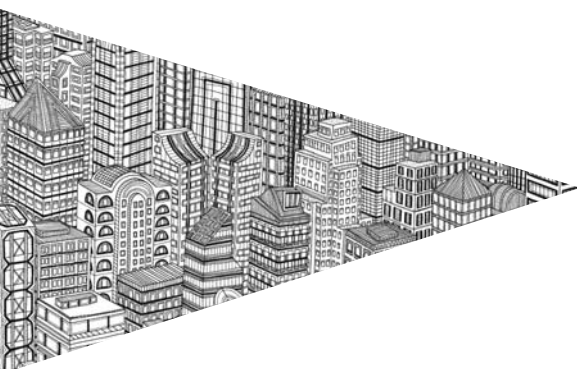


International Tax Alert



Proposed regulations clarify rules for controlling domestic shareholders to adopt, change method of accounting or taxable year on behalf of foreign corporation

Executive summary

On 4 November 2011, the Treasury Department (Treasury) released proposed regulations (Proposed Regulations), and withdrew previously proposed regulations issued in 1992 (the 1992 Proposed Regulations).¹ Similar to the 1992 Proposed Regulations, the Proposed Regulations would clarify the rules for controlling domestic shareholders to adopt or change a method of accounting or taxable year on behalf of a foreign corporation pursuant to Reg. Section 1.964-1. The Proposed Regulations also provide clarification of the required book-to-tax adjustments required under Reg. Section 1.964-1, including those in respect of depreciation and amortization, and provide useful examples illustrating the application of Reg. Section 1.964-1(a) and (c). Finally, the Proposed Regulations provide rules regarding method changes initiated by the IRS on audit.

The Proposed Regulations will apply to the computation of the earnings and profits of foreign corporations in taxable years of foreign corporations beginning on or after the date the Proposed Regulations are finalized, and taxable years of shareholders with or within which such taxable years of the foreign corporations end.

In 1991, Treasury issued proposed regulations (the 1991 Proposed Regulations) that provide a special definition of controlling domestic shareholders for certain controlled foreign corporations with insurance income. These proposed regulations have not been withdrawn. However, in the preamble to the Proposed Regulations, Treasury requests comments on whether the special control group definition contained in the 1991 proposed regulations should be adopted.

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Detailed discussion

Reg. Section 1.964-1 generally provides that earnings and profits (E&P) of a foreign corporation are computed by preparing a profit and loss statement from the corporation's books and making material adjustments necessary, to conform such statement to US financial and tax accounting principles. The regulations provide that action by or on behalf of a foreign corporation to make an election, or adopt a taxable year or method of accounting will be required on the due date (including extensions) of the return for a controlling US shareholder's first taxable year with or within which ends the foreign corporation's first taxable year where the earnings and profits computation is significant for US tax purposes.² In this respect, the regulations list non exclusive list of events that cause a foreign corporation's earnings and profits to have US tax significance.³

The Proposed Regulations provide clarification of the required book-to-tax adjustments, including those in respect of depreciation and amortization. Specifically, the Proposed Regulations provide that depreciation and amortization shall be computed in accordance with the provisions of Section 312(k) and the regulations under that section. In the case of a foreign corporation described in Section 312(k)(4) (one with less than 20 percent US-source gross income), depreciation and amortization of items that are not

described in Section 312(k)(2) or (k)(3) shall be determined under the rules for determining taxable income. For example, amortization for amortizable Section 197 intangibles (as defined in Section 197(c)) is calculated in accordance with Section 197, and depreciation for real property is calculated in accordance with Section 168(g)(2)(C)(iii). For any taxable year beginning before 1 July 1972, depreciation shall be computed in accordance with Section 167 and the regulations under that section.

The Proposed Regulations also provide that once a method of accounting or taxable year is adopted, such method of accounting or taxable year may be changed by or on behalf of the foreign corporation only in accordance with the applicable provisions of the Internal Revenue Code and regulations. The Proposed Regulations provide a number of examples illustrating the application of Reg. Section 1.964-1(a) and (c). The examples are helpful illustrations of the principles of the regulations and are consistent with the plain meaning of Reg. Section 1.964-1. Thus, the examples clarify the impact of making an accounting method election in a year to the calculation of CFC earnings for prior years, the impact on a minority shareholder that uses the tax book value method when the majority shareholder is not required to make or adopt an election or method of accounting

or tax year until a subsequent year, and the impact of the application of the regulations to 10/50 companies for taxable years beginning after 25 April 2006.

The Proposed Regulations also provide that if, in connection with an audit (or audits) of one or more shareholders of the foreign corporation who collectively would constitute the foreign corporation's controlling domestic shareholder(s) if they undertook to act on the corporation's behalf, the Internal Revenue Service (the IRS) determines that a method of accounting of the foreign corporation does not clearly reflect income, the computation of earnings and profits shall be made in a manner which, in the opinion of the IRS, does clearly reflect income.⁴ The IRS is required to provide written notice of the change in method of accounting to each such shareholder and to all other persons known by the IRS to be domestic shareholders who own (within the meaning of Section 958(a)) stock of the foreign corporation. However, failure of the IRS to provide such notice to any such other person shall not invalidate the change of method, which shall bind both the foreign corporation and all of its domestic shareholders as to the computation of the foreign corporation's earnings and profits for the taxable year of the foreign corporation for which the method of accounting is changed and in subsequent taxable years unless the IRS consents to a change.⁵

The Proposed Regulations are to have a prospective effective date and will apply to the computation of the earnings and profits of foreign corporations in taxable years of foreign corporations beginning on or after the date the Proposed Regulations are finalized, and taxable years of shareholders with or within which such taxable years of the foreign corporations end.

Implications

The Proposed Regulations provide useful guidance with respect to the book-to-tax adjustments required under Reg. Section 1.964-1. In particular, the regulations clarify the calculation of depreciation and amortization to take into account the exception under Section 312(k)(4) for certain foreign corporations that have less than 20 percent US source

gross income. In addition, while the conclusions of the added examples are not unexpected, they are nevertheless helpful in illustrating how the principles of Reg. Section 1.964-1 are to be applied. Finally, the regulations also explicitly describe the authority of the IRS on audit to compute earnings and profits if the method of accounting adopted by the CFC does not clearly reflect income.

Endnotes

1. 57 FR 29246.
2. Treas. Reg. Section 1.964-1(c)(6).
3. *Id.*
4. Proposed Reg. Section 1.964-1(c)(9),
5. *Id.*

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