

Application of Separate Limitations to Dividends From Noncontrolled Section 902 Corporations

Notice 2003-5

I. PURPOSE

This notice provides guidance relating to the application of section 904 to dividends paid by a foreign corporation that is a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) (10/50 corporation).¹ This guidance is necessary to reflect the provisions of the Taxpayer Relief Act of 1997 that modified the treatment of dividends from 10/50 corporations in taxable years beginning after December 31, 2002 (post-2002 taxable years). Treasury and the Service intend to issue regula-

tions concerning the treatment of dividends paid by a 10/50 corporation that incorporate the guidance set forth in this notice.

II. BACKGROUND

Prior to the Taxpayer Relief Act of 1997 (Public Law 105-34, 111 Stat. 788 (the 1997 Act)), section 904(d)(1)(E) required a domestic corporation meeting the stock ownership requirements of section 902(a) (qualifying shareholder) to compute a separate foreign tax credit limitation for dividends received from each 10/50 corporation. The 1997 Act eliminated the requirement that the foreign tax credit limitation be computed on the basis of a separate category (basket) for dividends from each 10/50 corporation, and instead provided that dividends paid by a 10/50 corporation out of earnings and profits accumulated in post-2002 taxable years (post-2002 earnings) generally will be treated as income in a separate basket based on the separate basket of the underlying earnings and profits being distributed (look-through treatment). Section 904(d)(4). Dividends paid by 10/50 corporations that are not passive foreign investment companies (PFICs) out of earnings and profits accumulated in taxable years beginning before January 1, 2003 (pre-2003 taxable years, and pre-2003 earnings), will be assigned to a single 10/50 dividend basket. Dividends paid by each 10/50 corporation that is a PFIC out of pre-2003 earnings will be assigned to a separate 10/50 dividend basket. Sections 904(d)(1)(E) and 904(d)(2)(E)(iv).

The 1997 Act amendments provide look-through treatment to qualifying shareholders for dividends paid by a 10/50 corporation in a manner similar to the treatment of dividends paid by a controlled foreign corporation (CFC). Dividends paid by a CFC to a U.S. shareholder (as defined in section 951(b)) are entitled to look-through treatment if the distribution is out of earnings and profits accumulated during periods in which the CFC was a CFC. Sections 904(d)(2)(E)(i) and 904(d)(3). A dividend paid by a CFC out of earnings accumulated when the CFC was not a CFC but was a 10/50 corporation is treated as a dividend from a 10/50 corporation. Accord-

¹Unless otherwise noted, references to section 904 in this notice are to the Internal Revenue Code of 1986 (Code), as in effect for taxable years beginning after December 31, 2002.

ingly, such a dividend receives look-through treatment if paid out of post-2002 earnings, but is treated as income in the single 10/50 dividend basket if paid out of pre-2003 earnings. Section 904(d)(3) extends look-through treatment to interest, rents, and royalties paid to a U.S. shareholder by a CFC as well as to inclusions of income under section 951(a)(1)(A) (subpart F inclusions). In the case of a 10/50 corporation, however, only dividends paid out of post-2002 earnings are eligible for look-through treatment.

III. APPLICATION OF LOOK-THROUGH RULES TO DIVIDENDS PAID BY 10/50 CORPORATIONS IN POST-2002 TAXABLE YEARS

A. In general

Under section 904(d)(4), dividends paid by a 10/50 corporation out of post-2002 earnings generally will be eligible for look-through treatment. Dividends paid by a 10/50 corporation out of pre-2003 earnings will be treated as income in the single 10/50 dividend basket (or, in the case of dividends from a PFIC, in a separate 10/50 dividend basket). Sections 904(d)(1)(E) and 904(d)(2)(E)(iv). Look-through treatment also applies to dividends paid by a CFC out of earnings accumulated during periods when it was a CFC. Section 904(d)(2)(E)(i). In light of this rule, Treasury and the Service believe that it is appropriate to provide comparable treatment for dividends paid by a 10/50 corporation out of such earnings. Accordingly, the regulations will apply look-through treatment to dividends paid by a 10/50 corporation out of pre-2003 earnings that were accumulated in periods during which the 10/50 corporation was a CFC, except as discussed below.

