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subject: Earnings and Profits Consequences of Section 951(a) Income Inclusions

This Generic Legal Advice Memorandum addresses the earnings and profits consequences of income inclusions under section 951(a)(1). This advice may not be used or cited as precedent.

ISSUE

Whether USP must increase its earnings and profits by the amount of its income inclusion with respect to FS under section 951(a)(1)?

CONCLUSION

Yes. USP must increase its earnings and profits by the amount of its income inclusion with respect to FS under section 951(a)(1) in the year of the inclusion, regardless of whether USP receives distributions from FS in the same year.

FACTS

USP is a domestic corporation that wholly owns FS. FS is a controlled foreign corporation within the meaning of section 957(a) (CFC), and accordingly USP is a United States shareholder (as defined in section 951(b)) of FS. FS earns subpart F income (as defined in section 952) and holds United States property (as defined in section 956(c)) in Tax Year 1. As a result, USP includes amounts in income under sections 951(a)(1)(A) and 951(a)(1)(B) with respect to FS for Tax Year 1.

LAW AND ANALYSIS

I. Determination of Earnings and Profits

A. E&P Increases upon Inclusion of Items in Income

The term "earnings and profits" (E&P) is not defined in the Internal Revenue Code. However, Treas. Reg. §1.312-6 provides that, "[a]mong the items entering into the computation of corporate earnings and profits for a particular period are . . . *all items* includible in gross income under section 61." (Emphasis added.) Section 61 makes clear that gross income means "all income from whatever source derived," and is not limited to the items enumerated in the statute.[1] Under section 951(a)(1), a United States shareholder of a CFC must include its pro rata share of the CFC's subpart F income, as well as the amount determined under section 956 with respect to the shareholder, in gross income (section 951 inclusions).

As noted above, the regulations provide that E&P for a "particular period" includes all items of gross income under section 61. Paragraph (a) of Treas. Reg. §1.312-6 provides that E&P must be computed using the same method of accounting used to compute taxable income. These provisions make clear that a domestic corporation's E&P is increased when it takes the corresponding item of income into account in computing taxable income. Thus, absent an express rule to the contrary, statutory provisions that affect the timing of income – deferral or acceleration – have a corresponding effect on the timing for increasing E&P.[2] Neither Treas. Reg. §1.312-6 nor any other regulatory or statutory provision contains timing rules for E&P that deviate from the timing rules for gross income with respect to section 951 inclusions. Thus, section 951 inclusions are subject to the general rule for items of gross income described in Treas. Reg. §1.312-6 and are included in the computation of E&P for the taxable year in which they are included in the domestic corporation's gross income. As

[1] Section 61(a); see also Treas. Reg. §1.61-14(a) ("[i]n addition to the items enumerated in section 61(a), there are many other kinds of gross income."); Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955) (indicating with respect to the predecessor to section 61 that the definition of gross income should be construed broadly, "in recognition of the intention of Congress to tax all gains except those specifically exempted.").

[2] Sections 312(k) and 312(n) provide particular circumstances in which E&P adjustments are decoupled from the inclusion of items of income to which they relate. The existence of a specific list of deviations between E&P and income confirms that absent a specific rule, the timing of E&P increases follows the timing of income inclusions. Furthermore, the deviations largely require an increase of E&P for income items prior to their inclusion in income. See, e.g., section 312(n)(5); Treas. Reg. §1.108(i)-1(d) (providing that deferred cancellation of indebtedness income increases E&P in the year realized and not when later includible in income).

discussed in Part I.B of the LAW AND ANALYSIS section of this memorandum, the application of Treas. Reg. §1.312-6 to section 951 inclusions is consistent with the general conceptual framework for the interaction between income, basis adjustments, and E&P articulated elsewhere in the Internal Revenue Code and in case law.

B. Relationship Between the Timing of Income Inclusion and Corresponding Basis Adjustments and E&P

Case law affirms the principle of Treas. Reg. §1.312-6 that E&P generally follows taxable income and demonstrates the operation of basis provisions within the framework governing income and E&P to ensure that items of gross income are neither duplicated nor excluded from taxable income or E&P. The interaction of basis provisions, income inclusions, and E&P illustrated by the case law is also reflected in the subpart F statutory provisions addressing the consequences of section 951 inclusions, as well as section 312(f)(2).

