Bloomberg BNA

Tax Management International Journal™

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What Amount of Foreign Taxes Is Pulled Up by a Redemption?

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This commentary will explore an important unanswered question in AM 2013-006 (Sept. 30, 2013) (the ''AM''), namely, what amount of foreign taxes of a foreign corporation is removed from the foreign corporation when it redeems a portion of its shares. The AM is silent on this question, and there appears to be no law on the question generally. To understand the question, it is helpful to review the known facts and the conclusion of the AM.

The AM addressed what appears to be an extremely simple set of facts. A U.S. parent (USP) owned 60% of the stock of a controlled foreign corporation (CFC). The remaining 40% of CFC's shares was owned by an unrelated foreign person (FP). On an unspecified date during year 1, CFC redeemed all of FP's shares in a redemption treated as a §302(a) exchange. Under §312(n)(7), the redemption resulted in a reduction of the earnings and profits (E&P) of CFC equal to FP's 40% pro rata share of CFC's E&P. In year 2, CFC distributed an amount equal to its remaining E&P to USP in a distribution treated as a dividend. USP claimed a §902 credit for foreign taxes associated with that distribution. The AM does not specify the amount of the foreign taxes claimed as a credit, but USP's position was that the foreign taxes of CFC were not reduced by the year 1 redemption of FP's shares.

The issue addressed by the AM was whether CFC's post-1986 foreign taxes were reduced by the redemption. The answer was yes. This commentary will assume that the answer was correct.[1] But the AM did not provide any clue into what the amount of that reduction was.

It may be useful to begin the inquiry by asking, first, what amount of E&P is extracted from CFC by reason of the redemption. The AM simply stated that it is the pro rata share of CFC's E&P as provided in §312(n)(7). However, nothing in the Code explicitly provides how to determine that amount. If the redemption just happened to take place on the last day of the taxable year of CFC, it seems fairly clear that the redemption would pull out a pro rata share of all E&P accumulated through that entire year, including any E&P accumulated during that year. However, if the redemption was effected in the middle of the taxable year, one must first ask whether it pulls out only the E&P accumulated through the prior year, the E&P accumulated through the full year of the redemption (including the portion of the year following the redemption), or only the E&P accumulated through the date of the actual redemption.

IRS rulings make clear that the rule for §302(a) redemptions takes account of all E&P accumulated through the date of the redemption. These rulings represent an extension of Reg. §1.316-2(b), which applies where a corporation has insufficient current E&P to support dividend characterization for all distributions made within a given taxable year. This approach stands in contrast to the ''nimble dividend'' rule that

[1] It is fairly clear that the IRS has authority under §902(c)(8) to provide a rule that would reduce a CFC's foreign tax pool when earnings are extracted by the redemption of a shareholder, even a shareholder who cannot benefit from those foreign taxes. The issue in the AM was whether existing regulations at Reg. §1.902-1(a)(8)(i) actually achieved this result.

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ISSN 0090-4600

applies to ordinary distributions described in §301. That rule takes into account all current E&P for the entire taxable year, without diminution by distributions during the year, and then looks back to all distributions during the year, allocating the current E&P to such distributions.[2] This is also the approach used in §902(c)(1), which by its terms applies only to amounts treated as dividends.

So, for example, in Rev. Rul. 74-338,[3] a corporation made ordinary distributions during a year and also redeemed some shares in a §302(a) exchange during the same year. The ruling assumed that the corporation could not prove when during the year the current E&P was earned, thus precluding a closing of the books allocation. Given that, the ruling allocated current E&P to the redemption on a per diem basis. In contrast, in PLR 200352015, the IRS permitted a REIT to allocate its current E&P to the redemption on a closing of the books basis, where the REIT represented that it was able to demonstrate the amount of E&P earned through the date of the redemption.

Thus, for purposes of §312(n)(7), it seems fairly well established that accumulated E&P includes current E&P through the date of the redemption. It also seems fairly clear that a corporation may use a closing of the books method to determine accumulated E&P through the redemption date, if it can show the amount of current E&P earned through that date. So let us suppose that the redemption in the AM occurred on June 30, 2009, that accumulated E&P through 2008 was 100, that E&P for the entire year 2009 was 100, and that current E&P through June 30, 2009, could be shown to be 20 using a closing of the books method for proration. Under a closing of the books method, the accumulated E&P at issue would have been 120. In that event, a redemption of 40% of the stock of CFC would have taken out 48 of E&P. In contrast, if it could not be shown how much current E&P was earned through June 30, 2009, then the current E&P would be prorated through June 30, resulting in E&P of 150 as of that date. The redemption in that case would have removed 60 of E&P.

The foregoing discussion of how much E&P is extracted by a redemption may or may not be relevant to determine the amount of foreign taxes pulled out corresponding to the removed E&P. The AM ruled simply that a ''corresponding amount'' of post-1986 foreign taxes was removed. But that raises the question of what the ''corresponding amount'' might be. Presumably one looks to the amount of foreign taxes in the pool as of the date of the redemption, given that it appears that E&P is calculated through that date. But what is in that pool on that date?

