INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-124785-00/CC:INTL:B4

Team Manager, Connecticut-Rhode Island Appeals

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:

LEGEND:

Sub1 =

Fsub1 =

Fsub2 =

Country X =

Year 1 =

Year 2 =

BB% =

CC% =

DD% =

Date X =

ξA =

ξaa =

ξbb =

ξcc =

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ξdd	=
ξ	=
ξee	=
ξff	=
ξgg	=
ξhh	=
ξii	=
$jj	=
$kk	=
$ll	=
$mm	=
$nn	=
$oo	=
$pp	=
$qq	=
$rr	=
$ss	=
$tt	=
$uu	=
$vv	=
$ww	=
$xx	=

$yy =

$zz =

ξaaa =

ISSUES:

How are the earnings and profits of a foreign corporation determined in a foreign functional currency (including both previously taxed earnings and profits (PTI) and taxable earnings and profits (nonPTI)) translated into U.S. dollars when distributed in a section 301 distribution pursuant to a section 304 transaction?

CONCLUSIONS:

The distribution of a foreign corporation's E&P will be determined in the foreign corporation's functional currency for purposes of section 301 and will be translated into U.S. dollars at the spot rate to the extent the distribution is taxable as a dividend under section 301(c)(1). The distribution of PTI under section 301 and the amount of the section 959 exclusion will be determined in the foreign corporation's functional currency. The distribution of PTI must be translated into U.S. dollars at the spot rate on the date of the distribution for purposes of determining the amount of exchange gain or loss recognized under section 986(c).

FACTS:

The taxpayer is a domestic corporation which files a U.S. consolidated return on behalf of a group of affiliates. In , the taxpayer organized Fsub1, a Country X corporation, with a contribution of cash and shortly thereafter contributed the stock of certain Country X corporations to Fsub1 in exchange for Fsub1 voting common stock and nonvoting preferred stock. In Year 1, the taxpayer incorporated Sub1, a domestic corporation, contributing BB% of its stock interest in Fsub1 to Sub1 for all of Sub1's stock. The taxpayer retained only a CC% interest in Fsub1.

On Date X, Sub1 organized Fsub2, a Country X holding company, and contributed ξA to Fsub2 in exchange for all of Fsub2's stock. Thus, Sub1 owned BB% of Fsub1 and DD% of Fsub2, both Country X corporations.

On Date X, Sub1 sold its BB% interest in Fsub1 to Fsub2 in exchange for cash of ξaa, notes of ξbb, and Fsub2 stock worth ξcc. On Schedule D of the consolidated return for the Year 2 tax year, the taxpayer characterized the portion of the sale of the Fsub1 stock for cash and notes totaling ξdd as a section 304 transaction. The taxpayer 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. The taxpayer treated the deemed capital contribution as a section 351 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, 1987-2 C.B. 395.

Because Sub1 constructively owned Fsub1 before and after the transaction, the taxpayer treated the deemed redemption as a dividend distribution by Fsub2 to the existent of its E&P and then as a dividend distribution by Fsub1 to the extent of its E&P. See sections 304(b)(2)(A) and 304(b)(2)(B). Fsub2 and Fsub1, both Country X corporations, had a foreign functional currency in ξ.

For the year Sub1 sold the Fsub1 stock to Fsub2, Fsub2 had earnings and profits (E&P) of ξee, and Fsub1 had E&P of ξff, of which ξgg was previously taxed earnings (PTI) under section 959 and ξhh was non-PTI. Sub1 had a dollar basis of $jj in the ξgg of PTI. At the time of the section 304 transaction, the dollar value of the PTI was $kk, resulting in an exchange gain of $ll ($kk - $jj) which the taxpayer reported under section 986(c).

At issue is how to translate the E&P of Fsub2 and Fsub1 from its foreign functional currency (ξ) into U.S. dollars for purposes of computing the section 301 distribution. The Field chose to translate the E&P into U.S. dollars by translating the PTI at its historical basis ($jj) and translating the non-PTI at the average rate for the year of the distribution. Under this view, the taxpayer would have a capital gain of $mm, because there is insufficient E&P to cover the full amount of the distribution and there is a recovery of basis of Sub1's basis in Fsub2. The computation of capital gain as determined by the Field is as follows:

Distribution:	ξdd	$ nn	(spot rate at Date X)
Fsub2's Non-PTI:	ξee	$ oo	(average for Year 2)
Fsub1's PTI:	ξgg	$ jj	(tax basis)
Fsub1'S Non-PTI: DM	<u>ξhh</u>	<u>$ pp</u>	(average for Year 2)
Total E&P:	ξii	$qq	

Amount of distribution in excess of E&P:	$ rr
Sub1's basis in Fsub2 stock:	$ ss
Reduced by PTI under section 961(b):	$ jj

Net basis amount:	$ tt
Section 301(c)(2) return of basis:	$ tt

Section 301(c)(3) capital gain:		$ mm
Total amount taxed:	Fsub2's E&P	$ oo
	Fsub1's non-PTI	$ pp
	Exchange gain	$ ll
	Capital gain	$ mm

	Total	$ uu

The taxpayer believes that the E&P of Fsub2 and Fsub1 should be kept in its functional currency and not translated into U.S. dollars for purposes of computing the section 301 distribution. This results in all of the distribution being treated as E&P, and none of the distribution being treated as a recovery of the taxpayer's basis in Fsub2 or as capital gain. The taxpayer would treat ξgg of the distribution as a nontaxable distribution of PTI under section 959, and would treat the remaining taxable E&P (non-PTI) as a taxable distribution. The amount of the taxable E&P distributed would be translated into U.S. dollars using the spot rate at the time of the distribution. The taxpayer's computations are as follows:

Distribution:	ξdd
Fsub2's Non-PTI:	ξee
Fsub1's PTI:	ξgg
Fsub1'S Non-PTI:	ξhh
Total E&P:	ξii

No return of basis under section 301(c)(2).

