce within the meaning of Treas. Reg. § 1.954-6(d)(1). Finally, Sub 1's assets that generated its gross income during these years do not appear to constitute the type of temporary investments described in Treas. Reg. § 1.955A-2(b)(2)(i). The regulation specifies "money, bank deposits, and other temporary investments which are reasonably necessary to meet the working capital requirements of such corporation in its conduct of foreign base company shipping operations." Since Sub 1 was not engaged in shipping operations, it had no need for working capital necessary to conduct such operations.

More generally, Corp A's position disregards the last sentence in section 954(f), which provides that foreign base company shipping income does not include any dividend or interest income that is foreign personal holding company income within the meaning of section 954(c), except for certain dividends and interest received from a foreign corporation in respect of which taxes are deemed paid by Sub 1 under section 902. That sentence was added to section 954(f) by section 13235(b) of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) in order to change the categorization of income derived from working capital for shipping operations from the shipping basket to the passive basket for foreign tax credit limitation purposes. See Rep. 103-213 (Conference Report), pp. 646-648.[9] Accordingly, even if Sub 1's income other than its purported management fees was in fact derived from temporary investments described in Treas. Reg. § 1.955A-2(b)(2)(i) as claimed by Corp A, it was not dividend and interest income received from foreign corporations in respect of which taxes were deemed paid by Sub 1 under section 902 (see discussion infra). As such, it is precisely the type of income that Congress intended to exclude from the definition of foreign base company shipping income as a result of the 1993 change to section 954(f).

4. Sub 1 May Have Received Foreign Base Company Shipping Income in the Form of Capital Gain.

Finally, foreign base company shipping income of a CFC includes generally dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902, and gain recognized from the sale, exchange, or

[9]Treas. Reg. § 1.954-6 does not yet reflect this change to section 954(f).

other disposition of stock or obligations of such a foreign corporation, but only to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income of the foreign corporation. Section 954(f)(1). Whether dividends, interest, and gains paid by a foreign corporation are attributable to foreign base company shipping income of the foreign corporation is determined according to the rules set forth in Treas. Reg. § 1.954-6(f)(4) (in the case of dividends) and Treas. Reg. § 1.954-6(f)(5) and (f)(6) (in the case of interest and gains).

During the years at issue, a foreign corporation did not qualify as a "foreign corporation in respect of which taxes are deemed paid under section 902" unless the CFC directly owned 10 percent or more of the voting stock of the corporation, the corporation was not more than three tiers below the U.S. shareholder in a chain of ownership, and certain 5 percent indirect ownership requirements were met. See section 902(b)(2) (prior to amendment by section 1113(a) of the Taxpayer Relief Act of 1997, PL. 105-34). Moreover, the determination of whether a foreign corporation is one with respect to which a CFC would be deemed under section 902 to pay taxes is made without regard to whether the foreign corporation actually pays any taxes or dividends. Treas. Reg. § 1.954-6(f)(2)(i).

Based on the information provided in connection with this memorandum, it appears that only a portion of the income received by Sub 1 during the years at issue may qualify as foreign base company shipping income within the meaning of section 954(f)(1). The facts indicate that during this time Sub 1 received dividends from entities in which Sub 1 had a less than 10 percent ownership interest; interest from several unrelated banks and other financial institutions; interest from its parent, Corp A; and capital gain from the sale of two of the Shipping Subsidiaries. Neither the dividends nor either kind of interest received by Sub 1 qualify as foreign base company shipping income within the meaning of section 954(f)(1), since such income was not paid by foreign corporations whose taxes Sub 1 would be deemed to have paid under section 902. Sub 1's interest in the entities paying the dividends was smaller than a 10 percent voting power interest, it did not own any interest in the banks and financial institutions that paid it interest, and Corp A was Sub 1's domestic parent.

On the other hand, capital gain from the sale of the two Related Subsidiaries will qualify as foreign base company shipping income if the following facts are shown. First, during the years at issue each of these entities must have been a foreign corporation in respect of which taxes would be deemed paid by Sub 1 under section 902. Second, the gain received by Sub 1 from the sale of each Related Subsidiary must have been attributable to foreign base company shipping income of that entity as described in Treas. Reg. §§ 1.954-6(f)(5)(i) and 1.954-6(f)(6). You will need to conduct additional factual development to determine whether these facts are present. In the event that you determine that both of these facts are present with respect to only one of the Related Subsidiaries sold by Sub 1, only the gain from the sale of that entity will

qualify as foreign base company shipping income within the meaning of section 954(f)(1).