In Commissioner v. Wheeler,[3] the taxpayers contributed appreciated stock to a corporation in a nonrecognition transaction; the corporation accordingly took a carryover basis in the stock.[4] The taxpayers argued that the carryover basis applied only for income tax purposes.[5] For purposes of determining the corporation's E&P after a subsequent sale of the contributed stock, the taxpayers used the higher fair market value basis that the corporation had recorded on its books at the time of the contribution.[6] The Supreme Court rejected the taxpayers' argument, holding that the lower carryover basis applied for purposes of determining the corporation's E&P as well as its taxable income.[7] The Supreme Court also upheld as valid the regulation, very similar to current Treas. Reg. §1.312-6, that provided that gains and losses are brought into E&P at the time and to the extent recognized.[8] Thus, the use of the carryover basis allowed the gain deferred on the contribution of the stock to be similarly deferred for E&P purposes such that it would be recognized and included in E&P at the time of the subsequent disposition.[9]

Bangor & Aroostok v. Commissioner[10] addressed a fact pattern in which income realized in a transaction was preserved for subsequent taxation through basis adjustments. In Bangor & Aroostok, the taxpayer excluded from its gross income "bond profit" realized on the repurchase of its bonds at a discount, instead consenting to reduce the basis of its property by the excluded amount.[11] It claimed, however, that the bond profit was includible in E&P when realized for purposes of determining its excess

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[3] Comm'r v. Wheeler, 324 U.S. 542 (1945).
[4] Id. at 543.
[5] Id. at 543-44.
[6] Id.
[7] Id. at 547.
[8] Id. at 546.
[9] Id. at 547.
[10] Bangor & Aroostok v. Comm'r, 16 T.C. 578 (1951).
[11] Id. at 579-80.

profits credit.[12] The Tax Court disagreed with the taxpayer's position, concluding that bond profit was includible in E&P for purposes of computing the excess profits credit only when the bond profit was includible in income.[13]

Wheeler and Bangor & Aroostok establish the relationship among E&P increases, income realization when the recognition of income is deferred, and basis provisions that preserve the income for future taxation. In income deferral situations, when income is preserved for subsequent taxation through basis carryover or reduction, no E&P increase is required or permitted at the time of the initial transaction giving rise to the deferred income, but an E&P increase is required at the time that the income is subsequently required to be taken into account. Thus, these cases demonstrate that if income will be taken into account, the E&P inclusion generally occurs at the time that the income is taken into account. This supports the conclusion that when realized income is included in taxable income and a basis increase would prevent inclusion of that income in E&P at a later time, the income must be included in E&P when realized and included in taxable income. As described below, the statutory provisions of Subpart F implement such a framework with respect to section 951 inclusions.

Subpart F provides for stock basis adjustments and the establishment of an account for "previously taxed earnings and profits" or previously taxed income (PTI) in conjunction with section 951 inclusions that represent the inverse of the basis consequences at issue in Wheeler and Bangor & Aroostok. Under sections 959 and 961(a), a United States shareholder increases its PTI account and its basis in the CFC stock by the amount included in its gross income under section 951(a) with respect to the stock. The increases in the PTI account balance and the basis in the CFC stock prevent the income from being included in gross income again upon distribution or if the stock is sold before the income is distributed. When the CFC distributes its earnings, the shareholder does not include the earnings in income a second time,[14] but reduces its basis in the CFC stock and the PTI account.[15] As a result, the shareholder includes its share of the CFC's subpart F income in its income only once despite the difference between the time that the shareholder is required to report its share of the CFC's subpart F income and the time that income is distributed from the CFC to the United States shareholder.[16]

Wheeler and Bangor & Aroostok address the E&P consequences of income deferral provisions with corresponding basis provisions that ensure that the gain will be recognized at a later time, rather than income acceleration provisions that require inclusion of income prior to receipt of cash or property. However, by demonstrating the relationship between basis provisions and the timing of income and E&P

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[12] Id. at 580.
[13] Id. at 586.
[14] See sections 959(a) and (d).
[15] See section 961(b).
[16] Subchapter K and subchapter S have similar basis adjustments that are also illustrative. See sections 705(a) and 1367(a).

