DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, (FINANCIAL SERVICES AND HEALTHCARE)(AREA 1-MANHATTAN)
CC:LM:FSH:MAN:1:TL-N-3809-00

FROM: Filiz A. Serbes
Chief, Branch 3 (Corporate) CC:CORP:B03

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 19, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Common Parent =

DS =

FS =

AS =

Country X =

Country Y =

Country Z =

Year A =

Year B =

Date 1 =

Date 2 =

Date 3	=
Date 4	=
Date 5	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
Currency	=
Authorities	=
Country Code Cite	=
Officer	=

ISSUES

Whether claimed foreign income tax credits under § 902 of the Internal Revenue Code can be disallowed in this case based on the theory that a purported $ a dividend received from a foreign subsidiary (following an increase of paid-in capital) should be recast under the step transaction doctrine as a nontaxable stock dividend within the meaning of § 305(a).

CONCLUSIONS

Claimed foreign income tax credits under § 902 can be disallowed in this case based on the theory that the purported $ a dividend received from a foreign subsidiary (following an increase of paid-in capital) can be recast as a nontaxable stock dividend under either a circular cash flow analysis or the step transaction doctrine. Furthermore, this result does not change because the subsidiary has cash from which it could have paid the purported dividend.

FACTS

Common Parent, a domestic corporation, is the parent company of a group of affiliated corporations that filed a consolidated federal income tax return ("the Common Parent Group" or "the taxpayer") for the Year A taxable year. Among other corporations, Common Parent owned all of the stock of DS, a domestic corporation. In turn, effective Date 1 of Year A[1], DS owned 100% of the stock of FS, a corporation incorporated in Country X. FS operates a Branch office in Country Y, which is subject to national and local income taxes in Country Y. For Year A, the statutory rate for such taxes was d%. The Common Parent Group and its foreign affiliates are collectively referred to as the Affiliates.

On Date 2 of Year A, the administrative committee of DS's Board of Directors executed a document entitled "Written Consent in Lieu of a Meeting of the Administrative Committee of the Board of Directors." Under this document, DS's Administrative Committee resolved to accept from Common Parent an $ a contribution to DS's additional paid-in capital. DS's Administrative Committee further resolved to authorize a contribution of $ a to FS. Through this contribution, DS could purchase e additional "ordinary" shares of FS at a purchase price per share of $ f.

Shortly thereafter, on Date 3 of Year A, FS's Board of Directors passed a resolution to pay, on Date 4 of Year A, a dividend in the amount of $ a to the holders of FS's ordinary shares. Although the resolution did not indicate FS's shareholder by name, DS was then the sole holder of such shares. Thus, this $ a dividend was to be paid to DS.

FS's unaudited financial statements represent that FS paid the $ a dividend to DS in Year A and that FS received the $ a capital contribution from DS. A footnote in these statements states that on Date 3 of Year A, FS issued to DS the e shares, thereby resulting in an $ a increase to FS's paid-in capital. During Year A but after issuance of the e shares, FS paid an $ a dividend to DS. In describing the combined effect of the capital contribution and dividend payment, the footnote stated that "in substance, this was a transfer of retained earnings to paid-in capital."

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[1] Immediately before Date 1 of Year A, DS owned b% of FS. The remaining c% of FS's stock was owned by AS, a wholly owned subsidiary of DS incorporated in Country Z.

This dividend and capital contribution were reported as separate transactions on the statement of cash flows to these financial statements.

The examining agent obtained evidence that this capital contribution and dividend were each recorded on FS's books as having been paid. A document of FS entitled "MONTHLY TRANSACTION REPORT" reports that FS paid a dividend of $ a on Date 4 of Year A. This document further shows that on Date 5 (which is a date in between Date 2 and Date 3) of Year A, DS invested $ g in FS. The entry description for that transaction was "share premium (APIC)". APIC is an abbreviation for additional paid-in capital. The $ g charged to APIC represents the difference between the entire $ a dividend and the $ e ($ h for each of the e stock shares issued) charged to FS's stock account.

