



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS

SUBJECT: Exchange gain in section 304 transaction; determination of  
earnings and profits

This Field Service Advice responds to your memorandum dated September 14, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

|        |   |
|--------|---|
| Parent | = |
| Sub1   | = |
| Fsub1  | = |
| Fsub2  | = |

|           |   |
|-----------|---|
| Country X | = |
| Region1   | = |
| State Y   | = |
| TY1       | = |
| TY2       | = |
| YearA     | = |
| YearB     | = |
| YearC     | = |
| YearD     | = |
| Date1     | = |
| Date2     | = |
| Date3     | = |
| Date4     | = |
| Date5     | = |
| Date6     | = |
| \$aa      | = |
| \$bb      | = |
| \$cc      | = |
| \$dd      | = |
| \$ee      | = |
| \$ff      | = |
| \$gg      | = |
| \$hh      | = |
| \$ii      | = |

|       |   |
|-------|---|
| \$jj  | = |
| \$kk  | = |
| \$ll  | = |
| \$mm  | = |
| \$nn  | = |
| \$oo  | = |
| \$pp  | = |
| \$qq  | = |
| \$rr  | = |
| \$ss  | = |
| \$tt  | = |
| \$uu  | = |
| \$vv  | = |
| \$ww  | = |
| \$xx  | = |
| \$yy  | = |
| \$zz  | = |
| \$aaa | = |
| \$bbb | = |
| \$ccc | = |
| \$ddd | = |
| \$eee | = |
| \$fff | = |
| \$ggg | = |

|         |   |
|---------|---|
| \$hhh   | = |
| saaa    | = |
| sbbb    | = |
| sccc    | = |
| sddd    | = |
| seee    | = |
| Court A | = |
| Case#   | = |
| r%      | = |
| s%      | = |
| t%      | = |

#### ISSUES:

1. Whether, for purposes of calculating the gain recognized in a transaction under I.R.C. ' 304(a)(1) in TY1, Sub1 should increase its basis in the stock of Fsub1 by the amount of an exchange gain recognized under I.R.C. ' 986(c)(1) with respect to the deemed distribution of previously taxed income (APT<sup>10</sup>) under I.R.C. ' 959.
2. Whether Fsub2's distribution to Sub1 in TY2 constituted a dividend rather than a return of capital.

#### CONCLUSIONS:

1. The exchange gain should not increase the basis of the acquiring corporation's stock for purposes of calculating capital gain on the section 304 transaction.
2. Any portion of the distribution in TY1 from Fsub1 to Fsub2 that was properly treated as a return of capital would not increase the E&P of Fsub2. Accordingly, under the facts presented, Fsub2's E&P was less than the amount of the distribution in TY2, and the amount of the distribution in excess of Fsub2's E&P would be treated as return of capital or capital gain under I.R.C. ' 301(c).

## ISSUE 1. CAPITAL GAIN ON ' 304 TRANSACTION

### FACTS:

#### A. Sub1's Sale of Fsub1 to Fsub2

Parent is a domestic corporation which was the common parent of an affiliated group that filed consolidated income tax returns for TY1 and TY2.

During YearB, Parent formed Fsub1, a Country X corporation, with a contribution of cash. On Date1, Parent transferred the stock it held in certain Country X corporations to Fsub1 in exchange for voting common stock and profit participation rights, which Parent characterizes for U.S. tax purposes as nonvoting preferred stock. During the YearB tax year, Parent restructured its Country X operations and, as a result of this restructuring, recognized a deemed dividend distribution under I.R.C. ' 1248<sup>1/</sup> flowing from Fsub1. This recognition resulted in PTI under I.R.C. ' 959 of approximately \$aa.<sup>1/</sup>.

On Date2, Parent incorporated Sub1 as a State Y corporation. At or around the same date, Parent transferred s% of its stock interest in Fsub1 to Sub1 in exchange for all of Sub1's stock. Parent retained a t% direct interest in Fsub1.

