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December 4, 2006

Mr. Eric Solomon  
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The Honorable Mark W. Everson  
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### Re: Report on Section 954(c)(6)

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1123. The Report discusses issues raised in connection with section 954(c)(6), which provides an exclusion from foreign personal holding company income status for payments made by a controlled foreign corporation (a "CFC") to a related CFC, where the payments consist of interest, rent, royalties, or dividends. The Report's recommendations are summarized as follows:

1. Section 954(c)(6) provides that in order for an amount to be eligible for the exclusion, it must be allocable to non-subpart F income, and that in determining whether payments are allocable to non-subpart F income, payments should be allocated under the rules applicable to payments under the regulations promulgated under sections

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904(d)(3)(C) and (D). While there is some potential for mismatching in applying the foreign tax credit rules of section 904 – which differentiate between passive and active income – to section 954(c)(6), which differentiates between subpart F and non-subpart F income, we see no compelling reason to deviate from the statute. Regulations should address the situation where a distribution is allocable to previously taxed income (“PTI”) and confirm that pre-acquisition earnings qualify for look-through treatment. Additionally, we believe that (i) in determining whether an amount is allocable to non-subpart F income, interest, rents and royalties that are deducted against amounts that would otherwise qualify for the high-tax exception should be considered to be allocable to non-subpart F income and (ii) if a payment fails to qualify under section 954(c)(6) because of a deficit in the earnings and profits (“E&P”) of the payor (as provided in the Technical Corrections Bill), the recipient should be entitled to an offsetting deduction, as, when and if the payor is required to recapture subpart F income under section 952(c)(2).

2. Unlike the same-country exception in section 954(c)(3), which excludes payments allocable to subpart F income, section 954(c)(6) requires that a payment be allocable to non-subpart F income. The latter formulation technically disqualifies any payment by a related CFC that has no income, even if it also has no subpart F income. We are uncertain whether this result was intended. The Report outlines three possible approaches to address this issue.

3. Factoring discount treated as income equivalent to interest under section 954(c)(1)(E) is explicitly made eligible for the exclusion under section 954(c)(6) by including the discount income within the definition of “interest.” We believe that in factoring arrangements that constitute financings, the seller of the receivable should be treated as the payor of the interest. It is appropriate for this purpose to treat the source of the discount income differently from discount arising in a sale of a trade or service receivable subject to the related person factoring rules of section 864(d), which look to the obligor rather than the seller.

4. Payments that are treated as “dividends” under the new provision should include payments treated as dividends under section 304 and amounts treated as dividends under section 964(e).

5. The rules currently applicable to payments received by partnerships under Treasury Regulation § 1.702-1(a)(8)(ii) and § 1.952-1(g) should apply for purposes of determining whether an amount is eligible for exclusion. No specific provision like those contained in Treasury Regulations §§ 1.954-1(g), 1.954-2(a)(5)(ii), 1.954-3(a)(6), and 1.954-4(b)(2)(iii) would appear relevant.

6. With respect to payments paid by a partnership, the existing rules applicable to partnership payments under Treasury Regulation § 1.954-2(b) provide an appropriate framework for purposes of determining whether an amount is eligible for exclusion. Under these provisions, if a partnership whose partners consist of corporate partners makes a payment of interest, rents, or royalties, a corporate partner will be treated as the payor of the interest, rents, or royalties if the rent or royalty payment gives rise to a partnership item of deduction to the extent the item of deduction is allocable to

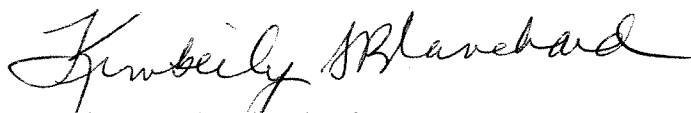
the corporate partner under section 704(b) or, where it is not specifically allocable, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)). Regulatory guidance should extend these provisions to section 954(c)(6).

7. Section 954(c)(6) authorizes the Secretary to promulgate anti-abuse rules. In doing so, the Secretary could take either of two approaches. One approach is to adopt an anti-abuse rule along the lines of the partnership anti-abuse rules, denying effect to any transaction that reduces the taxpayer's tax liability and that is inconsistent with the intent of section 954(c)(6), setting forth examples of transactions that are consistent with the intent of the section and those which are not. An alternative approach would be to write a narrow anti-abuse rule aimed at specific transactions, providing specific examples of prohibited transactions and transactions that do not invoke application of the prohibition. Transactions covered by the anti-abuse rule might include those that contain conduit features as a result of which the character of an item of income is changed from subpart F to non-subpart F income. Many of our members do not believe that anti-abuse rules should extend to foreign tax credit planning generally.

8. Two transition issues are presented by the enactment of section 954(c)(6). The first is with respect to the situation where payments were made between related CFCs in periods preceding the enactment date, but following the effective date. The second is for those taxpayers that find it necessary to reorganize in the event the legislation is not extended past its sunset. Some of our members believe that a technical correction to the statute is necessary to address the first issue.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

  
Kimberly S. Blanchard  
Chair

Enclosure

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