FS's unaudited financial statements provide some information about FS's available funds as of its year-ended Year A. Its balance sheet shows that, as of year-end Year A, FS had cash and interest-bearing equivalents of over $ i (as stated in U.S. dollars). A footnote to these financial statements represents that FS's branch in Country Y was subject to capital requirements imposed by Country Y's Authorities. The footnote alleges that, as of year-end Year A, FS had capital of over $ j (U.S. dollar equivalent) in excess of the amount it needed to maintain under Country Y's capital requirements.

Based on the purported dividend that FS paid to DS, for the Year A taxable year, DS reported $ k in dividend income for federal income tax purposes. The remaining $ l was excluded as previously-taxed income under § 959 (which the examining agent accepts as correct). Under § 902, DS claimed $ m in deemed-paid foreign income tax credits attributable to the $ k dividend and included $ m in income under § 78.

DS claimed no § 901 credit as it represents that no tax was withheld at the source on the dividend by Country X (or by Country Y, which tax would have been reflected in FS's § 902 foreign income taxes pool). It is unknown whether the purported dividend qualified as such under Country Y law. In this connection, the examining agent has not ascertained whether FS's Country Y branch was taxed as a corporation under Country Y's tax code. Under Country Y's tax law and civil code, a corporation with its principal place of business in Country Y is considered a domestic corporation. See, Country Code Cite. FS's financial statements shed no light on that issue. They state only that in Country Y "the Branch is subject to National and Local income taxes."

The examining agent agrees that payments were made consistent with FS's declaration of the $ a dividend and DS's contribution of capital to FS. The examining agent further agrees that at year-end Year A FS had earnings and profits under § 312 sufficient to treat $ k of the purported dividend as dividend income for income tax purposes.

The examining agent argues, however, that the question is whether the purported dividend should be respected as such for U.S. federal income tax purposes. The examine agent argues that because the dividend was paid only days after a capital contribution for the same amount that was received, it can be inferred that these allegedly separate transactions were prearranged. The examine agent further argues that the taxpayer intended the combined effect of these transactions to result in a capitalization of $ a of FS's retained earnings (i.e., a transfer from retained earnings to additional paid-in capital). The examining agent thereby concludes that these transactions, when viewed together, constitute a non-taxable stock dividend under § 305. The examining agent proposes adjustments to remove the dividend income from DS's Year A income tax return and to remove the income it reported under § 78. The examine agent would disallow DS's claimed $ m deemed-paid foreign tax credits under § 902 in connection with the purported dividend.

The taxpayer's position to date is that the dividend and associated § 902 tax credits should be respected for income tax purposes for the amounts claimed. It argues that, because DS had unrestricted use of the $ a payment it received, dividend characterization is correct. It has not asserted that any foreign tax requirement or benefit was met or achieved through these transactions.

LAW[2] AND ANALYSIS

Section 301(a) generally provides: "a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)."

Section 301(c)(1) provides: "In the case of a distribution to which subsection (a) applies ... That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income."

Section 305(a) provides: "Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." See also Eisner v. Macomber, 252 U.S. 189 (1920).

Section 316(a) provides, in part, that "the term 'dividend' means any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits."

Section 902 provides: "For purposes of this subpart [Subtitle A, Ch. 1N, Part IIIA], a domestic corporation which owns 10 percent or more of the voting stock of a

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[2] All citations to the Code and the regulations are as they were in effect for the year at issue.

foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as -- (1) the amount of such dividends (determined without regard to section 78), bears to (2) such foreign corporation's post-1986 undistributed earnings."

Section 1.902-1(a)(11) of the regulations provides: "For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies." See § 1.902-1(g).

Based on the facts above, a circular cash flow analysis and the step transaction doctrine should apply to treat the transaction as if FS issued a nontaxable stock dividend under § 305(a) to DS rather than a cash dividend under §§ 301 and 316. However, before explaining the application of circular cash flow analysis and step transaction, it is helpful to highlight the salient facts that demonstrate that each step taken by the Affiliates was done pursuant to a prearranged plan to obtain § 902 credits.

The Plan

While the form of the transaction is a capital contribution by DS to FS followed by a dividend from FS to DS days later, each step taken by the Affiliates was done pursuant to a plan to obtain § 902 credits from FS without diminishing the cash assets of FS (which would occur if an actual cash dividend was made). This position is supported by the following: (1) the close proximity in time and amount between the capital contribution and the dividend, (2) the amount distributed was equal to the amount contributed, (3) the control that DS had over FS by being its sole shareholder, and (4) FS's paying the dividend in U.S. dollars even though its functional currency was Currency.