Proposed § 1.904-4(g)(3)(i)(C)(1) would not provide look-through treatment in the case of earnings accumulated while the distributing corporation was a CFC but distributed after a pre-2003 intervening period during which the distributing corporation was a 10/50 corporation. *See also* Proposed § 1.904-4(g)(3)(i)(C)(2) (providing the same result more generally where a look-through corporation has an intervening period during which such corporation was not a look-through corporation). Treasury and the Service are considering modifying the proposed regulations when they

are finalized to provide for look-through treatment in such cases.

B. Distributions by 10/50 corporations out of pre-acquisition earnings and profits

The Secretary is authorized to prescribe regulations regarding the treatment of distributions by a 10/50 corporation out of earnings and profits accumulated in periods prior to the taxpayer's acquisition of the stock. *See* section 904(d)(4)(C)(ii)(II). Pursuant to this authority, the regulations will apply look-through treatment to dividends paid to a new qualifying shareholder by a 10/50 corporation out of post-2002 earnings accumulated during periods when the foreign corporation was either a 10/50 corporation with respect to any qualifying shareholder or a CFC but before the recipient became a shareholder of the corporation. The regulations also will provide that dividends paid by a 10/50 corporation out of post-2002 earnings accumulated in periods when the 10/50 corporation was neither a 10/50 corporation with respect to any qualifying shareholder nor a CFC are assigned to the single 10/50 dividend basket in the case of a distribution from a 10/50 corporation that is not a PFIC, and to a separate 10/50 dividend basket in the case of a 10/50 corporation that is a PFIC. Consistent with § 1.904-4(g)(3)(iii) (concerning earnings accumulated in the taxable year in which a corporation becomes a CFC), the regulations also will provide that earnings and profits accumulated in the taxable year in which the corporation became a 10/50 corporation will be considered earnings and profits accumulated after the corporation became a 10/50 corporation.

C. Ordering rule for post-2002 distributions from 10/50 corporations

Under section 902(c)(3), the multi-year pools of post-1986 undistributed earnings (as defined in section 902(c)(1)) and post-1986 foreign income taxes (as defined in section 902(c)(2)) of a foreign corporation are determined by taking into account only periods beginning on and after the first day of the foreign corporation's first taxable year in which a domestic corporation owns 10 percent or more of its voting stock, or in the case of a lower-tier foreign corporation, such corporation is a

member of a "qualified group" (as defined in section 902(b)(2)).

Under section 902(c)(6)(B)(i), dividends are treated as paid first out of the post-1986 undistributed earnings. Pre-1987 accumulated profits (defined in section 902(c)(6)(A) and § 1.902-1(a)(10) to include both earnings accumulated in pre-1987 taxable years and earnings accumulated in post-1986 taxable years preceding the first year in which the foreign corporation has a qualifying shareholder) are treated as distributed only after the pools of post-1986 undistributed earnings are exhausted, and then out of annual layers of earnings and taxes on a last-in, first-out (LIFO) basis. Distributions out of pre-1987 accumulated profits are governed by the section 902 rules in effect under pre-1987 law. Section 902(c)(6)(A).

Section 1.904-4(g)(3)(i)(B) sets forth a LIFO ordering rule for determining the earnings to which a dividend paid by a CFC is attributable. The dividend is deemed made first from the pools of post-1986 undistributed earnings attributable to the period after the corporation was a CFC (look-through pools), next from the non-look-through pool of post-1986 undistributed earnings (as defined in § 1.904-4(g)(3)(iv)(B)), if any, and finally on a LIFO basis from the annual layers of pre-1987 accumulated profits. Since 10/50 corporations will be considered look-through entities beginning in post-2002 taxable years, the regulations will provide a similar LIFO ordering rule for dividends from a 10/50 corporation. Specifically, a dividend from a 10/50 corporation will be deemed made first from post-1986 undistributed earnings attributable to the post-2002 period when the corporation was eligible for look-through; second, from the non-look-through pool of post-1986 undistributed earnings; and finally, on a LIFO basis from pre-1987 accumulated profits. Treasury and the IRS request comments on the allocation of deficits in the look-through pools or the non-look-through pool in determining the earnings to which a dividend from a 10/50 corporation is attributable, consistent with the rules of § 1.902-2.

