DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
NORTHERN CALIFORNIA DISTRICT, SAN FRANCISCO
ATTN: THOMAS G. SCHLEIER,
ASSISTANT DISTRICT COUNSEL

FROM: Barbara A. Felker
Chief CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated February 10, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Corp A =
Tax year M =
Tax year N =
Form x =

ISSUE

Whether, for purposes of apportioning interest expense, Corp A may use restated financial earnings for pre-1987 tax years in computing the adjusted basis in stock of its controlled foreign corporations under section 1.861-12T(c)(2) of the Temporary Income Tax Regulations where the restatement of prior year earnings was permitted, but not mandated, under revised guidelines issued by the Financial Accounting Standards Board in 1987.

CONCLUSION

Solely for purposes of allocating and apportioning interest expense, Corp A may use restated pre-1987 financial earnings to compute its adjusted basis in stock of its controlled foreign corporations pursuant to section 1.861-12T(c)(2), provided that restated financial earnings are used for all foreign corporations as required by section 1.861-12T(c)(2)(iv).

FACTS

Corp A is a United States corporation that files its federal income tax returns on a calendar year basis. Corp A has a substantial number of controlled foreign corporations (CFCs). For financial accounting purposes, Corp A computes the earnings of such CFCs using United States generally accepted accounting principles (GAAP). In 1986, Corp A computed the financial earnings of its CFCs using then-current GAAP accounting principles.

In December of 1987, the Financial Accounting Standards Board issued Statement No. 96 (FASB 96), which provided new guidelines for accounting for income taxes. As a result of the new guidelines, a company must annually adjust its deferred tax account by an amount equal to the difference between the book basis and the tax basis of its assets, multiplied by the tax rate in the taxing jurisdiction. FASB 96 was made effective for fiscal years beginning after December 15, 1988, although earlier application was encouraged.

Effective January 1, 1988, Corp A adopted the new guidelines under FASB 96 retroactively to January 1, 1986. Under FASB 96, the pre-1987 financial earnings of certain of Corp A’s CFCs were less than earnings computed under the previously-applicable GAAP rules. Corp A restated its 1986 and 1987 consolidated financial statements to reflect these changes and noted such changes in financial earnings on its 1988 Form x.

Prior to tax year M, Corp A used the pre-1987 financial earnings for its CFCs from the original 1986 financial statement in calculating adjustments to its basis in the stock of its CFCs pursuant to the method set forth in section 1.861-12T(c)(2)(iv). However, for tax year M through tax year N, Corp A used the financial earnings as restated under the FASB 96 guidelines, resulting in a smaller adjustment to its basis in the CFCs’ stock and a corresponding decrease in the amount of interest expense apportioned to foreign source income under section 864(e) of the Internal Revenue Code.

LAW AND ANALYSIS

Pursuant to section 864(e) of the Code[1], the taxable income of each member of an affiliated group is determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation, and all allocations and apportionments of interest expense are made on the basis of assets rather than gross income. Sections 864(e)(1) and (2). Section 864(e)(4) requires that, for purposes of allocating and apportioning expenses on the basis of assets, the adjusted basis of any stock in a nonaffiliated 10-percent owned corporation shall be: (i) increased by the amount of the earnings and profits of such corporation attributable to such stock and accumulated during the period the taxpayer held such stock, or (ii) reduced (but not below zero) by any deficit in earnings and profits of such corporation attributable to such stock for such period.

Sections 1.861-8T through -14T of the Temporary Income Tax Regulations, relating to the allocation and apportionment of interest and other expenses, were issued in September of 1988, effective for taxable years beginning after December 31, 1986. Section 1.861-12T(c)(2) provides further guidance on how to make the required basis adjustment for stock of a nonaffiliated 10-percent owned corporation. Section 1.861-12T(c)(2)(i) restates the adjustment to basis requirement of section 864(e)(4). Section 1.861-12T(c)(2)(iv) provides, in part, that, solely for purposes of determining the adjustment required under section 1.861-12T(c)(2)(i), for tax years beginning after 1912 and before 1987, financial earnings (or losses) of a foreign corporation computed using GAAP may be substituted for earnings and profits in making the required adjustment.

Section 1.861-12T(c)(2)(iv) further provides that a taxpayer is not required to isolate the financial earnings of a foreign corporation derived or incurred during its period of 10-percent ownership or during the post-1912 taxable years and determine earnings and profits (or deficits) attributable under section 1248 principles to the taxpayer’s stock in a 10-percent owned corporation. Instead, the taxpayer may include all historic financial earnings for purposes of this adjustment. If the affiliated group elects to use financial earnings with respect to any foreign corporation, financial earnings must be used by that group with respect to all foreign corporations, except that earnings and profits may, in any event, be used for controlled foreign corporations for taxable years beginning after 1962 and before 1987. However, if the affiliated group elects to use earnings and profits with respect to any single controlled foreign corporation for the 1963 through 1986 period, such election shall apply with respect to all its controlled foreign corporations. Section 1.861-12T(c)(2)(i) also provides that the basis adjustment for stock in a nonaffiliated 10-percent owned corporation is to be made annually and is noncumulative.

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[1]Section 864(e) was added to the Internal Revenue Code by section 1215 of the Tax Reform Act of 1986 (P.L. 99-514, 1986-3 C.B. 1, at 461). Its provisions are generally effective for taxable years beginning after December 31, 1986.

The only issue presented is whether Corp A can properly use restated pre-1987 financial earnings, as determined under FASB 96, to compute the basis adjustment required by section 1.861-12T(c)(2) for stock in nonaffiliated 10-percent corporations for purposes of allocating and apportioning its interest expense for tax year M through tax year N. Stock in nonaffiliated 10-percent owned corporations would include the stock of Corp A's CFCs.

The Code and the legislative history of section 864(e) provide no guidance on how to determine the financial earnings of such corporations prior to 1987 for purposes of adjusting the basis of such stock in the hands of Corp A. The temporary regulations under section 1.861-12T(c)(2)(iv) refer only to U.S. GAAP, without elaboration. The temporary regulations were proposed in September of 1987, prior to the issuance of FASB 96, and were issued in September of 1988, subsequent to the FASB 96 rule change. Corp A adopted the guidelines of FASB 96 on January 1, 1988, effective retroactively to 1986. Therefore, Corp A arguably should have used FASB 96 to compute pre-1987 financial earnings for purposes of interest expense apportionment beginning with the 1987 tax year, the first year for which the 1988 temporary income tax regulations implementing section 864(e) were effective.

Corp A's use of restated CFC financial earnings in computing adjustments to asset basis for purposes of interest expense apportionment for tax year M through tax year N, while different from the method used to compute financial earnings for prior years, does not constitute a change in a method of accounting since it does not affect the timing of a deduction. The change affects the apportionment of interest expense between U.S. and foreign source income, but does not affect the amount of interest expense that is deductible in any given year.

Solely for the purpose of determining the basis adjustment for stock in a 10-percent owned nonaffiliated corporation, section 1.861-12T(c)(2)(iv) permits a taxpayer to use GAAP to establish the financial earnings of a foreign corporation for tax years beginning after 1912 and before 1987. This basis adjustment calculation is an annual computation that is not cumulative. Corp A's use of restated financial earnings under FASB 96 is a permitted method under the regulations that is consistent with Corp A's adoption of the guideline effective as of January 1, 1988.

If you have any further questions, please call (202) 622-3850.

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