This position is also supported by two other factors. First, the resolution of DS, which accepts the capital contribution from Common Parent as additional paid-in capital and provides for the contribution of such monies to FS, has a signature line for Officer. The resolution of FS which provides for the dividend to DS also has a signature line for Officer.[3] Therefore, at least one person from FS, Officer, must

[3] The DS resolution was signed in counter-parts by Officer and another person. Therefore, there are two identical copies of the resolution each containing only one signature. The FS resolution contains the signature of another person (not the same person that signed the DS resolution) and a signature line for Officer. However, there does not appear to be an identical copy with Officer's signature. It is assumed that this resolution was also signed in counter-parts but the copy has not been received.

have known that FS would receive the contribution. It is difficult to believe that Officer would not know that FS would return the cash by way of dividend.[4]

In addition, DS only owned b% of FS until months prior to the capital contribution. It acquired the remaining c% (which is more than 50%) of the stock only months earlier from AS, a foreign subsidiary of DS. If the FS dividend was paid while AS also owned FS stock, DS may not have been able to claim as large a § 902 credit. However, the FS distribution to AS would likely have resulted in subpart F income of AS taxable to DS, with respect to which DS would have been entitled to claim a § 960 credit. Depending on the amount of AS's post-1986 undistributed earnings and foreign income tax pools, which would include taxes deemed paid by AS with respect to the dividend received from FS, the combined amounts of the § 960 credit from AS and § 902 credited from FS may have been more or less than the § 902 credit claimed by reason of treating the entire distribution as made directly to DS. [redacted]

Circular Flow of Cash

Having established that this transaction was undertaken to obtain § 902 credits, it is easy to see the circular flow of the cash whereby DS transfers cash to FS which is returned days later. The cash flows in this case are remarkably similar to the cash flows in Rev. Rul. 83-142, 1983-2 C.B. 68. In Rev. Rul. 83-142, X, a domestic corporation, owned all of the stock of FY, a foreign corporation. FY, in order to spin off one of its businesses to X, transferred the business to FZ in exchange for all of FZ's stock. However, FY could not just simply spin-off FZ to X because the transaction needed to be structured as a sale under foreign law. Therefore, as part of the transaction, X paid to FY an amount of money equal to the fair market value of the FZ stock. FY then declared a dividend to X equal to the amount X had just paid to FY plus certain other amounts.

The ruling holds: "The cash paid by X to FY and thereafter returned by FY to X as a dividend is disregarded." Like Rev. Rul. 83-142, the present case also involves the transfer of cash from a domestic parent, DS, to a foreign subsidiary, FS, which is returned by FS to DS.

Rev. Rul. 74-564, 1974-2 C.B. 124, is also similar to this case. In this revenue ruling, P owned all of S, which, in turn, owned 98% of R. In order to satisfy certain capitalization requirements, P contributed cash and its voting stock to Z, a

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[4] Even if Officer did not sign a counter-part of the FS resolution, the fact that he was supposed to sign suggests that Officer was aware that FS was to receive a large sum of cash from DS only to be returned to DS as a dividend.

new corporation formed for purposes of merging Z into R. The cash transferred by P to Z and then by Z to R in the merger was then transferred from R to S and then from S to P. Rev. Rul. 74-564 states that this circular cash flow is to be disregarded and has no tax consequences. Again, there is a transfer of cash from a parent to a subsidiary where the cash is ultimately returned to the parent, yet there is no dividend for tax purposes. See also Rev. Rul. 78-397, 1978-2 C.B. 150.

Based on these revenue rulings, the cash transferred from DS to FS and then returned by way of a purported dividend to DS should be disregarded and have no tax consequences. However, because FS actually issued stock to DS in the transaction, the stock cannot be disregarded. Giving effect to the issuance of this stock, it is clear that it merely represents a non-taxable stock dividend under § 305(a). See also Rev. Rul. 80-154, 1980-1 C.B. 68.

