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Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:
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Legend

Taxable years
Taxpayer
TIN
Foreign Corporation A
Country M
X business
Date A
Date B

This is in response to your letter, dated May 28, 1997, which requested rulings on two issues. The first of these addressed whether, in any taxable year, the amount includible in the gross income of a United States shareholder of a foreign personal holding company ("FPHC") as undistributed foreign personal holding company income ("UFPHCI") under section 551(b) of the Internal Revenue Code is limited by the corporation's current and accumulated earnings and profits ("E&P"). Subsequently, and in part in response to our ruling herein, a second request for a ruling was withdrawn.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted

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in support of the request for rulings, it is subject to verification on examination.

The information you submitted for consideration is summarized below.

Taxpayer, a United States citizen, owns 100% of the shares of stock of Foreign Corporation A, a Country M corporation, incorporated on Date A, that is engaged in the X business. In the course of X business, Foreign Corporation A generates rental income, primarily from unrelated persons but also from transactions with related persons. Foreign Corporation A's rental income is "foreign base company shipping income" within the meaning of IRC section 954(f).

Foreign Corporation A incurs substantial expenses that are directly related to its X business. As a result of these expenses, Foreign Corporation A has incurred losses from its X business since its inception, and anticipates incurring continued losses in one or more subsequent taxable years. Some of these expenses may not be deductible in the year in which they are incurred as the result of the application of IRC section 469 (regarding the limitation of passive activity losses and credits).

Foreign Corporation A also earns interest income which constitutes "foreign personal holding company income" ("FPHCI") under both sections 954(c) and 553(a).

On account of its X business operating losses, it is expected that Foreign Corporation A will have an accumulated deficit in earnings and profits at the end of its FYE ending Date B.

ISSUE: Do current and accumulated earnings and profits limit an inclusion of UFPHCI under section 551(b) by a United States shareholder of a FPHC?

Under section 551, the "United States shareholders" of a FPHC on the last day of the corporation's taxable year on which they meet the ownership test of section 552(a)(2) for FPHC status must include in gross income, as a dividend, an appropriate portion of the corporation's "undistributed foreign personal holding company income" ("UFPHCI"). Under section 551(b), in general, the amount to be included is the amount the United States shareholder would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholder, the proportionate part of the company's UFPHCI for the taxable year represented by the ratio of the portion of the taxable year up to and including such last day to the entire taxable year. Amplifying on this requirement, Treas. Reg. § 1.551-2(c) provides in part that the amount which each shareholder must include in gross income is the "amount which he would have received as a dividend if [his allocable share of UFPHCI] had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year . . ." (Emphasis supplied.) The emphasized language does not parallel

the language of section 551(b).

Under section 551(d), a FPHC's accumulated E&P is decreased to take into account any amounts required to be included as a dividend in the income of its United States shareholders. Under section 551(e), a United States shareholder's basis in its stock in a FPHC is increased to reflect amounts included in the shareholder's income under section 551(b).

UFPHCI is defined by section 556 and regulations thereunder as the FPHC's taxable income, determined as if the FPHC were a domestic corporation, with certain adjustments, minus dividends paid. UFPHCI is not limited by a FPHC's current or accumulated E&P.

Regulations under the FPHC provisions, and the examples illustrating those regulations, do not clearly state whether, in each case in which the treatment of an amount of UFPHCI by the FPHC's United States shareholders is at issue, the corporation has current or accumulated E&P sufficient to result in all of its UFPHCI being reportable by those shareholders under section 551(b).

For the reasons discussed in the paragraphs below regarding both the specific statutory language of section 551(b) as well as the overall structure of the FPHC and personal holding company ("PHC") regimes, we conclude that current and accumulated E&P limits the amount of UFPHCI that may be included in the gross income of a FPHC's United States shareholders.