IV. ALLOCATING AND APPORTIONING EXPENSES OF 10/50 CORPORATIONS; DIVIDENDS PAID BY LOWER-TIER CORPORATIONS

A. Expense allocation

Because 10/50 corporations will be treated as look-through entities with respect to certain dividends paid in post-2002 taxable years, deductible expenses of a 10/50 corporation will reduce the corporation's pools of post-1986 undistributed earnings. The regulations will generally provide that expenses of a 10/50 look-through corporation will be allocated and apportioned in the same manner as expenses of a CFC. *See, e.g.*, section 954(b)(5); § 1.904-5(c)(2)(ii).

However, the regulations will not extend the special allocation rule for related person interest expense under section 954(b)(5) and § 1.904-5(c)(2)(ii) (providing that interest paid by a CFC to a U.S. shareholder or any related look-through entity is first allocated to reduce foreign personal holding company income which is passive income) to interest paid by 10/50 corporations, since such corporations are not look-through entities with respect to interest payments and are not subject to subpart F. Accordingly, all interest paid by a 10/50 corporation will be apportioned to reduce the payor's pools of post-1986 undistributed earnings under the rules applicable to unrelated person interest expense.

B. Look-through treatment of dividends paid by certain lower-tier corporations

In order for a taxpayer to qualify for look-through treatment with respect to a dividend from a 10/50 corporation, the taxpayer must be a qualifying shareholder with respect to the 10/50 corporation. Sections 904(d)(2)(E) and 904(d)(4). Because a shareholder's eligibility for look-through treatment under section 904(d)(4) is based on the eligibility requirements under section 902, the regulations will apply look-through treatment to a dividend paid by a 10/50 corporation to another foreign corporation where the recipient is eligible to compute foreign taxes deemed paid under section 902(b)(1), (*i.e.*, where both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2)).

A taxpayer's eligibility for look-through treatment of a dividend paid by a 10/50 corporation is based on eligibility requirements under section 902. In contrast, a taxpayer's eligibility for look-through treatment of a dividend from a CFC is based on whether the taxpayer is a U.S. shareholder with respect to the CFC. *See* sections 904(d)(3)(A) and 904(d)(3)(D). Treasury and the Service believe that the eligibility requirements for look-through treatment for 10/50 corporations and CFCs should be conformed to the extent possible, taking into account the differing eligibility requirements under the Code for look-through treatment of dividends from CFCs and 10/50 corporations. Accordingly, the regulations will apply look-through treatment to any dividend paid by a CFC to another member of the same qualified group (as defined in section 902(b)). Finally, the regulations will retain the current rule of § 1.904-5(i)(3), to the extent it applies look-through treatment to dividends between CFCs that have a common 10 percent U.S. shareholder but do not meet the qualified group test.

C. Tax accounting elections

Section 1.964-1(c)(3) permits "controlling U.S. shareholders" of a CFC to make or change tax accounting elections on behalf of the CFC. The controlling U.S. shareholders must meet several requirements before an election is deemed made on behalf of the CFC. *See* § 1.964-1(c)(3). Section 1.861-9T(f)(3)(ii) provides similar rules to allow the controlling U.S. shareholders to elect the asset method or modified gross income method for purposes of apportioning interest expense.

The regulations will apply similar rules in order to provide a mechanism for shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation for purposes of computing the 10/50 corporation's earnings and profits for U.S. tax purposes. Specifically, the regulations will permit the majority domestic corporate shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation (subject to generally applicable restrictions, such as elections requiring the consent of the Commissioner). The term "majority domestic corporate shareholders" means those domestic corporations that meet the ownership requirements of section 902(a) with

respect to the 10/50 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as the 10/50 corporation), that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all of the voting stock of the 10/50 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or a relevant first-tier foreign corporation). *See* § 1.985-2(c)(3)(i).

