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Memorandum

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to:

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subject: Sections 302, 312 and 902(c)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether a foreign corporation's post-1986 foreign income taxes must be reduced when a minority shareholder's stock in the foreign corporation is redeemed pursuant to section 302(a)¹ and, as a consequence, the post-1986 undistributed earnings of the foreign corporation are reduced pursuant to section 312(a).

CONCLUSION

When a foreign corporation's post-1986 undistributed earnings are reduced under section 312(a) pursuant to a section 302(a) redemption, a corresponding reduction of the foreign corporation's post-1986 foreign income taxes is also required.

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

FACTS

U.S. Parent (USP) owns 60% of the stock of a controlled foreign corporation (CFC). The other 40% of the stock is owned by an unrelated foreign party (FP). CFC does not earn any subpart F income.

In Year 1, CFC redeems all of the stock owned by FP by way of a distribution of cash. Pursuant to section 302(b)(3), the redemption is treated as a section 302(a) distribution in full payment in exchange for the stock.

After the redemption, USP owns 100% of the stock of CFC.

The distribution of cash in the redemption results in a reduction of the post-1986 undistributed earnings of CFC pursuant to section 312(a). Section 312(n)(7) limits this reduction to an amount equal to FP's pro-rata share of CFC's post-1986 undistributed earnings.

In Year 2, CFC pays its entire remaining post-1986 undistributed earnings to USP as a dividend and USP claims a section 902 deemed paid foreign tax credit equal to CFC's total post-1986 foreign income taxes.

LAW AND ANALYSIS

1. Statute and Regulations

Section 902 provides that a domestic corporation that owns at least 10% of the voting stock of a foreign corporation will be deemed to have paid a portion of the foreign income taxes paid by that foreign corporation (the "section 902 corporation") when it receives a dividend from the section 902 corporation. The amount of the section 902 corporation's foreign income taxes deemed to have been paid is equal to the same proportion of the section 902 corporation's post-1986 foreign income taxes that the amount of the dividend bears to the section 902 corporation's post-1986 undistributed earnings.² The purpose of the section 902 deemed paid credit is to avoid double taxation of a U.S. corporation on income earned through a foreign subsidiary as well as to eliminate the disparity that would otherwise exist between foreign branches and foreign subsidiaries of U.S. corporations by allowing the U.S. corporation a credit corresponding to the direct credit it would have been allowed had the U.S. corporation earned the foreign-taxed income through a foreign branch. See U.S. v. Goodyear Tire & Rubber Co., 493 U.S. 132, 141 (1989).

Section 902(c) defines post-1986 undistributed earnings as the earnings and profits of a section 902 corporation (computed in accordance with sections 964(a) and 986)

² Under section 960(a)(1), which provides that section 902 shall be applied as if a section 951(a) inclusion were a dividend, foreign taxes are also deemed paid in connection with an income inclusion under subpart F.

accumulated in taxable years beginning after 1986 as of the end of the section 902 corporation's taxable year, without diminution by reason of dividends paid during the year. Section 964 and Treas. Reg. §1.964-1(a)(1) generally provide that the earnings and profits of a foreign corporation are computed substantially as if such corporation were a domestic corporation, that is, in accordance with the rules of section 312. See Treas. Reg. §1.902-1(a)(9).

Section 902(c) defines post-1986 foreign income taxes as the foreign income taxes paid by a section 902 corporation with respect to the taxable year in which the dividend is paid as well as foreign income taxes paid with respect to prior taxable years beginning after December 31, 1986, to the extent the foreign taxes are not attributable to dividends distributed by the section 902 corporation in prior taxable years.

Section 902(c)(8) provides authority for regulations as may be necessary or appropriate to carry out the provisions of section 902.³ See generally Mayo Foundation for Medical Education and Research v. United States, 131 S. Ct. 704 (2011).

Treas. Reg. § 1.902-1(a)(8)(i) provides, in part:

Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not attributable to dividends distributed to, or earnings otherwise included (for example, under section 304, 367(b), 551, 951(a), 1248, or 1293) in the income of, a foreign or domestic shareholder in prior taxable years. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by a foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (for example, an individual or a corporation that owns less than 10% of the foreign corporation's voting stock), or

³ Section 902(c)(8) states:

The Secretary shall provide such regulations as may be necessary or appropriate to carry out the provisions of this section and section 960, including provisions which provide for the separate application of this section and section 960 to reflect the separate application of section 904 to separate types of income and loss.

to a foreign person that does not meet the definition of an upper-tier corporation under paragraph (a)(6) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. (Emphasis added.)

