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Tax Alert

AM 2015-01 – Does Previously Taxed Income "Tier up" to a Domestic Corporate Shareholder?

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Introduction

In a recent chief counsel memorandum (AM 2015-01), the IRS addressed a long uncertain tax question: when a US corporate shareholder includes an amount in income under subpart F, does the subpart F inclusion increase the corporate shareholder's "earnings and profits" immediately or only when the earnings are actually distributed as a tax-free distribution of previously taxed income ("*PTI*")? Despite the IRS's answer, the AM primarily reveals the ambiguity inherent in the question. As can be gleaned from the AM, "earnings and profits" and PTI questions remain uncertain at best and difficult to predict without reference to the specific facts and provision at issue and exercise of careful judgment.

The IRS Conclusion in the Advice Memorandum

Subpart F taxes US shareholders on inclusions of subpart F income and amounts determined under Section 956. To prevent double taxation, Section 959 allows the shareholder to exclude from its gross income an amount of CFC's earnings and profits equal to the previously taxed amounts when actually distributed to the shareholder. Further, in a system of notional investment adjustments, Section 961 increases the shareholder's basis in CFC stock for the amounts included by the shareholder in income under subpart F, and decreases the shareholder's basis in CFC stock by the amount of previously taxed earnings distributed.

In AM 2015-01, the IRS addressed the implications of a subpart F inclusion in the calculation of the US Parent's earnings and profits account. (Such earnings and profits would be relevant primarily to determine whether a distribution by the US Parent to its shareholders constitutes a dividend or potential return of capital).

In theory, there are at least two possible times at which a subpart F inclusion might affect the US Parent's earnings and profits. First, subpart F income could increase E&P of the US Parent when it is earned by the CFC and included in taxable income by the Parent – *i.e.*, by treating the subpart F income as if it were an actual dividend of the CFC's earnings. Second, subpart F income might increase E&P of the US Parent only when actually distributed by the CFC or treated as distributed through a sale of CFC stock, on the theory that the distribution of PTI is akin to tax-exempt income that must be added to E&P due to the increase of corporate net worth.

Each of these approaches appears to have some support in the case law definition of "earnings and profits." The former approach would seem to be supported by the "accounting consistency" rule, which provides that amounts of taxable income are taken into account at the same time for income tax and earnings and profits purposes. This approach essentially would treat the shareholder's net worth as increasing to reflect the step-up in basis of the CFC's stock. The distribution of PTI that reduces basis would then be treated as effectively a return-of-capital, rather than an item of tax-exempt income as seems to be contemplated by § 959(a). The latter approach, by contrast, appears to find support in the principle that E&P is "an economic concept which the tax law has utilized to approximate a corporation's power to make distributions which are more than just a return of investment." *Henry C. Beck Co. v. Commissioner*, 52 TC 1, 6 (1969), *aff'd*, 433 F.2d 309 (5th Cir. 1970) (Per curiam). As illustrated by *Beck*, the time when an item is realized as an economic profit (and as a component of earnings and profits) does not always correspond to the time when it is taken into account in taxable income.

In the AM, the IRS comes down firmly on the side of the former approach, and holds that a subpart F inclusion immediately increases E&P of the US Parent when included in taxable income. In support, the IRS relies on Treas. Reg. § 1.312-6(a) and related case law. Under this regulation, items of income and expense enter E&P according to the same methods of accounting used for computing taxable income. Similarly, realized but unrecognized gains (*e.g.*, in a corporate reorganization) are generally recognized for E&P purposes at the same time as they are recognized for income tax purposes. *See* Treas. Reg. § 1.312-7(b)(2), Example 1 (property acquired in a non-recognition transaction has the same basis for E&P as for income tax purposes). Since subpart F income increases the shareholder's basis in its stock, the AM equates the inclusion of subpart F income with a recognition event that increases the US Parent's net worth and dividend paying ability.

Also, the IRS cites Section 312(f)(2)(A) to treat the actual distribution of PTI as not giving rise to E&P. That section provides that no adjustment to E&P shall be made for the amount of any distribution that is not taxed to the shareholder (under the law at the time the distribution is made) to the extent the distribution is directly applied in reduction of basis of the corporation's stock. An example in the regulations (Treas. Reg. § 1.312-8(b), Example 1) illustrates that this rule applies to a distribution out of pre-1913 accumulated earnings and profits that is treated as a return of capital under § 301(c)(2). The AM then relies on this section to conclude that the actual distribution of PTI (since it is excluded from income and triggers a reduction in basis) must be excluded from E&P, so that the only appropriate time to increase US Parent's E&P is at the time of the underlying subpart F inclusion.