V. CARRYOVERS AND CARRYBACKS OF EXCESS FOREIGN TAXES UNDER SECTION 904(c)

Section 904(c) provides that to the extent a taxpayer's foreign income taxes paid or accrued in any taxable year exceed the limitation under section 904 for that year, the excess is carried back first to the second taxable year preceding the taxable year, and then to the first taxable year preceding the taxable year, and finally is carried forward to the five taxable years following the taxable year. As discussed below, regulations will provide transition rules for the carryover and carryback of excess foreign income taxes (excess credits) between pre-2003 taxable years (when pre-2003 distributions from 10/50 corporations are treated as income in separate 10/50 dividend baskets) and post-2002 taxable years (when distributions out of post-2002 earnings are subject to look-through treatment, and distributions out of pre-2003 earnings are treated as income in the single 10/50 dividend basket or, in the case of a PFIC, a separate 10/50 dividend basket).

Except as discussed below in Part VI.A, to the extent a taxpayer has pre-2003 excess credits in any non-PFIC separate 10/50 dividend basket and these credits are carried forward to post-2002 taxable years, the regulations will provide that such credits may be used to the extent that the single 10/50 dividend basket has excess foreign tax credit limitation. This treatment is consistent with consolidating in the single 10/50 dividend basket dividends paid by all non-PFIC 10/50 corporations out of pre-2003 accumulated earnings. Treasury and the Service do not believe that it is consistent with the statute to carry forward excess credits in the separate 10/50 dividend baskets, on a look-through basis, to the baskets to which dividends paid by a 10/50

corporation out of post-2003 earnings are assigned. Excess credits in separate 10/50 dividend baskets should be carried forward to the single 10/50 dividend basket and not the look-through baskets because such excess credits are most appropriately associated with pre-2003 earnings, dividends out of which are allocated to the single 10/50 dividend basket.

With respect to carrybacks of excess credits from post-2002 taxable years to pre-2003 taxable years, the regulations will apply a rule similar to the carryforward rule discussed above: to the extent a taxpayer has post-2002 excess credits in the single 10/50 dividend basket and these credits are carried back to pre-2003 taxable years, the credits will reduce excess limitation in separate 10/50 dividend baskets (other than 10/50 dividend baskets with respect to PFICs). If the amount of credits carried back to the 2001 or 2002 taxable year is smaller than the aggregate excess limitation in all of the taxpayer's separate 10/50 dividend baskets for the year, the regulations will provide that the amount will be allocated *pro rata* among the non-PFIC separate 10/50 dividend baskets based on the relative amount of excess limitation in each such basket. The regulations will provide that to the extent a taxpayer has post-2002 excess credits in a look-through basket and these credits are carried back to pre-2003 taxable years, the credits will be carried back within the same look-through basket and not to the separate 10/50 dividend baskets. Excess credits in one separate 10/50 dividend basket carried forward from taxable years beginning in 1998–2002 cannot then be carried back to reduce excess limitation in a different separate 10/50 dividend basket with excess limitation in taxable years beginning in 2001 or 2002. Under section 904(c), only foreign taxes that are paid or accrued in a taxable year (and not taxes that are carried forward from a prior taxable year) are eligible to be carried back to prior taxable years.

VI. SEPARATE LIMITATION LOSSES AND OVERALL FOREIGN LOSSES

Section 904(f) contains rules for allocating and recapturing foreign losses. To the extent a loss in a separate basket (separate limitation loss or SLL) exceeds income in the same basket, the SLL is allocated to and reduces income in other baskets on a proportionate basis. Section

904(f)(5)(B). The SLL is subject to recapture in subsequent years to the extent income is earned in the loss basket. Section 904(f)(5)(C). An overall foreign loss (OFL) arises where there is a loss in all of a taxpayer's baskets combined. To the extent an OFL reduces U.S. source taxable income, it is subject to recapture in subsequent years at a rate of 50 percent (or such larger percent as the taxpayer may choose) of any foreign source income earned. Section 904(f)(1); § 1.904(f)-1(d)(1). Since all the non-PFIC separate 10/50 dividend baskets will be replaced by a single 10/50 dividend basket in post-2002 taxable years, the regulations will provide transition rules, as described below, for recapture in a post-2002 taxable year of (1) an OFL or SLL in a separate 10/50 dividend basket that offset U.S. source income or foreign source income in other baskets in a pre-2003 taxable year, and (2) an SLL in another basket (*e.g.*, the general or passive basket) that offset income in a separate 10/50 dividend basket in a pre-2003 taxable year.

