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## MEMORANDUM

Re: Foreign Tax Developments – I.R.C. § 951 Proposed Regulations and Barbados Protocol

From: Lori J. Brown and Biruta P. Kelly

Date: August 24, 2004

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### **Prop. Treas. Reg. § 1.951-1(e)**

Generally, I.R.C. § 951(a)(1) requires a U.S. shareholder of a controlled foreign corporation (CFC) to be taxed on such shareholder's pro rata share of the CFC's subpart F income. This month the IRS proposed regulations to determine such pro rata share, proposed to be effective for taxable years of CFC's beginning on or after January 1, 2005.

#### CFC's with One Class of Stock

The proposed regulations add an explicit rule to clarify the method by which a U.S. shareholder's pro rata share is determined in the case of the CFC having only one class of stock outstanding. In those cases, the U.S. shareholder's share shall be determined on a per share basis. Prop. Treas. Reg. § 1.951-1(e)(2).

#### CFC's with Multiple Classes of Stock

The guidance retains the existing basic approach which requires taxpayers to calculate Subpart F income using a particular ratio which reflects hypothetical distributions of earnings and profits in certain cases. This rule applies where the allocation of the amount of the CFC's earnings and profits among the different classes of stock is not dependent on the decision of the board of directors. Prop. Treas. Reg. § 1.951-1(e)(3)(i). However, a new rule applies where the

distribution of earnings among two or more classes of stock is dependent on the exercise of discretion by the board of directors or similar body. Generally, the earnings and profits are allocated to the classes of shares with discretionary distribution rights by reference to the relative values of such classes of stock on the hypothetical distribution date. Prop. Treas. Reg. § 1.951-1(e)(3)(ii). When the value of each share of two or more classes of stock with discretionary distribution rights is generally the same, for purposes of allocating earnings and profits, each class of stock will be treated as if they constitute one class of stock.

In cases of stock with mixed distribution rights, the proposed regulations require separate allocations of earnings and profits based on the non-discretionary distribution rights and the relative value of the discretionary distribution rights. Prop. Treas. Reg. § 1.951-1(e)(3)(iii). Additionally, the proposed regulations contain a special rule that no amount shall be considered to be a distribution with respect to a particular stock of class, if that distribution takes the form of a distribution in redemption of stock, a distribution in liquidation, or a return of capital. Prop. Treas. Reg. § 1.951-1(e)(4).

#### Stock with Restrictions on Distributions

Finally, the proposed rules provide that, except for cases in which there is a governmental restriction as described in I.R.C. § 964(b), a restriction or limitation of the distribution of earnings and profits to a U.S. shareholder from the CFC will not be taken into consideration when determining the amount of earnings and profits allocated to a class of stock or the amount of the U.S. shareholder's pro rata share. Prop. Treas. Reg. § 1.951-1(e)(5). This rule will apply in all cases, regardless of whether the restriction or limitation is the result of an arrangement between unrelated parties, or a non-tax motivated business purpose.

#### **Barbados Protocol**

In July the Treasury Department released a signed Protocol to the treaty with Barbados, proposing a new limitations on benefits provision. The negotiators were focusing on the denial of treaty benefits to companies that had "inverted." Consequently, the limitation on benefits language is extremely restrictive and even makes it very difficult for Barbados subsidiaries of U.S. corporations that are publicly traded in the U.S. to qualify for benefits under the treaty, without requesting a Competent Authority determination. The Protocol is not yet effective, but when it enters into force, it will apply to all companies currently in existence. Barbados companies, therefore, should review the provisions of the Protocol to determine whether they will continue to qualify for treaty benefits.

The Protocol also contains a definition of "insurance company" (for purposes of the active trade or business test for qualifying for treaty benefits) that excludes a reinsurance company. Such rule emphasizes how restrictive the new Protocol is.