On or about Date3, Sub1 formed Fsub2, a Country X holding company, by contributing saaa to Fsub2 in exchange for r% of Fsub2's stock. Thus, as of Date3, Sub1 owned s% of the stock of Fsub1 and r% of the stock of Fsub2, both Country X corporations.

On Date3, Sub1 sold its s% interest in Fsub1 to Fsub2, receiving cash of \$bb, notes of \$cc, and additional stock of Fsub2 of \$dd for a total purchase price of \$ee. The Service does not dispute the purchase price paid by Fsub2 for the Fsub1 stock.

#### B. Taxpayer's treatment of Sub1's transfer to Fsub2

On Schedule D of the consolidated income tax return for TY1, Parent identified Sub1's transfer of its s% stock interest in Fsub1 as part of the "Region1 Transactions" and treated

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<sup>1/</sup> Section 1248 generally requires a United States shareholder selling or exchanging stock in certain foreign corporations to report a portion of any recognized gain as dividend.

<sup>2/</sup> Section 959(e) generally excludes from the gross income of a United States shareholder amounts which the United States shareholder previously included in income under section 1248. This exclusion occurs at the time the PTI is distributed or deemed distributed.

it as a section 304 transaction. It further characterized the section 304 transaction as consisting of two parts: First, as a deemed capital contribution by Sub1 of the Fsub1 stock to the capital of Fsub2, and second as a deemed redemption by Fsub2 of its stock held by Sub1.

Parent treated the deemed capital contribution as a section 351(a) exchange and included a statement with the consolidated return entering into a gain recognition agreement under section 367, consistent with Temp. Treas. Reg. ' 1.367(a)-3T(g) and Notice 87-85.<sup>1/</sup> As a result, it recognized no gain with respect to this part of the transaction.

Because Sub1 constructively owned Fsub1 both before and after the transaction, the taxpayer treated the deemed redemption as a dividend distribution by Fsub2 to the extent of its earnings and profits (AE&P@) and then as a dividend distribution by Fsub1 to the extent of its E&P. See I.R.C. ' ' 304(b)(2)(A) and 304(b)(2)(B).

At the time Sub1 sold the Fsub1 stock to Fsub2 on Date3, Fsub2 had E&P of sbbb (\$ff) with no PTI, and Fsub1 had E&P of sccc (\$gg), of which sddd was PTI and seee (\$hh) was nonPTI. Sub1 had a dollar basis of \$aa in the sddd of PTI, which had dollar value on Date3 of \$ii.

Since Fsub1's accumulated E&P included the \$aa of PTI from the YearB fiscal year, the taxpayer excluded it from income under section 959. However, as a result of the receipt of the PTI, the taxpayer recognized and reported an exchange gain of \$aaa pursuant to section 986(c)(1). During the audit, Examination and the taxpayer agreed that the amount of Sub1's exchange gain was \$jj, which is the difference between the dollar value of the PTI (\$ii) on Date3 and Sub1's dollar basis (\$aa) in the PTI.

In addition to the exchange gain, the taxpayer recognized and reported a capital gain in the amount of \$kk. In arriving at the capital gain of \$kk, the taxpayer treated the exchange gain as having been distributed immediately prior to the sale of the Fsub1 stock, thereby increasing Sub1's basis in Fsub1's stock. In a statement attached to the return, the taxpayer acknowledged that if the exchange gain did not increase Sub1's basis, the capital gain recognized would be \$bbb, rather than the \$kk reported.

The taxpayer treated the \$jj of exchange gain under the section 1248 transaction rule, sec. 2(c) of Notice 88-71, 1988-2 C.B. 374, at 380, which treats the distribution of PTI as

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<sup>3/</sup> Normally, section 367 requires a U.S. taxpayer to recognize gain on certain transfers to a foreign corporation. Thus, Parent and Sub1 by entering into the gain recognition agreement avoided tax on Sub1's deemed capital contribution of Fsub1's stock to Fsub2.

occurring immediately before the transaction for purposes of computing the exchange gain.

