

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **201030024**

Release Date: 7/30/2010

CC:PSI:B02:CChyr
POSTN-155021-09

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 1375.00-00, 1362.02-03

date: April 16, 2010

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subject:

This memorandum responds to your request for chief counsel advice. This advice may not be used or cited as precedent.

LEGEND

S Corp =

DC1 =

DC2 =

DC3 =

CFC1 =

CFC2 =

Z =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
\$a =
\$b =
\$c =
\$d =
Year 1 =
Year 4 =

ISSUES

1. Whether the controlled foreign corporations (as defined in Internal Revenue Code (Code) section 957) (“CFCs”) owned by S Corp are “C corporations” for purposes of section 1362(d)(3)(C)(iv).
2. Whether amounts that S Corp included in income under section 951(a) with respect to its CFCs are “passive investment income” as defined in section 1362(d)(3)(C).
3. Whether the section 1248 amounts that DC2 and DC3 included in gross income are considered dividends from a lower-tier subsidiary under Treas. Reg. § 1.1362-8(b)(2) for purposes of applying section 1362(d)(3)(C)(iv) to the Date 4 distribution from DC1 to S Corp.
4. Whether the amount included in DC2 and DC3’s gross income under section 78 with respect to the deemed paid foreign tax credit allowed under section 902(a)(1) attributable to the section 1248 amount is considered a dividend

- from a lower-tier subsidiary under Treas. Reg. § 1.1362-8(b)(2) for purposes of applying section 1362(d)(3)(C)(iv) to the Date 4 distribution from DC1 to S Corp.
5. Whether any portion of the distribution from DC1 to S Corp on Date 4 is attributable to the deemed dividend recognized by DC2 and DC3 pursuant to section 1248 on Date 3 for purposes of section 1362(d)(3)(C)(iv).
 6. Whether the gross receipts of Z would be included in determining DC1's total gross receipts for the year in which the earnings and profits are produced, for purposes of applying section 1362(d)(3)(C)(iv) to the dividends paid by DC1 to S Corp.

FACTS

S Corp, a domestic corporation, elected to be an S corporation effective Date 2. Prior to becoming an S corporation, S Corp had been a C corporation. S Corp wholly owned CFCs.

S Corp wholly owned DC1 (a domestic C corporation and the parent of a group of corporations filing a consolidated return ("the DC1 Group")), which in turn, wholly owned domestic subsidiaries and CFCs and indirectly owned other domestic subsidiaries and CFCs. The DC1 Group had a taxable year ending on Date 5 of each year. One of the domestic subsidiaries wholly owned by DC1, and a member of the DC1 Group, is DC2. DC2 wholly owned DC3, also a domestic corporation and a member of the DC1 Group. DC2 and DC3 in turn owned CFC1. CFC2 was owned by DC2 and DC3 after the Date 3 transaction.

On Date 3, DC2 and DC3 contributed all of the outstanding stock of CFC1 to CFC2 in exchange for common stock and preferred stock treated under section 351(g)(2) as nonqualified preferred stock. DC2 and DC3 recognized gain of \$c on the exchange pursuant to section 351(b) based on the fair market value of the nonqualified preferred stock they received.

On Date 4, DC1 paid to S Corp a dividend of \$d. \$d was less than \$c.

On Date 1, Z was formed as a domestic partnership for federal income tax purposes, and was wholly owned by corporations that are included in the DC1 Group. DC1 Group reported income from Z.

At the time of S Corp's S election, S Corp had earnings and profits of approximately \$a to \$b. For each taxable year from Year 1 through Year 4, S Corp reported substantial amounts of section 316 dividends from CFCs, dividend distributions from DC1, and section 951(a) income inclusions with respect to its CFCs.

LAW AND ANALYSIS

Section 1375(a) imposes a tax on an S corporation's excess passive investment income for any taxable year in which an S corporation has (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts more than 25 percent of which are passive investment income. The tax is computed by multiplying the excess net passive investment income by the highest rate of tax specified in section 11(b).