Step Transaction

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as if they constitute a single integrated transaction. Three tests are used to determine if the doctrine applies. They are the binding commitment test, the mutual interdependence test, and the end result test. Under the binding commitment test, a series of formally separate transactions are stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Commissioner v. Gordon, 391 U.S. 83, 96 (1968), 1968-2 C.B. 148. Under the mutual interdependence test, a series of formally separate transactions are stepped together or collapsed if they are "so interdependent that the legal relations created by one transaction would be fruitless without completion of the series." See, e.g., American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). Finally, under the end result test, a series of formally separate transactions are stepped together or collapsed if they appear to be "really prearranged parts of a single transaction intended from the outset to reach the ultimate result." Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).

Based on the facts above, it is likely that a court would apply at least one of the tests to this case to determine the actual substance of the transaction. Accordingly, the net effect of the transaction is a non-taxable stock dividend under § 305(a). See also Rev. Rul. 80-154.

Ability to Pay Dividend in Cash

Based on the information provided, it appears that FS, absent the capital contribution, may still have been able to pay the cash dividend. Where it is unclear whether a taxable cash dividend or a non-taxable stock dividend exists, some courts have considered the lack of cash in its determination that a stock dividend exists because it demonstrates that the corporation could not have paid a cash dividend. E.g., Jackson v. Commissioner, 51 F.2d 650 (3d Cir. 1931), rev'g Crellin

v. Commissioner, 12 B.T.A. 234 (1928); U.S. v. Mellon, 281 F. 645 (3d Cir. 1922), aff'g 279 F. 910 (W.D. Pa. 1919); and Maverick-Clarke Litho Co. v. Commissioner, 11 T.C. 1087 (1948), acq.1949-1 C.B. 3, aff'd, 180 F.2d 587 (5th Cir. 1950).

Nevertheless, this line of cases should not be interpreted as dictating that a dividend is a cash dividend when the corporation has cash available to pay the dividend. First, the fact that courts looked at the lack of cash assets to determine whether something is a cash or stock dividend does not mean it is the only factor to consider. Second, simply looking at cash assets does not reflect whether a corporation actually has the ability to pay a cash dividend because it could have borrowed against its hard assets. See Irving v. U.S., 44 F.2d 246 (Ct. Cl. 1930)(stating "No provision was made for the borrowing of any money by the corporation for dividend purposes and at the time of the declaration of the dividend the company had already borrowed within [close to its limit]. . . of its established lines of credit at its banks"); and Wright v. Commissioner, 10 B.T.A. 806 (1928), acq. 1928-2 C.B. 43(stating "we seriously doubt the ability of the Company to borrow on its assets any large sums of money to be used in paying dividends").

Finally, GCM 37195 (July 15, 1977), the GCM underlying Rev. Rul. 80-154, holds that, under the facts of the GCM, a dividend used by the shareholders of a foreign corporation to increase the capital of the foreign corporation is a nontaxable stock dividend under § 305(a). The GCM concludes "In the event that a ruling on this point is ultimately published we suggest that it contain the fact that the corporation lacked the ability to pay a cash dividend." However, Rev. Rul. 80-154 is silent on this point indicating that it is not a relevant factor. In fact, the statement in Rev. Rul. 80-154, addressing a related issue under § 305(b)(1), that "the fact that X and Y could have initially directed Z to distribute its profits to them in cash or other property. . ." suggests that the corporation in the revenue ruling did have cash to make a distribution yet a nontaxable stock dividend was found.

Accordingly, the fact that FS has sufficient cash to pay a dividend does not require that the distribution be treated as a taxable dividend under § 301.

Section 902

Because the distribution by FS to DS (following the increase of paid-in capital to FS) qualifies under § 305(a) as a nontaxable stock dividend, §§ 301 and 316 are inapplicable. Accordingly, the Common Parent Group is not entitled to a deemed-paid foreign tax credit under § 902 since the distribution is not a dividend within the meaning of § 1.902-1(a)(11).

Substance over Form

While the step transaction doctrine and circular cash flow analysis (which mandate a nontaxable stock dividend under § 305) should govern the results in this case, if a more general substance over form argument becomes an issue, please contact us for further assistance. Compare the cases cited in the fourth paragraph of the analysis section of GCM 37195 with the cases cited in the fifth paragraph. See also Jackson, supra, and Mellon, supra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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