5. Other Categories of Foreign Base Company Income Received by Sub 1.

As discussed above, we believe that the only type of income that Sub 1 received during the years at issue that may qualify as foreign base company shipping income within the meaning of section 954(f) is the capital gain from the sale of the Related Subsidiaries. Sub 1's other income, specifically the dividends and interest received by Sub 1 (including the interest received from Corp A), may be foreign personal holding company income within the meaning of section 954(c)(1)(A). In addition, to the extent that capital gain from the sale of Sub 1's subsidiaries does not qualify as foreign base company shipping income, it will likely qualify as foreign personal holding company income within the meaning of section 954(c)(1)(B). Whether Sub 1 earned income qualifying as foreign personal holding company income is relevant to the application of the expense allocation and apportionment rules, discussed infra, to the facts of this case.

C. Expense Allocation and Apportionment Rules.

If it is determined that any of Sub 1's gross income qualifies as foreign base company shipping income under section 954(f), the next step is to determine the net income or loss in this category of foreign base company income. As noted previously, because there are no rules under section 952 for making this determination, it is appropriate to follow the rules under sections 861 and 904 for allocating expenses to determine net income. Treas. Reg. § 1.904-5(c) provides rules for allocating and apportioning expenses of a CFC to determine the separate limitation character of interest paid by a CFC to its U.S. shareholder under the look-through rules of section 904(d)(e). These rules are as follows:

(1) First, the CFC's gross income in each separate category is determined. Treas. Reg. § 1.904-5(c)(2)(ii)(A). In effect, this requires that each item of income first be grouped according to the category of subpart F income from which it is derived, and then each of these categories must be grouped according to the applicable foreign tax credit limitation categories. Id.

(2) Second, any expenses that are definitely related to less than all of gross income as a class are allocated and apportioned under the principles of Treas. Reg. §§ 1.861-8 or 1.861-10T, as applicable, to income in each separate category. Treas. Reg. § 1.904-5(c)(2)(ii)(B). An expense is considered definitely related to a class of gross income, and therefore allocable to such class, if the CFC incurs the expense as a result of, or

incident to, an activity or in connection with property from which the class of gross income is derived. Treas. Reg. § 1.861-8(b)(2).

(3) Third, expense from related person interest is allocated to and reduces (but not below zero) the income in the passive foreign personal holding company income category (as determined in step 1, supra). Treas. Reg. § 1.904-5(c)(2)(ii)(C). For purposes of these rules, related person interest is defined as any interest paid or accrued by a CFC to any United States shareholder (within the meaning of section 951(b)) with respect to the CFC (or to any other related person) to which the look-through rules of section 904(d)(3) apply. Treas. Reg. § 1.904-5(c)(2)(i).

(4) Fourth, related person interest expense in excess of passive foreign personal holding company income ("excess related person interest expense") is apportioned among all of the CFC's remaining foreign tax credit limitation categories containing income using either the asset method or the modified gross income method (discussed infra). Treas. Reg. § 1.904-5(c)(2)(ii)(D).[10]

1. Determine Sub 1's Gross Income Within Each Category and Subcategory of Subpart F Income.

a. Subpart F Income Categories.

In accordance with rules summarized in the preceding paragraph, the first step in the process of allocating and apportioning Sub 1's expenses is to determine the amount of Sub 1's gross income in the applicable subpart F categories as described in Treas. Reg. § 4.954-1(c). Treas. Reg. § 1.904-5(c)(2)(ii)(A). As discussed above, Sub 1 reported the following income during the years at issue:

(1) management fees from the Contracting Subsidiaries under the Management Agreement;

(2) dividends from entities in which Sub 1 had a less than 10 percent ownership interest;

[10]The expense allocation and apportionment rules contain a fifth step applicable to expenses that are not definitely related expenses or that are definitely related to all of a CFC's gross income as a class. See Treas. Reg. § 1.904-5(c)(2)(ii)(E). Since the facts provided in connection with this memorandum indicate that Sub 1 did not have any expenses of this type, we will not discuss this step in this memorandum.