inclusions, Wheeler and Bangor & Aroostok buttress the related conclusion that when income is taken into account and basis is increased to prevent the same income from being taxed twice, an E&P inclusion must result. Moreover, if E&P were not increased when income is recognized and basis is increased, that income might never be properly taken into account for E&P purposes. For example, if a shareholder were to sell stock after its basis in the stock was increased as a result of a section 951 inclusion, the basis adjustment would reduce the amount of gain recognized on the sale, allowing the shareholder to permanently avoid an E&P increase for that amount. The subpart F stock basis adjustments and PTI account serve the same essential function as the provisions at issue in Wheeler and Bangor & Aroostok; they ensure that amounts are included once, and only once, in income.

Although section 961(b) provides for a basis decrease in respect of a distribution that is not included in a United States shareholder's gross income pursuant to section 959, it does not expressly address the effect of that distribution on the shareholder's E&P. Section 312(f)(2), however, does expressly address the E&P consequences of a nontaxable distribution in respect of stock in which the shareholder's basis in the stock is reduced. Section 312(f)(2) generally provides that a nontaxable distribution in which the stock basis is decreased does not increase the E&P of the distributee corporation. Distributions to which sections 959 and 961(b) apply are described in section 312(f)(2). Accordingly, a United States shareholder should not increase its E&P when it receives a distribution to which sections 959 and 961(b) apply.

Lastly, distributions of PTI, which cannot "be again included in the gross income" of a United States shareholder receiving a distribution thereof,[17] are distinct from "income exempted by statute" that must be included in E&P when received under Treas. Reg. §1.312-6(b). Unlike exempt income, PTI distributions constitute income that has already been subject to tax, rather than income that is never taxed.[18]

In sum, the appropriate time to increase a United States shareholder's E&P is at the time of the section 951 inclusion, not at the time of receipt of the PTI distribution.

Possible Counterarguments

A CFC that accrues subpart F income must increase its E&P by the amount of its income at the time of accrual under Treas. Reg. §1.312-6(b),[19] and, as discussed in

[17] Section 959(a).
[18] Contrast Bangor & Aroostok, which indicates that in a situation where realized income is permanently exempt from taxation, such that it will not be included in E&P in the future, the realized income must be included in E&P when realized. 16 T.C. at 585 ("The present case must be distinguished from situations where fully realized income which is exempt from tax … is included in earnings and profits. … [T]he income from discharge of indebtedness escapes taxation only by reason of the option [to reduce basis], and the effect of exercise of the option is not a complete withdrawal or insulation of the profit from tax. … In reality, by providing for an adjustment altering the basis of property which petitioner would otherwise be entitled to use, Congress did not relieve the profit of tax but only postponed the time for levying the tax.").
[19] Section 964(a).

Part I.B. of the LAW AND ANALYSIS section of this memorandum, the United States shareholder increases its E&P to the extent the CFC's subpart F income is included in the United States shareholder's gross income as a section 951 inclusion.

USP might argue that section 951 income inclusions do not increase its E&P because its ability to make dividend distributions is not increased unless it receives a distribution of cash or other property. However, E&P is not simply a measure of cash flow.[20] Specific statutory and regulatory guidance on E&P clearly reflects that a corporation's E&P increases even when an income inclusion does not coincide with the receipt of cash or other property.[21] Thus, an increase of E&P for section 951 inclusions is consistent with the guidance on E&P.

Because, absent a distribution, FS retains the E&P attributable to the subpart F income, while USP also has E&P arising from the section 951 inclusion attributable to the subpart F income, USP might also argue that E&P cannot be in two places at once, and that USP will increase its E&P when FS distributes the earnings attributable to the section 951 inclusion to USP. This argument has some superficial appeal because generally a corporate shareholder does not have income from a subsidiary corporation when the subsidiary corporation earns income; therefore, the corporate shareholder generally does not increase its E&P or its basis in the stock of the subsidiary corporation at such time. Rather, the corporate shareholder has income and increases its E&P when the subsidiary corporation distributes its E&P as a dividend. Thus, when a corporate shareholder's income inclusion depends upon a distribution of E&P by a subsidiary corporation, the corporate shareholder's E&P does not increase until the time of the distribution, when the subsidiary corporation's E&P decreases.