A. Recapture of an OFL or SLL arising in a separate 10/50 dividend basket

The regulations will provide that a taxpayer consolidates OFL and SLL accounts of non-PFIC separate 10/50 dividend baskets (*i.e.*, OFLs and SLLs arising in non-PFIC separate 10/50 dividend baskets that offset U.S. source income or foreign source income in other baskets, respectively) into one set of OFL and SLL accounts of the single 10/50 dividend basket beginning in the taxpayer's first post-2002 taxable year. Thus, for example, where a taxpayer had OFLs and SLLs in non-PFIC separate 10/50 dividend baskets that offset U.S. source income and foreign source income in the general and passive baskets, the OFL and SLL recapture accounts will be consolidated in the single 10/50 dividend basket, and income subsequently earned in the single 10/50 dividend basket will be recaptured as U.S. source income and foreign source income in the general and passive baskets to the extent of the respective OFL and SLL combined accounts. Any SLL recapture account in a non-PFIC separate 10/50 dividend basket with respect to another non-PFIC separate 10/50 dividend basket will be eliminated since "recapture" to and from the single 10/50 dividend basket would be meaningless.

Treasury and the Service recognize that requiring taxpayers to consolidate the separate 10/50 OFL and SLL recapture accounts into one set of OFL and SLL accounts of the single 10/50 dividend basket may be unfavorable to taxpayers that have an OFL or SLL account in a separate 10/50 dividend basket and that no longer are qualifying shareholders with respect to the foreign corporation. In pre-2003 taxable years, recapture of the OFL or SLL account would not occur because the taxpayer would not receive any additional dividends from the corporation that would be treated as 10/50 dividend income in the separate 10/50 loss basket (unless the former shareholder reacquired a sufficient interest in the corporation to become a qualifying shareholder). Accordingly, the regulations will provide that where a taxpayer no longer is a qualifying shareholder with respect to a foreign corporation on December 20, 2002 (or no longer is a qualifying shareholder on the first day of the taxpayer's first post-2002 taxable year, pursuant to a transaction that is the subject of a binding contract which is in effect on December 20, 2002), any OFL or SLL recapture accounts with respect to the taxpayer's separate 10/50 dividend basket for that corporation will not be consolidated into the single 10/50 dividend basket's OFL and SLL accounts.

Consistent with the exception for OFL and SLL accounts with respect to stock of a foreign corporation in which the taxpayer is no longer a qualifying shareholder, the regulations will not permit a taxpayer to carry over excess credits arising in separate 10/50 dividend baskets to the single 10/50 dividend basket where OFL and SLL accounts in the separate 10/50 dividend baskets are not consolidated into the OFL and SLL accounts of the single 10/50 dividend basket. However, the regulations will allow a taxpayer to elect to carry over all excess credits in non-PFIC separate 10/50 dividend baskets to the single 10/50 dividend basket if the taxpayer consolidates the OFL and SLL recapture accounts of all such separate 10/50 dividend baskets into the OFL and SLL accounts of the single 10/50 dividend basket.

B. Recapture of an SLL arising in other baskets

The regulations will provide that to the extent an SLL in another basket (*e.g.*, the general or passive basket) offset income in

a non-PFIC separate 10/50 dividend basket in a pre-2003 taxable year, income in the loss basket subsequently earned in post-2002 taxable years will be recaptured as income in the single 10/50 dividend basket. Recapturing SLL accounts that originally offset income in separate 10/50 dividend baskets as income in the single 10/50 dividend basket is consistent with the rule (discussed in Part V, above) permitting taxpayers to carry over excess credits from separate 10/50 dividend baskets into the single 10/50 dividend basket. For example, assume a general basket SLL offset income in a separate 10/50 dividend basket. In such a case, any excess credits in that separate 10/50 basket will carry over to the single 10/50 dividend basket, and general basket income in a post-2002 taxable year will be recharacterized as income in the single 10/50 dividend basket.