As a result, the taxpayer increased Sub1's basis in Fsub1 by the amount of the exchange gain in computing Sub1's basis in Fsub2 stock for purposes of the section 301/304 distribution, as follows:

|                                                   |      |      |
|---------------------------------------------------|------|------|
| Basis in Fsub1 contributed to Fsub2 <sup>4/</sup> | \$ll |      |
| Subpart F income (YearC) <sup>4/</sup>            |      | \$mm |
| Subpart F income (YearD)                          | \$nn |      |
| Subtotal                                          | \$oo |      |
| Exchange Gain - Section 986(c)                    | \$jj |      |
| Total Basis                                       | \$pp |      |

The taxpayer's calculation of capital gain in the section 304 transaction is as follows:

|                                   |        |
|-----------------------------------|--------|
| Cash & Notes proceeds             | \$ccc  |
| Less:                             |        |
| Fsub2 dividend                    | (\$ff) |
| Fsub1 PTI                         | (\$aa) |
| Fsub1 dividend                    | (\$hh) |
| Exchange gain (PTI)               | (\$jj) |
| Subtotal                          | \$qq   |
| Section 301(c)(2) basis recapture | (\$qq) |
| Section 301(c)(3) capital gain    | \$rr   |

### C. Exam's audit of the transfer

On audit, Exam agreed with the taxpayer that the transfer constituted a section 304 transaction to which section 301 applies. Accordingly, it also agreed that in calculating the

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<sup>4/</sup> Taxpayer apparently treats Sub1's original basis in Fsub2 as \$rr, even though Sub1 initially contributed saaa to Fsub2 at the time of its organization.

<sup>5/</sup> We assume these amounts constitute subpart F income which increased the basis in Fsub1 stock under section 961(a).

deemed dividend, the taxpayer properly followed the rules of sections 304(b)(2)(A) and 304(b)(2)(B) by looking first to the E&P of Fsub2, the acquiring corporation, and then to the E&P of Fsub1, the issuing corporation. However, Exam disagreed with the amount of the exchange gain and its impact on Sub1's basis in the section 304 transaction.

Subsequently, Exam and the taxpayer agreed that the amount of exchange gain should be increased to \$jj. However, the parties continued to disagree on the impact of the exchange gain on Sub1's basis for purposes of computing the capital gain on the transaction. In a notice of deficiency issued on Date5, the Service disallowed Sub1's increase in its stock of Fsub1 by the amount of the currency exchange gain for TY1, determining an adjustment to Sub1's capital gain as follows:

|                             |      |             |
|-----------------------------|------|-------------|
| Cash & Notes proceeds:      |      | \$ccc       |
| Less:                       |      |             |
| Fsub2 - Dividend            |      | \$ff        |
| Fsub1 - PTI                 | \$aa |             |
| Fsub1 - Dividend            |      | <u>\$hh</u> |
| Balance Proceeds            |      | \$zz        |
| Less: Sub1's basis in Fsub2 |      | (\$ddd)     |
| Capital Gain                |      | \$ss        |
| Capital Gain-Per Return     |      | (\$kk)      |
| Adjustment                  |      | <u>\$tt</u> |

## LAW AND ANALYSIS

Under I.R.C. ' 304(a)(1), if one or more persons are in control of each of two corporations and one of the corporations acquires stock in the other from a controlling person in return for property, then the property paid for the stock is treated as a distribution in redemption of the acquiring corporation's stock. The tax treatment of the redemption is subject to the rules of I.R.C. ' 302 to determine whether it is treated as an exchange or as a distribution of property under I.R.C. ' 301. To the extent the redemption is treated as a distribution of property subject to I.R.C. ' 301, the stock so acquired is treated as having been transferred by the person from whom acquired, and as having been received by the acquiring corporation, as a contribution to the capital of the acquiring corporation.<sup>1/</sup>

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<sup>6/</sup> Effective for distributions or acquisitions after June 8, 1997, this provision was amended

For purposes of I.R.C. ' 304, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. I.R.C. ' 304(c)(1). Pursuant to I.R.C. ' 304(c)(3), the constructive ownership rules of I.R.C. ' 318(a) are applicable, with certain modifications not relevant here, for purposes of determining control.