"Passive investment income" means gross receipts derived from royalties, rents, dividends, interest, and annuities. Section 1375(b)(3); Section 1362(d)(3)(C). "Excess net passive investment income" means an amount which bears the same ratio to the net passive income for the taxable year as (1) the amount by which the passive investment income for the taxable year exceeds 25 percent of the gross receipts for the taxable year, bears to (2) the passive investment income for the taxable year. Section 1375(b)(1). Section 1362(d)(3)(A)(i) provides that an S election terminates whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Under section 1362(d)(3)(C)(i), except otherwise provided in section 1362(d)(3)(C), "passive investment income" includes gross receipts derived from dividends. Treas. Reg. § 1.1362-2(c)(5)(ii)(C) states that the term "dividends" include dividends as defined in section 316, amounts included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565. Section 1362(d)(3)(C)(iv), however, excludes dividends of certain C corporations from the definition of "passive investment income." Specifically, section 1362(d)(3)(C)(iv) provides that if an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term "passive investment income" does not include dividends from such C corporation to the extent such dividends are attributable to the earnings and profits of the C corporation that are derived from the active conduct of a trade or business. In addition, Treas. Reg. § 1.1362-8(b)(2) provides that if such C corporation ("upper-tier corporation") owns stock in another C corporation ("lower-tier subsidiary") that meets the requirements of section 1504(a)(2), the upper-tier corporation's gross receipts attributable to dividends from the lower-tier subsidiary "are considered to be derived from the active conduct of a trade or business to the extent the lower tier subsidiary's earnings and profits are attributable to the active conduct of a trade or business by the subsidiary under paragraph (b)(1), (3), (4), or (5)" of Treas. Reg. § 1.1362-8.

Section 1361(a)(2) provides that the term "C corporation" means, with respect to any taxable year, a corporation which is not an S corporation for such year. Section 1504(a)(2) provides that the ownership of stock of any corporation meets the requirements of this paragraph if it (1) possesses at least 80 percent of the total voting

power of the stock of such corporation, and (2) has a value equal to at least 80 percent of the total value of the stock of such corporation.

Issue 1

The exclusion of certain dividends from the definition of “passive investment income” as provided in section 1362(d)(3)(C)(iv) applies only to dividends that an S corporation receives from a C corporation in which the S corporation owns stock that meets the ownership requirements of section 1504(a)(2). For purposes of section 1362(d)(3)(c)(iv), the term “C corporation” includes a foreign entity that is treated as a corporation for U.S. tax purposes. See Section 1361(a)(2). Accordingly, the CFCs that are owned by S Corp fall within the meaning of “C corporation” for purposes of section 1362(d)(3)(C)(iv).

Based on the facts presented, S Corp holds the requisite stock ownership with respect to its directly wholly-owned CFCs and thus is eligible for the exclusion set forth in section 1362(d)(3)(C)(iv) with respect to section 316 dividends received from such CFCs.

Issue 2

For purposes of sections 1362 and 1375, the term “passive investment income” is limited to gross receipts derived from royalties, rents, dividends, interest, and annuities. Amounts included in S Corp’s income under section 951(a) do not fall within any of the enumerated types of passive investment income. In particular, a section 951(a) inclusion is not a “dividend” for purposes of section 1362(d)(3)(C)(i). Accordingly, the amounts that S Corp included in income under section 951(a) with respect to its CFCs are not “passive investment income” within the meaning of section 1362(d)(3)(C).

Issue 3

Section 1248(a) provides that gain recognized on the sale or exchange by a United States person of stock in a foreign corporation must be included in the gross income of the U.S. person as a dividend to the extent of the foreign corporation’s earnings and profits that were accumulated while the stock was held by the U.S. person and the foreign corporation was a CFC. For purposes of section 1248(a), a U.S. person is treated as having sold stock if such person recognizes gain from the sale or exchange of such stock. Section 1248(a) and Treas. Reg. § 1.1248-1(c). Section 1248(a), therefore, applies to treat the gain recognized by DC2 and DC3 under section 351(b) on the exchange of CFC1 stock for CFC2 nonqualified preferred stock as a dividend to DC2 and DC3 to the extent of CFC1’s earnings and profits accumulated during periods in which CFC1 was a CFC owned by DC2 and DC3. As a result of this dividend treatment, the look-through rule of Treas. Reg. § 1.1362-8(b)(2) applies to treat the gross receipts deemed to have been received by DC2 and DC3 as active to the

extent that the earnings and profits of CFC1 are derived from the active conduct of a trade or business. Because both DC2 and DC3 are members of the DC1 Group, the earnings and profits attributable to the dividend are treated as earnings and profits of DC1. See Treas. Reg. § 1.1502-33(b)(1). Accordingly, the actual dividend paid from DC1 to S Corp on Date 4 will not be passive investment income under section 1362(d)(3)(C)(iv) to the extent that the gross income of DC1 is attributable to earnings and profits of CFC1 derived from the active conduct of a trade or business.

Issue 4

Treas. Reg. § 1.1248-1(d)(1) provides that the foreign tax credit provisions, including section 902, apply “in the same manner and subject to the same conditions and limitations” as if there had been an actual distribution of a dividend. Treas. Reg. § 1.1248-1(d)(2) refers to the fact that under section 78, amounts are included in the shareholder’s gross income as a dividend if deemed paid foreign tax credits under section 902(a)(1) are claimed with respect to the section 1248 dividend.