VII. TREATMENT OF SEPARATE 10/50 DIVIDEND BASKETS MAINTAINED AT THE CFC LEVEL

Where a CFC has non-PFIC separate 10/50 dividend baskets containing earnings and deficits accumulated in pre-2003 taxable years, the regulations will require, as a general rule, that the earnings and deficits be consolidated in and form the opening balance of the earnings pool of the single 10/50 dividend basket beginning in the CFC's first U.S. post-2002 taxable year. The pools of post-1986 foreign income taxes in the non-PFIC separate 10/50 dividend baskets similarly will be consolidated in the post-1986 foreign income taxes pool of the single 10/50 dividend basket. However, a separate 10/50 dividend basket containing non-look-through earnings of the CFC accumulated in periods prior to becoming a CFC will not be consolidated. These earnings will be treated as earnings in the non-look-through pool of post-1986 undistributed earnings, which are deemed distributed only after distributions exhaust the post-1986 look-through pools, which include the earnings in the pool of the post-2002 single 10/50 dividend basket. *See* § 1.904-4(g)(3)(i)(B).

The regulations also will provide an exception from the general rule combining earnings and deficits and foreign income taxes where a CFC has an accumulated deficit in a separate 10/50 dividend basket with respect to stock in a foreign corporation that is no longer a member of a

qualified group that includes the CFC. Treasury and the Service were concerned that requiring consolidation in this case could result in a large deficit in the single 10/50 dividend basket for some CFCs. Treasury and the Service also believe it is appropriate in this situation to simplify the general rule requiring the ratable allocation of deficits in determining deemed-paid taxes in connection with distributions or inclusions. *See* § 1.960-1(i)(4). Accordingly, the regulations will provide that where a CFC has a deficit in a separate 10/50 dividend basket with respect to stock in a foreign corporation that is not a member of a qualified group that includes the CFC on December 20, 2002 (or is not a qualified group member on the first day of the CFC's first post-2002 taxable year pursuant to a binding contract in effect on December 20, 2002), the deficit in the separate 10/50 dividend basket will not be consolidated in the opening balance of the CFC's single 10/50 dividend basket. Instead, the deficit will be allocated to reduce post-1986 undistributed earnings in the CFC's other baskets (ratably on the basis of accumulated earnings in the other baskets as of the first day of the CFC's first post-2002 taxable year), and the deficit will be permanently reduced to zero. In pre-2003 taxable years, only dividend income from the same 10/50 corporation could eliminate the deficit in the separate 10/50 dividend basket, so that if the 10/50 corporation was no longer a member of the same qualified group as the CFC, the CFC would not have any additional earnings in that basket out of which to pay a dividend, and its U.S. shareholder therefore would be ineligible to claim an indirect credit with respect to any foreign taxes in the deficit basket. *See* § 1.902-1(b)(4). Accordingly, any foreign taxes in the separate 10/50 dividend basket will remain in that basket, and a qualifying shareholder of the CFC generally will not be eligible to claim an indirect credit for these taxes.

VIII. EFFECTIVE DATE

Regulations to be issued relating to the guidance set forth in this notice will be effective for taxable years beginning after December 31, 2002. Until such regulations are issued, taxpayers may rely on this notice.

IX. REQUEST FOR COMMENTS AND CONTACT INFORMATION

Treasury and the Service request comments on the rules described in this notice and any additional issues that should be addressed by regulations. Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Ginny Chung (Notice 2003-5), room 4555, CC:INTL:Br3, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.Comments@m1.irs.counsel.treas.gov. Comments will be available for public inspection and copying. Treasury and the IRS request comments by February 18, 2003. For further information regarding this notice, contact Ginny Chung of the Office of Associate Chief Counsel (International) at (202) 622-3850 (not a toll-free call).