Corp X owns 60% of the stock of Corp Y, a controlled foreign corporation (CFC). The other 40% of the stock is owned by Corp Z. Corp Y does not earn any subpart F income. In Year 1, Corp Y redeems all of the stock owned by Corp Z by way of a distribution of cash. Pursuant to section 302(b)(3), the redemption is treated as a section 302(a) distribution in full payment in exchange for the stock. After the redemption, Corp X owns 100% of the stock of Corp Y. The distribution of cash in the redemption results in a reduction of the post-1986 undistributed earnings of Corp Y pursuant to section 312(a). Section 312(n)(7) limits this reduction to an amount equal to Corp X’s pro-rata share of Corp Y’s post-1986 undistributed earnings. In Year 2, Corp Y pays its entire remaining post-1986 undistributed earnings to Corp X as a dividend and Corp X claims a section 902 deemed paid foreign tax credit equal to Corp Y’s total post-1986 foreign income taxes.

Under the facts set forth above, it is clear that as a result of the Year 2 dividend distribution from Corp Y, Corp X will be deemed to have paid an amount of foreign income taxes equal to 100% of the balance in Corp Y’s pool of post-1986 foreign income taxes as of the end of Year 2. In order to determine the amount of that balance, it is necessary to determine what effect the Year 1 redemption of the stock held by Corp Z has, if any, on Corp Y’s pool of post-1986 foreign income taxes. Although the distribution of cash by Corp Y in redemption of the stock held by Corp Z is treated as a sale or exchange transaction under section 302 rather than a dividend, section 312(a) and (n)(7) provides that Corp Y’s earnings and profits are decreased by the amount of the distribution to the extent of the ratable share of the earnings and profits attributable to the stock so redeemed. Accordingly, Corp Y’s post-1986 undistributed earnings are reduced to take into account the Year 1 redemption.

At issue in the CCA was whether there was also a corresponding reduction in Corp Y’s post-1986 foreign income taxes by an amount of taxes attributable to the Year 1 distribution made by Corp Y in redemption of the stock held by Corp Z. As noted, this distribution is treated as a sale or exchange transaction under section 302 rather than a dividend. The statutory language of section 902(c)(2) specifically refers to reductions to post-1986 foreign income taxes for foreign taxes attributable to dividends distributed. The regulatory grant of section 902(c)(8) authorizes regulations further to provide such regulations as may be necessary or appropriate to carry out the provisions of this section. The regulation language under Treas. Reg. §1.902-1(a)(8) also refers to foreign taxes attributable to earnings that are “otherwise removed” from post-1986 undistributed earnings. The CCA indicates that language of the regulation is sufficiently broad to cover reductions of earnings under section 312(a) related to redividends that are treated as a sale or exchange transaction under section 302. Accordingly, the CCA held that Corp Y’s post-1986 foreign income taxes are reduced as a result of the Year 1 redemption of the stock held by Corp Z.

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