It is very clear that foreign taxes are treated as accruing only on the last day of the foreign tax period.[4] This is an application of the ''all the events'' test, which requires that the taxpayer's liability to pay the tax be fixed. Therefore, the most logical answer is that the E&P pulled out a corresponding amount of only those foreign taxes that had accrued through the date of the redemption. In the example above, involving a mid-year redemption, this would include only foreign taxes accrued as of the end of 2008, the year prior to the year in which the redemption occurred. Stated differently, a mid-year redemption should not pull out foreign taxes that have not yet accrued under the operative rules of the Code.

It might be argued that if E&P is accrued through the date of the redemption, foreign taxes should be as well. Under this argument, presumably the foreign taxes for the entire year 2009 would be prorated either on a closing of the books or per diem basis and a corresponding portion would be pulled out as of the redemption date. But such an approach contradicts the rule for accrual of foreign taxes.

This issue is not entirely without precedent. When §898 was first enacted, the IRS realized that forcing a CFC onto a U.S. taxable year different from its foreign taxable year could result in a mismatch of Subpart F inclusions and foreign taxes available for credit, due to the fact that foreign taxes are deemed to arise only on the last day of the foreign taxable year. The Preamble to the proposed regulations under §898 rejected any fix for this problem, including an apportionment of foreign taxes between the two short years caused by the taxable year mismatch:

> A foreign income tax accrues only when the liability for it is fixed and the amount of the liability can be determined. This event generally occurs at the end of the foreign taxable year with respect to a foreign income tax that is imposed on that year's income. . . While we considered several options to address the effect of the foreign tax accrual rule in this context, we believe that adherence to the foreign tax accrual rule is justified for several reasons.[5]

The question whether unaccrued foreign taxes should be pulled out by a mid-year redemption is similar to, but ultimately distinct from, the question of how to allocate taxes between different taxpayers. For example, where a §338 election is made for a foreign target whose foreign taxable year does not close on

[2] §316(a)(2); Reg. §1.316-1.

[3] 1974-2 C.B. 101.

[4] Reg. §1.461-4(g)(6)(iii)(B), cross-referencing to the all events test set out at Reg. §1.446-1(c)(1)(ii).

[5] IL-848-89, 58 Fed. Reg. 290 (Jan. 5, 1993).

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ISSN 0090-4600

the deemed sale date, the foreign income taxes that accrue at the end of the foreign taxable year following the deemed sale are allocated between the old target and the new target under the principles of the consolidated group rules at Reg. §1.1502-76(b). Those principles require that taxes, including foreign income taxes, be apportioned based on what is essentially a closing of the books method. While these rules may at first seem inconsistent with the presumption that foreign taxes should be taken into account only at the end of a foreign taxable year, these rules are addressing situations in which the foreign corporation in question ceases to exist (or to exist as part of a consolidated group) for tax purposes.[6] The question presented by the AM is different: whether a redemption by a continuing corporation should be deemed to extract foreign taxes not yet accrued.

It seems possible that the amount of foreign taxes pulled out by a redemption could depend on whether a closing of the books or per diem method is applied. This is not simply a question of whether any current-year foreign taxes are calculated on a closing of the books or a per diem basis. The larger question is whether the method used to allocate current E&P through the date of the redemption affects whether unaccrued foreign taxes should be counted at all.

A CFC's E&P is determined after the deduction of its foreign taxes, if any. If a per diem approach is used for E&P, it might seem logical that the full year's E&P be reduced by the full year's accrued taxes before allocating the E&P on a per diem basis. In such a case, one would wait until year-end to determine the actual amount of foreign taxes owed, and then apportion the full year's accrued taxes on a per diem basis. But if the CFC's books are closed as of the date of the redemption, foreign taxes that do not accrue until the close of the taxable year should be excluded. Those foreign taxes will have not been applied to reduce the E&P, which will therefore be larger. In effect, the foreign taxes accruing after the redemption arise in a completely different tax period.

The regulations appear to give taxpayers the right to use a closing of the books method if the amount of E&P accumulated through the redemption date can be determined. In doing so, the regulations must have assumed that foreign taxes need not be subtracted from the apportioned E&P, given that foreign taxes do not accrue until a later date. It also appears that a corporation could simply choose to use a per diem method for apportioning E&P, even if it were able to employ a closing of the books method. This suggests that a corporation has a choice: either use the closing of the books method and ignore foreign taxes accruing on the following year-end, or use a per diem method and allocate foreign taxes accruing at year-end through the date of the redemption on a per diem basis.

[6] Similarly, real property taxes also accrue only on the last day of the applicable taxable year, when they become legally owing and fixed. This is why special rules like that of §164(d) and §461(c) are needed in order to economically pro-rate property taxes between two different taxpayers — a buyer and seller of real property.

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ISSN 0090-4600