Appraising the AM's Analysis

The AM decides the issue before it on the basis of the accounting consistency rule and § 312(f)(2). However, the AM analysis, if correct, could lead to some unusual results.

First, as noted above, E&P has commonly been said to be an "economic concept" measuring the corporation's power to make distributions that are more than a return of capital. *See, e.g.*, *Henry Beck Co.*, 52 T.C. at 6. Under this approach, the receipt of a dividend from a domestic subsidiary increases earnings and profits, despite the dividends received deduction, because the distribution increases the recipient's power to make distributions to its shareholders. *See Weyerhauser v. Commissioner*, 33 B.T.A. 594, 597 (1935); PLR 200952031 (Sept. 23, 2009). How such a dividend should be treated when there has also been a reduction in the shareholder's basis under § 1059 has been a matter of previous dispute. *See* Field Service Advisories #0868 (Oct. 16, 1992) and #0721 (undated) (addressing same case of a dividend-stripping transaction).

PTI is analogous to a dividend covered by a dividends-received deduction in that it is a distribution of earnings that goes untaxed in order to avoid double taxation. Like other forms of tax-exempt income, the actual distribution of PTI increases the corporate shareholder's net worth on a stand-alone basis and its ability to pay dividends to its shareholders. Prior to that time, it is debatable that there has been any accession to wealth in the economic sense. Indeed, to the extent the inclusion of subpart F income requires the shareholder to make a cash outlay to pay Federal income taxes, the shareholder's net worth is *reduced*.

Second, the AM's conclusion is difficult to square with the statutory language of Section 959, which treats PTI as a part of the CFC's earnings and profits. In this regard, Section 959 differs from other anti-deferral rules that treat taxable income inclusions as deemed distributed and then re-contributed to capital.[1] Section 959(c), by contrast, treats the categories of PTI as part of the earnings and profits of the CFC. Section 959(a)(1) further provides for an exclusion from gross income of "earnings and profits of a foreign corporation… when such amounts are distributed" to the US shareholder, clearly implying that the PTI is an amount of earnings and profits. Under the AM, the same earnings are simultaneously included in both the CFC's and US Parent's E&P accounts.

AM 2015-01 acknowledges this concern with duplication of E&P, but relies on the consolidated return regulations for the proposition that E&P can "tier up" and be included in more than one corporation's E&P at the same time.

However, this analysis overlooks that the tiering up of E&P in a consolidated group is provided for by regulations, *see* Treas. Reg. § 1.1502-33, and is part of the consolidated return's investment adjustment system whereby both losses and income are reflected in the upper-tier members' E&P accounts as earned by the subsidiary, *see* Treas. Reg. § 1.1502-33(a)(3), Ex. 1(e). Since E&P has already tiered up to the parent of the group, the consolidated E&P of a member leaving a group also is eliminated. *See* Treas. Reg. § 1.1502-33(e)(1). In other words, E&P of the parent of a consolidated group is computed by treating the group largely as if it were a single entity. Subpart F, by contrast, respects the separate existence of the CFC. A CFC retains its PTI accounts in its E&P when it is sold or disposed of so that such earnings can be distributed to the purchaser. *See* Treas. Reg. § 1.959-1(d). Treating the E&P as if it automatically tiered up to the US Parent of the CFC upon a subpart F inclusion would seem to duplicate the same E&P in two corporations at the same time without specific statutory or regulatory authority to do so.

Conclusion

The AM reflects a strong tendency by the IRS in favor of the accounting consistency rule. Under this rule, adjustments to tax basis (upward or downward) would seem to be the appropriate time for adjusting earnings and profits, rather than a later time when the related item has a direct economic effect on the recipient corporation's net worth or dividend-paying ability.

1 *See* § 565(c) (consent dividends by a personal holding company deemed distributed and then re-contributed to capital) and Former IRC § 551(f) (same for undistributed foreign personal holding company income). Subpart F deliberately avoids this approach in order to ensure that PTI remains earnings and profits of the CFC to be recovered at the earliest possible time by the US shareholder.

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