However, the general rule that a corporate shareholder does not have E&P until it receives a distribution from the corporation does not always apply. If a domestic parent and subsidiary file a consolidated return, the parent's E&P is increased (or decreased) each year to reflect increases (or decreases) in the E&P of the subsidiary during the consolidated return year.[22] In addition, in the consolidated return context, if a corporation becomes a subsidiary as a result of a reverse acquisition, the subsidiary's E&P is immediately included in the E&P of the common parent as well.[23] Thus, the E&P will be reflected in the accounts of both the subsidiary and the parent,[24] as it is in the case of a CFC with subpart F income and its United States shareholder with a corresponding section 951 inclusion.[25]

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[20] See Snap-Drape, Inc. v. Comm'r, 98 F.3d 194 (5th Cir. 1996); Henry C. Beck Co. v Comm'r, 52 T.C. 1 (1969), aff'd per curiam, 433 F.2d 309 (5th Cir. 1970).

[21] For example, section 1272(a)(1) requires the inclusion of accrued original issue discount ("OID") in gross income, and accordingly, under Treas. Reg. §1.312-6, in E&P, notwithstanding the fact that no cash is received in connection with OID accrual.

[22] See Treas. Reg. §1.1502-32; Treas. Reg. §1.1502-33.

[23] Treas. Reg. §1.1502-33(f).

[24] Duplication can be eliminated, however, by an actual distribution or if the subsidiary ceases to be a member of the consolidated group. Treas. Reg. §1.1502-33(e).

[25] In the consolidated group context, corresponding adjustments are also made to the parent's basis in

Furthermore, despite its superficial appeal, the argument that E&P cannot be in two places at once lacks technical support and is not strong enough to overcome the rule in Treas. Reg. §1.312-6 that E&P includes all items includible in gross income under section 61. Section 951(a) requires United States shareholders of a CFC to include in income their pro rata share of the CFC's subpart F income, as well as the amount determined under section 956, irrespective of whether the E&P attributable to such amounts are distributed. As discussed in Part I.B. of the LAW AND ANALYSIS section of this memorandum, distributions of PTI attributable to a United States shareholder's section 951 inclusion generally are not treated as dividends[26] and are not included in the income of a United States shareholder that is a domestic corporation.[27] Thus, United States shareholders that are domestic corporations do not increase their E&P pursuant to Treas. Reg. §1.312-6 upon a distribution of PTI that is not includible in the shareholders' income. The period to increase a corporate United States shareholder's E&P for a section 951 inclusion is the shareholder's taxable year of the inclusion, and does not depend on when the CFC reduces its E&P by some future distribution.

II. Conclusion

As a United States shareholder with respect to FS, USP includes in its gross income its pro rata share of the subpart F income of FS, as well as amounts determined under section 956 with respect to USP.[28] The section 951 inclusion also increases USP's basis in the stock of FS by the same amount.[29] Accordingly, under the framework described in Part I of the LAW AND ANALYSIS section of this memorandum, USP must increase its earnings and profits by the amount of its income inclusion with respect to FS under section 951(a)(1) in the year of the inclusion, regardless of whether USP receives distributions from FS in the same year.

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the stock of the subsidiary by the amount of the subsidiary's earnings and profits, under a framework comparable to sections 959 and 961, discussed supra in Part I.B. See Treas. Reg. §1.1502-33. Similarly, a distribution from a subsidiary to a parent of a consolidated group is excluded from the income and E&P of the parent corporation and reduces the parent's basis in the stock of the subsidiary. See Treas. Reg. §§1.1502-13, 1.1502-32, 1.1502-33.

[26] Section 959(d). Distributions of PTI are not treated as dividends for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code except for a limited foreign tax credit purpose as provided in section 960(a)(3). Sections 959(d) and 960(a)(3). However, certain distributions of PTI are treated as dividends for purposes of section 1411, which is in chapter 2A of the Code (relating to unearned income Medicare contributions). Treas. Reg. §1.1411-10(c)(1)(i). Section 1411 applies only to individuals, estates, and trusts, and not to corporations. See section 1411(a).

[27] Section 959(a). Distributions of PTI in excess of a shareholder's basis are treated as gain from the sale or exchange of property and are included in the shareholder's gross income. Treas. Reg. §1.961-2(c).

[28] Section 951(a)(1).

[29] Section 961(a).