In a transaction subject to I.R.C. ' 304(a), the determination of whether the redemption is treated as an exchange under the rules of I.R.C. ' 302(b) is made by reference to the issuing corporation (i.e., the corporation whose stock is transferred). In applying the constructive ownership rules of I.R.C. ' 318(a) with respect to I.R.C. ' 302(b), sections 318(a)(2)(C) (involving attribution from a corporation) and 318(a)(3)(C) (involving attribution to a corporation) are applied without regard to the 50 percent limitation contained in those provisions. I.R.C. ' 304(b)(1).

In the case of a section 304 redemption that is treated as a distribution under I.R.C. ' 301, the amount treated as a dividend is determined as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits. I.R.C. ' 304(b)(2).

In the instant case, Sub1 owned s% of Fsub1 and r% of Fsub2 at the time of the sale of the Fsub1 stock to Fsub2. Accordingly, Sub1 held the requisite 50 percent stock ownership to control (within the meaning section 304(c)) both Fsub1 and Fsub2 for purposes of section 304(a)(1)(A). Thus, Sub1's sale of the Fsub1 stock to Fsub2 in exchange for cash of \$bb and notes of \$cc constituted a distribution to Sub1 in redemption of Fsub2 stock pursuant to section 304(a)(1). Because Sub1 held s% of Fsub1 both before and after the sale to Fsub2, the redemption fails to qualify as an exchange under section 302(b) and is treated as a distribution subject to section 301.

The exchange of Fsub1 stock for additional Fsub2 stock is not subject to section 304(a) because the Fsub2 stock is not Aproperty,@ as defined by I.R.C. ' 317(a). However, because Sub1 had control (within the meaning of section 368(c)) of Fsub2 immediately after the transfer of the Fsub1 stock to Fsub2, the transfer of the part of the Fsub1 stock

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to provide that in a distribution subject to I.R.C. ' 301, the transferor and acquiring corporations are treated as if the transferor had transferred the stock to the acquiring corporation in a transaction to which I.R.C. ' 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

equivalent in value to the Fsub2 stock received in the exchange is treated as a section 351(a) exchange. See Rev. Rul. 73-2, 1973-1 C.B. 171; Rev. Rul. 78-422, 1978-2 C.B. 129. As a result, Sub1 did not recognize any gain or loss with respect to the additional Fsub2 stock received in the exchange, and the amount of the payment subject to section 304 (and therefore treated as a distribution under section 301) includes only the amount of the cash and notes worth \$ccc (\$bb + \$cc).

Because the deemed redemption is treated as a distribution subject to section 301, the Fsub1 stock transferred by Sub1 to Fsub2 is treated as a contribution to the capital of Fsub2 pursuant to section 304(a)(1) (prior to the 1997 amendments noted above). Under I.R.C. ' 367(c)(2), Sub1's contribution of the Fsub1 stock to the capital of Fsub2 is treated as an exchange of the Fsub1 stock for Fsub2 stock of equal value because Sub1 owned at least 80 percent of the Fsub2 voting stock. In light of Sub1's direct ownership of all of the Fsub2 stock immediately after the transfer, the exchange qualified as a section 351(a) exchange even though there was no actual transfer of Fsub2 stock to Sub1 in the section 304 transaction. See *Lessinger v. Commissioner*, 85 T.C. 894 (1985) (issuance of additional stock to sole shareholder would have been meaningless gesture), *rev'd on other grounds*, 872 F.2d 519 (2d Cir. 1989). Accordingly, taxpayer treated the transfer as a section 351(a) exchange and properly entered into a gain recognition agreement with respect to the deemed section 351(a) exchange under Notice 87-85 and Temp. Treas. Reg. ' 1.367(a)-3T(g).

In determining the amount of the section 301 distribution that is treated as a dividend, section 304(b)(2) treats the distribution as if the property were distributed first by the acquiring corporation (i.e., Fsub2) to the extent of its E&P, and then by the issuing corporation (i.e., Fsub1) to the extent of its E&P. As previously noted, Fsub2 had E&P of \$ff, and Fsub1 had E&P of \$gg on the date of the transfer. Thus, of the \$ccc distributed to Sub1 in the section 304 transaction, at least \$eee (\$ff + \$gg) would be treated as a dividend under sections 301(a) and 304(b)(2). However, \$aa of Fsub1's E&P was PTI, which would not be taxed again, pursuant to I.R.C. ' 959(a).