Treas. Reg. § 1.78-1(a) provides that “[a] section 78 dividend shall be treated as a dividend for all purposes of the Code, except that it shall not be treated as a dividend under section 245.” DC2 and DC3 included in their gross incomes as dividends under section 78 amounts equal to the deemed paid foreign tax credits they claimed under section 902(a)(1) and which were attributable to the section 1248 amounts DC2 and DC3 included in their gross incomes as a dividend. As a result of this dividend treatment of the section 78 amounts, the look-through rule of Treas. Reg. § 1.1362-8(b)(2) applies to treat the gross receipts deemed to have been received by DC2 and DC3 as active to the extent that the earnings and profits of CFC1 are derived from the active conduct of a trade or business. Under Treas. Reg. § 1.1502-33(b)(1), DC2 and DC3’s earnings and profits attributable to the dividend are treated as earnings and profits of DC1. Accordingly, the actual dividend paid from DC1 to S Corp on Date 4 will not be passive investment income under section 1362(d)(3)(C)(iv) to the extent that the gross income of DC1 is attributable to earnings and profits of CFC1 derived from the active conduct of a trade or business.

Issue 5

Section 316(a)(2) provides that the term “dividend” means any distribution of property made by a corporation to its shareholders out of its accumulated earnings and profits or its earnings and profits of the taxable year, without regard to the amount of earnings and profits at the time the distribution was made. Thus, the deemed dividends recognized by DC2 and DC3 from the application of section 1248(a) in connection with the exchange of CFC1 stock for CFC2 stock are taken into account by DC2 and DC3 in determining their current earnings and profits for the taxable year ending on Date 6. Accordingly, the distribution made by DC1 to S Corp on Date 4, which is earlier than Date 3, is a dividend out of such earnings and profits notwithstanding the fact that it was

made before the deemed dividends to DC2 and DC3 under section 1248(a) were recognized.

Issue 6

A corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts (as defined in Treas. Reg. § 1.1362-2(c)(4)) derived from activities that would not produce passive investment income (if the C corporation were an S corporation), including those that do not produce passive investment income under Treas. Reg. § 1.1362-8 paragraphs (b)(2) through (b)(4), bear to the corporation's total gross receipts for the year in which the earnings and profits are produced. Treas. Reg. § 1.1362-8(b)(5). "Gross receipts" generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions. Treas. Reg. § 1.1362-2(c)(4)(i). Z's gross receipts, accordingly, are includable in determining DC1's total gross receipts for the year in which the earnings and profits are produced for purposes of applying section 1362(d)(3)(C)(iv) to dividends paid to S Corp. See Section 1375(b)(3); Treas. Reg. § 1.1362-8(b)(5); Treas. Reg. § 1.1362-2(c)(4).

CONCLUSIONS

Based solely on the facts submitted, and with respect to the facts of this case only, we conclude the following:

1. S Corp's CFCs are "C corporations" for purposes of section 1362(d)(3)(C)(iv).
2. The amounts that S Corp included in income under section 951(a) with respect to its CFCs are not "passive investment income" within the meaning of section 1362(d)(3)(C).
3. The amounts included in DC2 and DC3's gross income under section 1248 are considered dividends from a lower-tier subsidiary under Treas. Reg. § 1.1362-8(b)(2) for purposes of applying section 1362(d)(3)(C)(iv) to the Date 4 distribution from DC1 to S Corp.
4. The amount included in DC2 and DC3's gross income under section 78 with respect to the deemed paid foreign tax credit allowed under section 902(a)(1) attributable to the section 1248 amount is considered a dividend from a lower-tier subsidiary under Treas. Reg. § 1.1362-8(b)(2) for purposes of applying section 1362(d)(3)(C)(iv) to the Date 4 distribution from DC1 to S Corp.
5. The distribution made by DC1 to S Corp on Date 4 is a dividend out of the earnings and profits of DC1 attributable to the deemed dividends recognized by DC2 and DC3 pursuant to section 1248 on Date 3, notwithstanding the fact

that such distribution was made before the deemed dividends to DC2 and DC3 were recognized. Therefore, the actual dividend paid from DC1 to S Corp on Date 4 will be active in proportion to the gross receipts of DC1 that are attributable to active income of CFC1.

6. Z's gross receipts are includable in determining DC1's total gross receipts for the year in which the earnings and profits are produced.

Please call Charlotte Chyr at (202) 622-3060 or Barbara E. Rasch at (202) 622-3840 if you have any further questions.