No capital gain under section 301(c)(3).

The total amount taxed would be as follows:

Fsub2's E&P	$ vv (at the spot rate)
Fsub1's non-PTI	$ xx (at the spot rate)
Exchange gain	$ ll

Total	$ yy

The taxpayer and the Field have requested technical advice from the National Office.

LAW AND ANALYSIS:

In determining the amount of the section 301 distribution that is treated as a dividend in a section 304 transaction, section 304(b)(2) treats the distribution as if the property were distributed first by the acquiring corporation (Fsub2) to the extent of its E&P, and then by the issuing corporation (Fsub1) to the extent of its E&P. As previously noted, Fsub2 had E&P consisting of non-PTI of ξee, and Fsub1 had E&P consisting of non-PTI of ξhh and PTI of ξgg on the date of the transfer.

Under section 986(b), the earnings and profits of a foreign corporation are determined in the corporation's functional currency, and when such earnings and profits are distributed (or deemed distributed) to a U.S. shareholder, the earnings and profits are translated (if necessary) into U.S. dollars using the appropriate exchange rate. Under section 989(b)(1), the appropriate exchange rate for an actual distribution of earnings and profits is the spot rate on the date such distribution is included in income.

Under section 959(a), the distribution of E&P of a foreign corporation that has been previously taxed to a U.S. shareholder under section 951(a) (subpart F income) is not taxed again when distributed to the U.S. shareholder or to a successor in interest.

Under section 961(a), a U.S. shareholder's basis in a controlled foreign corporation is increased by the amount required to be included in gross income under section 951(a) with respect to such stock. Under section 961(b), the adjusted basis of stock with respect to which a U.S. shareholder receives an amount excluded from income under section 959(a) is reduced by the amount excluded.

Under section 986(c), foreign currency gain or loss is recognized on distributions of PTI attributable to the movement of exchange rates between the time of the previous inclusion in income and the actual distribution of the PTI. Such gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion.

The issue is whether the E&P of Fsub2 and Fsub1 should be kept in its foreign functional currency (ξ) or translated into U.S. dollars for purposes of determining the taxability of the distribution under section 301. We agree with the taxpayer that the E&P should be determined in the corporations' foreign functional currency for purposes of section 301. Under section 986(b), the earnings and profits of a foreign corporation are determined in the corporation's functional currency. The amount of the section 301 distribution (i.e. the amount of cash and notes paid in the section 304 transaction) is also determined in the foreign corporation's functional currency. Since the amount of the distribution and the E&P are both stated in the foreign functional currency, the E&P of Fsub2 and Fsub1 should be determined in the foreign functional currency for purposes of determining the taxability of the distribution under section 301.

Because there is sufficient E&P in Fsub2 and Fsub1 (totaling ξii) to cover the entire amount of the distribution (ξdd), the entire distribution is potentially taxable as a dividend under section 301(c)(1). Thus, there is no return of basis or capital gain under section 301(c) as proposed by the Field. The portion of the distribution from previously taxed E&P (PTI) is not taxable as a dividend, because it is excluded from income under section 959. Thus, of the ξdd distribution, the portion of the distribution consisting of PTI (ξgg) will be excluded from income under section 959 and will not be taxable as a dividend under section 301(c)(1). However, the exchange gain of $ll attributable to the PTI distribution will be recognized under section 986(c). The remainder of the distribution (ξaaa) which constitutes non-PTI is taxable as a dividend under section 301(c)(1) and must be translated at the spot rate at the time of the distribution under section 989(b)(1). The spot rate for the ξaaa distribution is $zz, and this amount is taxable to Sub1 as a dividend.

The distribution of non-PTI is translated into U.S. dollars because it is taxable as a dividend under section 301(c)(1). See section 989(b)(1), which provides for the translation of a distribution into U.S. dollars when the distribution is "included in income". The distribution of PTI and the amount of the section 959 exclusion is not translated into U.S. dollars but kept in foreign functional currency for purposes of section 301, because the PTI distribution is not taxable as a dividend under section 301(c)(1). The PTI distribution, however, must be translated into U..S. dollars to determine the amount of exchange gain or loss under section 986(c), which is the difference between the spot rate of the PTI distribution on the distribution date and the historic basis of the PTI (which is the U.S. dollar value of the PTI previously included in income under section 951).

Because Sub1's basis in Fsub2 stock is in U.S. dollars, the amount of the section 959 exclusion must be translated into U.S. dollars for purposes of section 961(b) to determine the amount by which the basis in Fsub2 stock is reduced. The reduction in basis under section 961(b) should reflect the prior basis increase under section 961(a). See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 106 (1962). Thus, the section 959 exclusion should be translated at the PTI's historic basis ($jj) for purposes of section 961(b), as that amount increased basis under section 961(a).

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.