The amount of the distribution in excess of Fsub2's and Fsub1's E&P is treated as a return of capital that reduces the basis of the acquiring corporation (i.e., Fsub2) under section 301(c)(2), and then as capital gain under section 301(c)(3). In determining Sub1's basis in the stock of Fsub2, the taxpayer treated the \$jj of exchange gain under the section 1248 transaction rule, Notice 88-71, sec. 2(c), 1988-2 C.B. 374, at 380. That rule treats the distribution of PTI as occurring immediately before the transaction for purposes of computing the exchange gain. In a section 1248 transaction, the exchange gain is recognized and increases the basis of stock immediately before the transaction. Under section 986(c), foreign currency gain is defined as gain with respect to distributions of PTI

attributable to movements in exchange rates between the time of deemed and actual distribution and is treated as ordinary income.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. Taxpayer's reliance on Notice 88-71 is inappropriate because that provision of the notice applies only to section 1248 and 1291 transactions (see sec. 2(c) of Notice 88-71 at 280). The section 304 redemption transaction in this case does not constitute a section 1248 disposition. Under section 1248, gain from the sale or exchange of stock of a CFC is treated as a dividend to the extent of its E&P. In this section 304 transaction, the PTI (previously taxed E&P) is derived from Fsub1, but the stock of Fsub2 (not Fsub1) is exchanged pursuant to a stock redemption under section 302 pursuant to section 304. Thus, there is no exchange of Fsub1 stock from which its E&P is derived, as required by a section 1248 transaction.

Additionally, the rationale for the basis increase under Notice 88-71 does not apply to the section 304 transaction in this case. Under section 1248(d)(1), E&P constituting PTI is excluded from a section 1248 deemed dividend distribution. Thus, solely for purposes of section 986(c), Notice 88-71 treats PTI as being distributed before a section 1248 sale so that the exchange gain or loss that accrued during the selling U.S. shareholder's holding period is recognized by the U.S. shareholder (otherwise, the exchange gain or loss would not be recognized in a section 1248 transaction because the PTI would not be treated as distributed). Under the notice, the basis in the CFC stock is adjusted by the exchange gain or loss immediately before the section 1248 sale, so that the exchange gain already included into income is not reflected in gain on the sale. In the section 304 transaction, PTI is not excluded from the section 301 distribution.<sup>1/</sup> Hence, the exchange gain on the distribution of PTI is recognized pursuant to the section 301 distribution under section 304. Thus, there is no reason to treat all of the PTI as being distributed before the transaction and increasing the basis of stock.

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<sup>1/</sup> It should be noted that section 304 was amended under the 1997 Taxpayer Relief Act to exclude PTI from section 301 distributions, by applying the section 1248(d) exclusions. The effective date of this amendment is for distributions and acquisitions after June 8, 1997. Thus, the amendment would not apply to the transaction at issue, which occurred in 1991. In any event, this provision was subsequently repealed, effective as if included in the 1997 Act, by ' 6010(d)(1) of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-34.

The PTI, therefore, is treated as distributed and giving rise to exchange gain pursuant to the section 301 distribution. The PTI is not taxable under section 959(a), which provides that PTI will not be taxed again on its distribution. The exchange gain, however, is taxable under section 986(c).

The PTI account (E&P) of Fsub1 should be reduced by the PTI distributed and, therefore, should be included in the section 301(c)(1) distribution pursuant to section 304.<sup>8/</sup> The exchange gain, however, is not reflected in Fsub1's PTI account.<sup>9/</sup> Therefore, the exchange gain should not reduce Fsub2's or Fsub1's E&P and should not be included in the section 301(c)(1) distribution.