(3) interest from banks and other financial institutions unrelated to Sub 1;

(4) interest on a loan made by Sub 1 to its parent, Corp A; and

(5) capital gain from the sale of the two Related Subsidiaries.

Based on our examination of the facts provided in connection with this memorandum, we concluded that fees received by Sub 1 in connection with the Management Agreement likely constituted agency fees or commissions that did not qualify as foreign base company shipping income. We also concluded that the gross income described in paragraphs (2) - (4) was probably foreign personal holding company income within the meaning of section 954(c), not foreign base company shipping income as contended by Corp A. Finally, we concluded that the capital gain described in paragraph (5) constituted foreign base company shipping income only to the extent that (1) Sub 1's interest in each Related Subsidiary met the ownership requirements in section 902 as in effect during the years at issue, and (2) gain from the sale of each Related Subsidiary was attributable to its own foreign base company shipping income as described in Treas. Reg. §§ 1.954-6(f)(5)(i) and 1.954-6(f)(6). All other gain from the sale of the Related Subsidiaries likely constituted foreign personal holding company income within the meaning of section 954(c)(1)(B). Accordingly, for subpart F purposes, it appears that Sub 1's income during the years at issue consisted largely of foreign personal holding company income with possibly a small amount of foreign base company shipping income.

b. Foreign Tax Credit Limitation Categories.

Section 904(d)(2) defines the various foreign tax credit limitation categories. Based on the facts provided in connection with this memorandum, all of Sub 1's foreign base company shipping income, to the extent it received any, constituted income in the shipping foreign tax credit limitation category. See section 904(d)(2)(D).

With respect to the foreign personal holding company income received by Sub 1 during the years at issue, it appears that most, if not all, of that income constituted income in the passive foreign tax credit limitation category. See section 904(d)(2)(A)(i). Sub 1 was not predominantly engaged in the active conduct of a banking, financing, or similar business and thus none of the interest it received qualified as financial services income within the meaning of section 904(d)(2)(C). See section 904(d)(2)(A)(iii)(I) (income in the passive foreign tax credit limitation category does not include financial services income). Sub 1 owned less than 10 percent of the entities paying the dividends that it received, and therefore that income did not qualify

as dividends from noncontrolled section 902 corporations within the meaning of section 904(d)(2)(E). See section 904(d)(2)(A)(iii)(I) (income in the passive foreign tax credit limitation category does not include dividends from noncontrolled section 902 corporations). Finally, none of the dividends and interest received by Sub 1 during the years at issue qualified for look-through treatment under section 904(d)(3), since none of this income was paid by related entities entitled to look-through treatment under Treas. Reg. § 1.904-5. See Treas. Reg. § 1.904-5(c)(i).

The only foreign personal holding company income received by Sub 1 during the years at issue that may not constitute income in the passive foreign tax credit limitation category is the interest from the banks and other financial institutions unrelated to Sub 1. You will need to conduct additional fact development to determine whether such income constitutes high withholding tax interest within the meaning of section 904(d)(2)(B). To the extent that it does, that income will constitute income in that foreign tax credit limitation category and not income in the passive foreign tax credit limitation category.

2. Directly Allocate Sub 1's Expense from the Performance of Services.

The second step in the process of allocating and apportioning Sub 1's expenses is to allocate expenses that are definitely related to less than all of Sub 1's gross income as a class. The only definitely related expenses that have been claimed by the Sub 1 are expenses related to the management services. However, as discussed above, even if Sub 1 legitimately accrued fees in connection with the performance of services on behalf of the Contracting Subsidiaries, we do not believe that such fees constituted foreign base company shipping income, although they may have qualified as foreign base company services income within the meaning of section 954(e). To the extent Sub 1 incurred expenses in connection with these fees and these fees qualified as foreign base company services income, such expenses are allocable to these fees. If such allocation creates a net loss in this category of foreign base company income, the portion of the deficit attributable to this net loss would be available under the qualified chain deficit rule solely to offset foreign base company services income (if any) earned by the Shipping Subsidiaries. If you determine that Sub 1 actually received income related to the performance of services, we will be happy to provide additional guidance on applying the qualified chain deficit rule to determine what portion of Sub 1's deficits are attributable to this other income.