2. History of Statute and Regulations

The current post-1986 multi-year “pooling rules” under section 902(c) revised prior law under which deemed paid credits were determined based on annual accounts of earnings and foreign income taxes. The pooling rules were enacted in 1986 in part to prevent the loss of deemed-paid foreign tax credits in situations in which a section 902 corporation had earnings and profits deficits in one or more years but paid foreign taxes in those years.⁴ The pooling rules also were enacted to limit foreign tax credit planning that timed repatriations to take advantage of foreign subsidiaries’ varying effective foreign tax rates from one year to another by accumulating earnings in years in which the effective foreign tax rate was low and distributing earnings in years in which the effective tax rate was high.⁵ The pooling rules therefore represent Congress’ attempt to ensure that the amount of a taxpayer’s indirect foreign tax credit is determined based on the average effective rate of foreign tax associated with foreign earnings over time. If there is no corresponding reduction to post-1986 foreign income taxes for taxes associated with post-1986 undistributed earnings that have been eliminated, there will be a distortion in the average effective rate of tax associated with the remaining earnings, thereby frustrating a principal goal of the pooling rules. In addition, the result would run counter to the broader policies of section 902 concerning the avoidance of double taxation and achieving branch/subsidiary parity if USP is allowed a credit for foreign income taxes that relate to earnings of CFC that USP does not take into account as income.

After Treas. Reg. § 1.902-1(a)(8) was issued in proposed form, the Service became aware that some taxpayers were taking the position that a section 902 corporation’s post-1986 foreign income taxes were required to be reduced only for taxes attributable to distributions with respect to which a shareholder both was eligible to claim a credit for taxes deemed paid under section 902(a) and in fact elected to credit, rather than deduct, foreign taxes for the taxable year of the distribution.⁶

⁴ See S. Rep. No. 99-313, 99th Cong., 2d Sess, 305. (1986).

⁵ *Id.*

⁶ T.D. 8708, January 6, 1997. At the time the proposed and final regulations were issued, the language of section 902(c) only referred to reductions for foreign taxes “deemed paid with respect to dividends distributed,” which some taxpayers argued only meant taxes for which a shareholder claimed a deemed-paid credit. Section 902(c) was amended later in 1997 (Public Law 105-34) to refer to foreign taxes “attributable to dividends distributed,” so as to preclude the argument that only foreign taxes attributable to earnings distributed to or included in income by a shareholder that was eligible for, and in fact claimed, a deemed-paid foreign tax credit were removed from the pool of post-1986 foreign income taxes.

In response to this argument, the text of the proposed regulations was revised in the final regulation by, among other changes, adding the second sentence of the quoted text above. The preamble to the final regulations explains the revisions as follows:

The IRS has not changed its position . . . that the foreign taxes pool must be reduced to account for foreign taxes attributable to all distributions and deemed distributions or inclusions to all shareholders. However, the text of the final regulations has been amended to clarify the rule. The requirement that the foreign taxes pool must be reduced proportionately as the earnings pool is reduced is consistent with the legislative history of the Tax Reform Act of 1986 (Public Law 99-514).⁷

3. Application of the Law to Section 302 Redemptions

Under the facts set forth above, it is clear that as a result of the Year 2 dividend distribution from CFC, USP will be deemed to have paid an amount of foreign income taxes equal to 100% of the balance in CFC's pool of post-1986 foreign income taxes as of the end of Year 2. In order to determine the amount of that balance, it is necessary to determine what effect the Year 1 redemption of the stock held by FP has, if any, on CFC's pool of post-1986 foreign income taxes.

Although the distribution of cash by CFC in redemption of the stock held by FP is treated as a sale or exchange transaction under section 302(a) rather than a dividend, section 312(a) and (n)(7) provides that CFC's earnings and profits are decreased by the amount of the distribution to the extent of the ratable share of the earnings and profits attributable to the stock so redeemed. Accordingly, CFC's post-1986 undistributed earnings are reduced to take into account the Year 1 redemption.