The amount of PTI treated as distributed in the section 304 transaction should also reduce the U.S. shareholder's basis in the Fsub2 stock. Under section 961(b), distributions of PTI reduce the basis of stock of a CFC; this reduction in basis offsets the basis increase under section 961(a) when PTI (i.e. subpart F income) is earned and included into income. This transaction is unique in that the basis increase occurred with respect to Fsub1 stock (because Fsub1 earned the PTI) but the basis decrease occurs with respect to Fsub2 stock upon the distribution of PTI. This is the correct result, however, because Fsub1's basis (and hence, the basis increase for PTI) is reflected in the Fsub2 stock basis. Thus, since Fsub2's basis is increased by Fsub1's PTI, it should correspondingly be decreased by the distribution of that PTI. We also believe the statutory language of section 961(b) is broad enough to allow for this treatment.<sup>10/</sup>

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<sup>8/</sup> See section 959(d), which provides that distributions of PTI will reduce E&P. The issue present in this case is that while the PTI of Fsub1 is treated as distributed for purposes of section 304, the PTI does not actually leave the corporation. Under section 304, a distribution of E&P (that is not PTI) from the issuing corporation will reduce E&P in order to prevent the same E&P from being taxed again on a subsequent distribution. This also prevents the foreign tax credits attributable to the E&P from being used a second time. We believe the treatment of PTI should be consistent with the overall treatment of E&P.

<sup>9/</sup> The exchange gain is not included in Fsub1's E&P, because the exchange gain is a tax attribute of the shareholder and is not an income item of Fsub1 or Fsub2 included in its E&P. The U.S. shareholder takes a U.S. dollar basis in the foreign functional currency PTI, equal to the U.S. dollar amount of subpart F income previously included in income. These amounts should have been translated into U.S. dollars at the average exchange rate for the taxable year the subpart F income was included in income (see section 989(b)(3)). Exchange gain or loss equals the difference in the dollar value of the PTI at the time of the inclusion and its dollar value at the time of the distribution.

<sup>10/</sup> Section 961(b) provides for the reduction in basis of stock with respect to which a U.S.

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shareholder receives a distribution of PTI. In this case, Sub1 (the U.S. shareholder) receives PTI with respect to the distribution in redemption of Fsub2 stock. While the drafters of section 961(b) probably contemplated that the receipt of PTI with respect to the stock of a corporation would be from the E&P of that corporation, the statute is broad enough to allow for the unique circumstance under section 304 where amounts are distributed with respect to Fsub2 stock even though the PTI came from the E&P of Fsub1.

Based on the above, the basis and capital gain on the section 304 transaction are recomputed as follows, excluding Sub1's exchange gain from the basis of Fsub2 stock:

|                                     |      |
|-------------------------------------|------|
| Basis in Fsub1 contributed to Fsub2 | \$ll |
| Subpart F income (YearC)            | \$mm |
| Subpart F income (YearD)            | \$nn |
| Subtotal                            | \$oo |

The calculation of capital gain is as follows:

|                       |       |
|-----------------------|-------|
| Cash & Notes proceeds | \$ccc |
|-----------------------|-------|

Less:

|                |        |
|----------------|--------|
| Fsub2 dividend | (\$ff) |
| Fsub1 PTI      | (\$aa) |
| Fsub1 dividend | (\$hh) |

|          |      |
|----------|------|
| Subtotal | \$zz |
|----------|------|

|                                                                             |                |
|-----------------------------------------------------------------------------|----------------|
| Reduction in Fsub2 stock basis by PTI<br>distribution under section 961(b): | \$oo<br>(\$aa) |
|-----------------------------------------------------------------------------|----------------|

|            |       |
|------------|-------|
| Net Basis: | \$ddd |
|------------|-------|

|                                   |         |
|-----------------------------------|---------|
| Section 301(c)(2) basis recapture | (\$ddd) |
| Section 301(c)(3) capital gain    | \$ss    |

2. We note that the facts discussed below under issue 2 indicate that Fsub1 apparently had current E&P in TY1 of \$fff inasmuch as Examination determined that amount to be a dividend to Fsub2 with respect to the distribution of \$ggg on Date4, after the section 304 transaction discussed above. We note, however, that Treas. Reg. ' 1.316-2(b)&(c) provide for the allocation of current E&P among all distributions occurring in a taxable year. Because the section 304/section 301 distribution discussed above also occurred during TY1, a portion of Fsub1's current E&P should have been allocated to that deemed distribution. We cannot determine from the available information whether such an allocation was made and recommend further investigation on this point.