3. Directly Allocate Sub 1's Related Person Interest Expense To Its Passive Foreign Personal Holding Company Income.

The third step in the process of allocating and apportioning Sub 1's expenses is to allocate Sub 1's related person interest expense to and reduce (but not below zero) Sub 1's passive foreign personal holding company income. All of Sub 1's interest expense during the years at issue appears to have constituted related person interest expense, since all of its interest payments during that time were made on the Dividend Note to Corp A, its United States shareholder. Further, the facts indicate that Sub 1's related person interest expense greatly exceeded its passive foreign personal holding company income that it received during this period. Accordingly, for each year at issue, you will need to allocate to Sub 1's passive foreign personal holding company income an amount of its interest expense equal to such income.

4. Apportion Sub 1's Excess Related Person Interest Expense Among the Various Categories of Its Remaining Gross Income.

The fourth step in the process of allocating and apportioning Sub 1's expenses is to apportion Sub 1's excess related person interest expense between or among all of its remaining foreign tax credit limitation categories containing income. As discussed above, it appears that the only other foreign tax credit limitation categories of Sub 1 that contained income were the shipping basket and possibly the high withholding tax interest basket. Pursuant to Treas. Reg. § 1.904-5(c)(2)(ii)(E), Sub 1's excess related person interest expense must be apportioned among these statutory groupings in the manner described below.

a. Methods for Apportioning Excess Related Person Interest Expense of a CFC.

In general, a CFC apportions interest expense not directly allocable to a particular category of gross income using either the asset method of Treas. Reg. § 1.861-9T(g) or the modified gross income method of Treas. Reg. § 1.861-9T(f)(3)(i). If the asset method is used, the apportionment generally is made using the average total value of the CFC's assets within each such grouping for the taxable year computed on the basis of values at the beginning and end of the year. Treas. Reg. § 1.861-9T(g)(1)(i) and (2)(i). In determining the value of its assets, the CFC elects to use either their tax book value or their fair market value. Treas. Reg. § 1.861-9T(g)(1)(ii). Alternatively, if the modified gross income method is used, the apportionment is made on the basis of the CFC's gross income as determined under Treas. Reg. § 1.861-9T(j).[11]

[11]Note that domestic corporations are limited to apportioning their interest expense (continued...)

b. Procedure for Electing Method of Apportionment.

The decision to use either the asset method of apportionment or the modified gross income method of apportionment is made by the controlling United States shareholders on behalf of the CFC. See Notice 89-91, 1989-2 C.B. 408, 410 (stating Service's intent to clarify and amend Treas. Reg. § 1.861-9T(f)(3)(ii)). For this purpose, the term "controlling United States shareholders" means those United States shareholders (as defined in section 951(b)) who, in aggregate, own (directly or indirectly) more than 50 percent of the total combined voting power of all classes of stock of the CFC entitled to vote. Treas. Reg. § 1.861-9T(f)(3)(ii). The controlling United States shareholders make the election by attaching a written statement described in Treas. Reg. § 1.964-1(c)(3)(ii) to their return. Id. A controlling United States shareholder that apportions its interest expense under the asset method using the fair market value method of valuation may not elect the modified gross income method of apportionment on behalf of its CFCs. Treas. Reg. § 1.861-9T(f)(3)(i).

For reasons of simplicity and ease of administration, domestic corporations traditionally have chosen to apportion their interest expense under the asset method using the tax book value method of valuation, and domestic corporations that are controlling United States shareholders traditionally have elected the modified gross income method of interest expense apportionment on behalf of their CFCs. We were not provided with any information regarding the methods of interest expense apportionment used by Corp A and Sub 1. Accordingly, consistent with these trends, we have assumed for purposes of this memorandum that Corp A apportioned its interest expense using the asset method of apportionment and that it determined the value of its assets using the tax book value method of valuation. Similarly, we have assumed that Corp A elected the modified gross income method of apportionment on Sub 1's behalf. You will need to develop additional facts to determine whether these assumptions are correct. If you determine that these assumptions are not correct, we will be happy to provide additional guidance regarding the proper application of the interest expense allocation and apportionment rules in light of the new facts.

c. Apportion Sub 1's Excess Related Person Interest Expense Using the Modified Gross Income Method of Apportionment.