Unlike section 541 et seq. (regarding the PHC tax), section 551(b) expressly incorporates an E&P limitation on the amount of UFPHCI by referring to the amount which "would have been received as a dividend" by the shareholder had it been distributed by the corporation at the end of its taxable year (or on the last date on which it met the stock ownership test of section 552(a)(2)). Amounts exceeding current and accumulated E&P would not be treated "as a dividend" under section 316(a).

It is the existence of this limitation which accounts for certain differences in the overall structure of the FPHC provisions. Specifically, the existence of an E&P limitation in determining the amount of UFPHCI that is includible in the gross income of a FPHC's United States shareholders is the only plausible explanation for certain distinctions between the PHC and FPHC regimes, as discussed in the following paragraphs.

Sections 541 through 547 address the taxation of PHC's. In many respects, a PHC is definitionally similar to a FPHC. Unlike a FPHC, however, a PHC itself is subject to tax on its "undistributed personal holding company income" ("UPHCI"), as defined in section 545, at a flat rate ((39.6% for taxable years beginning after 1992). Under

section 545, UPHCI is defined in general as the corporation's taxable income for the year, adjusted as described in sections 545(b), (c), and (d), and minus the dividends paid deduction (described in sections 561 through 564).

Certain Code provisions apply to both the PHC and FPHC regimes. Because both the PHC tax and the tax imposed on a shareholder with respect to UFPHCI were intended to penalize corporate accumulations of earnings, and to promote making actual distributions of such earnings to shareholders (in the case of a PHC) or to require deemed distributions of such earnings to shareholders (in the case of a FPHC), the provisions common to both the PHC and FPHC regimes include those pertaining to the dividends paid deduction and to consent dividends (described in section 565). Because of differences in the manner in which taxes are imposed on a PHC with respect to its UPHCI and on the shareholders of a FPHC with respect to its UFPHCI, however, certain portions of those provisions must differentiate between PHC's and FPHC's. In particular, section 316(b)(2)(A) provides that in the case of a PHC, the term "dividend" is not limited to its ordinary meaning (i.e., a distribution out of current or accumulated E&P, as described in section 316(a)), but generally includes any distribution of property by the PHC to its shareholders, to the extent of its UPHCI for such year. The legislative history of this provision makes clear that section 316(b)(2)(A) was intended as a relief provision to take into account the possibility that a PHC's UPHCI for the taxable year might exceed its E&P, as for example, when a net capital loss reduces E&P but does not reduce either the corporation's taxable income or its UPHCI. See H. Rept. 2333, 77th Cong., 1st Sess. (1942), reprinted in 1942-2 C.B. 372, at 473-474. (See also Treas. Reg. § 1.316-1(e), Example (2).) In such a case, absent the special rule of section 316(b)(2)(A), the PHC would not be able to distribute a "dividend" during the taxable year (or within two and one-half months thereafter, as provided in section 563(b)) and so would be unable to avoid the PHC tax. No comparable provision applies with respect to FPHC's; none is necessary, we conclude, because of the dividend limitation already incorporated in section 551(b).

Another distinction between the treatment of PHC's and FPHC's arises in the characterization of their liquidating distributions. Prior to 1964, a PHC's liquidating distributions were treated as dividends for purposes of the dividends paid deduction to the extent of the corporation's accumulated E&P. As a result, income that would have been subject to the PHC tax escaped such treatment in the year in which a PHC was liquidated; its shareholders included such amounts in income at capital gains rates rather than as ordinary income. See H. Rept. 749, 88th Cong., 1st Sess. (1963), reprinted in 1964-1 (Part 2) C.B. 125, at 206. In the Revenue Act of 1964, P.L. 88-272, Congress narrowed the circumstances under which a PHC's liquidating distributions would be treated as dividends under section 316 by adding to the Code section 316(b)(2)(B). Under that subsection, only certain designated liquidating distributions to noncorporate PHC shareholders may be treated in whole or in part under section 316

as dividends, and then only to the extent such distributions do not exceed such shareholders' allocable shares of UPHCI. P.L. 88-272, § 225(f)(1). Section 316(b)(2)(B) prevents a PHC with noncorporate shareholders that wishes to liquidate from finding itself unable to make a dividend distribution and therefore to avoid the PHC tax by eliminating all of its UPHCI for the year in which it liquidates.[1]