## ISSUE 2. DISTRIBUTION IN TY2 FROM FSUB2 TO SUB1

### FACTS

After Sub1's transfer to Fsub2 on Date3, Sub1 retained its r% stock ownership of Fsub2, and Fsub2 owned a s% interest in Fsub1, with Parent owning the other t% interest. On Date4, Fsub1 made a \$ggg distribution to Fsub2. Examination has determined that \$fff of this distribution was a dividend to Fsub2 and the remaining \$www was a return of capital.

During the subsequent TY2, Fsub2 made distributions to Sub1 totaling \$uu. On the consolidated return, the taxpayer did not include the distributions as dividends in Sub1's U.S. taxable income, contending that the distributions were not dividends under section 316 because Fsub2 had no E&P. Because the taxpayer asserts that Sub1 had a basis of approximately \$vv in the Fsub2 stock at the time of the distribution, it takes the position that the \$uu distribution constituted a return of capital under section 301(c)(2) and was not taxable to Sub1.

Examination and the taxpayer agree that immediately after the transfer of Date3, Fsub2 possessed E&P of \$rr. This conclusion apparently reflects the fact that Fsub2 distributed its entire \$ff of accumulated E&P as a dividend to Sub1 as part of the section 304 transaction. However, in Examination's view, the \$www treated by the taxpayer as return of capital, as well as the \$fff dividend, increased the E&P of Fsub2. Thus, the notice of deficiency issued to Parent on Date5 treated Fsub2 as having sufficient E&P to support the entire \$uu distribution to Sub1 as a dividend.

On Date6, Parent commenced a proceeding in Court A , Case#, contesting the entire deficiency asserted with respect to TY2, including the adjustment related to this issue.

### LAW AND ANALYSIS

Under I.R.C. ' 316(a), the term Adividend@ means any distribution of property by a corporation to its shareholders (i) out of its E&P accumulated after February 28, 1913, or (ii) out of its earnings and profits of the taxable year computed without regard to the amount of E&P at the time of the distribution. The E&P of the taxable year is computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. I.R.C. ' 316(a); Treas. Reg. ' 1.316-1(a)(1). Every distribution by a corporation is deemed to be made out of E&P to the extent thereof, and from the most recently accumulated E&P. I.R.C. ' 316(a). Under Treas. Reg. ' 1.316-2(a), a distribution of E&P is made first out of the E&P of the current taxable year, then out of E&P accumulated after February 28, 1913, and finally out of E&P accumulated before February 28, 1913.

As previously noted, where the distribution exceeds all of the corporation's E&P, section 301(c)(2) treats the excess as a return of capital to the extent of the shareholder's basis

under section 301(c)(2), and section 301(c)(3) treats any remaining amount as gain from the sale or exchange of property. In accordance with I.R.C. ' 312(f)(2)(A) and Treas. Reg. ' 1.312-8, a distribution that is applied against the basis of the stock of the distributing corporation does not increase the E&P of a corporate shareholder, but a gain by the shareholder under section 301(c)(3) increases the shareholder's E&P.

Assuming the \$fff of Fsub1's current E&P in TY1 is allocable to the \$ggg distribution from Fsub1 to Fsub2, the treatment of the distribution should be as follows. The \$fff portion of the distribution (from Fsub1's E&P) would be a dividend to Fsub2 and foreign personal holding company income (subpart F income) to Sub1 taxable under section 951(a). If Fsub2's basis in Fsub1 was \$oo (Sub1's carryover basis in Fsub1 stock), the remainder of the distribution (\$ww) would be a return of basis to Fsub2 under section 302(c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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Please call if you have any further questions.

By:

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STEVEN J. HANKIN  
Acting Chief, Corporate Branch