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[11](...continued)
using the asset method of apportionment. See Treas. Reg. § 1.861-9T(f)(1). They may not use the modified gross income method. However, like CFCs, when using the asset method of apportionment, they may choose either the fair market value method of valuation or the tax book value method of valuation. Treas. Reg. § 1.861-9T(g)(1)(ii).

As stated above, under the modified gross income method of apportionment, a CFC apportions its interest expense on the basis of its gross income. If a CFC does not own stock in any lower-tier CFC, its interest expense is allocated on the basis of its own gross income. Treas. Reg. § 1.861-9T(j)(1). In the case of a CFC that owns stock (either directly or indirectly) in any lower tier CFC, this rule is applied as follows:

(1) Commencing with the lowest-tier CFC in the chain, allocate and apportion that corporation's interest expense on the basis of its own gross income. This yields gross income in each grouping net of interest expense. Treas. Reg. § 1.861-9T(j)(2)(i).

(2) Moving to the next higher-tier CFC in the chain, combine the gross income of that corporation within each grouping with its pro rata share (as determined under principles similar to section 951(a)(2)) of the gross income net of interest expense of the lower-tier CFC within the same grouping subject to the following adjustments:

(a) exclude from the gross income of the upper-tier CFC any dividends or other payments received from the lower-tier corporation other than interest subject to look-through under section 904(d)(3); and

(b) exclude from the gross income net of interest expense of the lower-tier CFC any subpart F income (net of interest expense apportioned to such income).

Treas. Reg. § 1.861-9T(j)(2)(ii).

(3) Repeat the process in paragraph (2), supra, for each next higher-tier CFC in the chain. Treas. Reg. § 1.861-9T(j)(2).

The facts indicate that during the years at issue, Sub 1 received a nominal amount of passive foreign personal holding company income and that it possibly received nominal amounts of foreign base company shipping income and high withholding tax interest income. The facts also indicate that Sub 1's related person interest expense during the years at issue greatly exceeded the nominal amount of passive foreign personal holding company income that it received.

Sub 1 owned stock (both directly and indirectly) in the Shipping Subsidiaries. We have assumed for purposes of this memorandum that the only income received by the Shipping Subsidiaries was foreign base company shipping income. Pursuant to the rules prescribed by Treas. Reg. § 1.861-9T(j)(2)(ii) for applying the modified gross income method of apportionment in cases involving multiple tiers of CFCs, such income is effectively ignored when apportioning Sub 1's interest expense between (or among) its statutory and residual groupings of gross income other than its passive foreign personal holding company income.

Accordingly, Sub 1 ‘s excess related person interest expense must be apportioned among its remaining gross income based on the proportion that such income in each foreign tax credit limitation category bears to its total remaining income. See Treas. Reg. § 1.904-5(c)(2)(ii)(D)(1). This means that if Sub 1 received foreign base company shipping income and some high withholding tax interest income in a particular year at issue, its excess related person interest expense for that year will be apportioned among both of those categories of income based on the percentage of its total income (other than its passive foreign personal holding company income) that each of these categories of income reflects. The portion of Sub 1's deficit in its earnings and profits for that year that will be considered attributable to the qualified activity that generates foreign base company shipping income (and thus available under the qualified chain deficit rule to offset foreign base company shipping income of the Shipping Subsidiaries) will be the portion that bears the same relationship to its total deficit for that year that the net loss in its shipping basket bears to its total net losses for that year.

Alternatively, if Sub 1 did not receive any high withholding tax interest income, then all of its excess related person interest expense will be apportioned to its shipping basket, and the total amount of its deficit in its earnings and profits will be attributable to the qualified activity that generates foreign base company shipping income.

The analysis in this memorandum is based on a number of assumed facts. If you determine that the facts are different from what we have assumed and you need additional guidance applying these rules in light of the new facts, or you have any additional questions, please call Kelly Myers Kogan at (202) 622-3840.

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