The Revenue Act of 1964 dealt with the consequences of certain FPHC liquidating distributions in a different manner. Section 551(b) was amended to provide that distributions in liquidation do not affect the calculation of the corporation's UFPHCI for that taxable year. Instead, the FPHC's shareholders are in effect taxed on the liquidation proceeds (to the extent of E&P) as a hypothetical dividend. The additional basis in their stock yielded by section 551(f) offsets the gain from the liquidating distribution, which is thus in substance converted from capital gain to ordinary income. See P.L. 88-272, § 225(f)(4); see also "Technical Explanation [of H.R. 8363]," reprinted as an appendix to H. Rept. 749, 88th Cong., 1st Sess. (1963), in 1964-1 (Part 2) C.B. 251, at 355. Again, this treatment is consistent with, and explicable only in light of, the existence of an E&P limitation on the amount of UFPHCI.

Accordingly, based on both the express language of section 551(b) and the overall statutory scheme and purposes of the FPHC provisions, we conclude that current and accumulated E&P limits the amount of UFPHCI that is includible in the gross income of the FPHC's United States shareholders.

We believe that our view of Treas. Reg. § 1.551-2(c) is bolstered by certain parallel language in section 555(b) and the terms of regulations thereunder.

Section 555(b) applies for purposes of determining whether a foreign corporation meets the gross income test of section 551(a)(1) and for purposes of determining the amount of UFPHCI includible in its shareholders' gross income. It provides that in the case of a foreign corporation which is a shareholder of another FPHC, the first company must include in its gross income, as a "dividend," the amount it would have received had the lower-tier corporation made a distribution on the last day of the taxable year in which it met the stock ownership test of section 551(a)(2). Section 555(b) was intended to "reach down through a chain of corporations to bring the income of [FPHC's] into the [FPHC], the income of which is treated as income of American stockholders." H. Rept.

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[1] Under section 562(b), certain post-1963 liquidating distributions by a PHC to a corporate shareholder are treated as dividends for purposes of the dividends paid deduction but not for purposes of determining the corporate shareholder's treatment on the liquidation. See "Technical Explanation [of H.R. 8363]," reprinted as an appendix to H. Rept. 749, 88th Cong., 1st Sess. (1963), in 1964-1 (Part 2) C.B. 251, at 352.

No. 1546, 75th Cong., 1st Sess., 16 (1938).

Where Treas. Reg. § 1.551-2(c) states that each shareholder must include in gross income the "amount which he would have received as a dividend if [his allocable share of UFPHCI] had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year" (emphasis supplied), Treas. Reg. § 1.555-2(a)(2), by contrast, provides that the amount to be included in the gross income of the upper-tier company "as a dividend" is "the amount the first company would have received as a dividend, if [on the relevant date] there had been distributed by the [the lower-tier FPHC], and received by the shareholders," the relevant portion of the second company's UFPHCI. The regulation does not repeat the phrase "as a dividend" a second time, and so does not suggest that the deemed distribution be treated as supported by E&P and so necessarily characterized as a dividend.

Thus, section 555(b) includes language that parallels the relevant statutory language found in section 551(b), but Treas. Reg. § 1.555-2(a)(2) fails to echo Treas. Reg. § 1.551-2(c) by suggesting that a deemed distribution of UFPHCI by a lower-tier to an upper-tier foreign company must necessarily be treated as a dividend by the upper-tier foreign company even in the absence of E&P in the lower-tier corporation. We view the absence of symmetry between these two regulations as additional confirmation of the existence of an E&P limitation in section 551(b).

CONCLUSION

Based on the facts and representations made, we hold that current and accumulated E&P limits the amount of UFPHCI that is includible in the gross income of the Taxpayer as FPHCI.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

/s/ Phyllis E. Marcus
Phyllis E. Marcus
Chief, Branch 2
Associate Chief Counsel (International)