At issue is whether there is also a corresponding reduction in CFC's post-1986 foreign income taxes by an amount of taxes attributable to the Year 1 distribution made by CFC in redemption of the stock held by FP. As noted, this distribution is treated as a sale or exchange transaction under section 302 rather than a dividend. The statutory language of section 902(c)(2) specifically refers to reductions to post-1986 foreign income taxes for foreign taxes attributable to dividends distributed. The regulatory grant of section 902(c)(8) authorizes regulations further to provide such regulations as may be necessary or appropriate to carry out the provisions of this section. The regulation language under Treas. Reg. §1.902-1(a)(8) also refers to foreign taxes attributable to earnings that are "otherwise removed" from post-1986 undistributed earnings. The language of the regulation is sufficiently broad to cover reductions of earnings under section 312(a) related to redemptions that are treated as a sale or exchange transaction under section 302. Accordingly, CFC's post-1986 foreign income taxes are reduced as a result of the Year 1 redemption of the stock held by FP. As discussed below, to

⁷ Id.

interpret the regulation instead as limited to dividend distributions (or deemed distributions or inclusions⁸) would frustrate the purpose of the statute and regulations evidenced in the history of the pooling rules to avoid distortions in the average effective rate of the remaining foreign taxes in the taxes pool associated with the remaining earnings in the earnings pool.

Taxpayers have argued that this is not a proper interpretation of the language “otherwise removed” in Treas. Reg. §1.902-1(a)(8), quoted above, taking into consideration the context of the paragraph.

Under this view, the reference to income “otherwise included” in the first sentence should be read only to refer to deemed distributions or inclusions out of earnings and profits, given that the parenthetical only includes examples of deemed distributions or inclusions, with no reference to section 302(a) redemptions. The consequence is also urged that the third sentence beginning “thus, if an amount is distributed or deemed distributed,” further narrows the application to dividends or deemed distributions or inclusions. Taking these two sentences into account, it is asserted that the language in the second sentence about earnings that are “otherwise removed” refers only to earnings removed by dividend or deemed distributions or inclusions.

We disagree with the latter interpretation. Neither the first nor the third sentence requires that reading of the second sentence. The parenthetical in the first sentence describing earnings “otherwise included” begins with the language “for example,” which indicates it is not intended as an exclusive list. The parenthetical does not include an express reference to section 302 or section 312, but neither does it specifically exclude those Code sections, under which a stock redemption clearly results in a reduction under section 312(a) in earnings and profits, and so creates the potential for distorting the effective rate associated with the remaining pools of foreign taxes and earnings, absent a reduction in the taxes pool for foreign taxes attributable to the earnings being “otherwise removed” from the earnings pool. Similarly, the third sentence plainly should be read as an example of the application of the rule provided in the second sentence, and not as limiting the scope of that rule.

The suggested interpretation is contrary to the intent and the text of the final regulation and the preamble to the regulations, and more generally to the principles and purpose of the section 902 rules, as discussed above. Interpreting the regulations to require reductions in foreign taxes corresponding to section 302 reductions in earnings resulting from stock redemptions serves the purpose of the section 902 rules, while the interpretation limiting foreign tax pool reductions to dividend or deemed distributions or inclusions would frustrate the purpose of the pooling rules by distorting the effective tax rate associated with the pools of foreign taxes and earnings remaining after a stock redemption. Under the recognized canons of construction, preference must be given to

⁸ The statutory scheme similarly requires adjustments to be made to the taxes pool in respect of subpart F inclusions that give rise to deemed-paid credits under section 960, which like the redemptions at issue herein are not addressed by the express language of section 902(c).

an available interpretation that best serves the purpose of the statute or regulation being construed.⁹ See Johnson v. United States, 529 U.S. 694, 710 n. 10 (2000). See also Boeing Co. v. United States, 258 F.3d 958, 967 (9th Cir. 2001) (recognizing that the tenets of statutory construction apply to regulations as well).

Please call (202) 622-3850 if you have any further questions.

⁹ The conclusion in this memorandum, based on our interpretation of the Treasury regulation promulgated pursuant to the statutory grant of regulatory authority, is unaffected by the proposal to codify this result. See General Explanation of the Administration's Fiscal Year 2013 Budget Proposal, Dept. of the Treasury, 100, February 2012; Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal, JCS-2-12, 426, June 2012.