FP, a corporation organized under the laws of foreign country A, owns all the stock of DX, a domestic corporation, and FX, a corporation organized under the laws of foreign country Z. FX owns all the stock of FY, also a country Z corporation. DX is not and never has been a real property holding corporation as defined in section 897(c). Neither FX nor FY is engaged in a trade or business in the United States. As of the close of the 1991 taxable year, DX had earnings and profits of $90x and FY had earnings and profits of $110x. The United States and A have entered into a tax convention that is identical to the 1981 draft U.S. model income tax treaty. The United States also has entered into a tax convention with Z. The U.S.-Z treaty is similar to the U.S.-A treaty except the U.S.-Z treaty provides higher withholding tax rates on dividends.

FX sold all the FY stock to DX for its fair market value of $200x on December 31, 1991. Because FX controlled both FY and DX (through attribution), the sale of the FY stock by FX to DX is a transaction described in section 304(a)(1). The $200x received by FX therefore is treated as a distribution in redemption of the DX stock. The distribution received by FX is treated as a dividend by reference to the earnings and profits of DX and FY. The distribution received by FX is a dividend of $200x, of which $90x is considered paid directly to FX by DX out of its earnings and profits, and $110x is considered paid directly to FX by FY out of its earnings and profits. Section 881(a)(1) imposes a tax of 30 percent on the amount of dividends received by a foreign corporation from sources within the United States. Only $90x of the $200x deemed dividend is from U.S. sources and taxable under section 881(a)(1). The remainder of the dividend, $110x, is not taxable under either section 881 or 882 because it is foreign source income that is not effectively connected with the conduct of a trade or business in the United States.

The income tax treaty between the United States and Z is the appropriate treaty for purposes of determining the rate of withholding tax on the deemed dividend paid by DX to FX. Because the U.S.-Z treaty is less favorable than the treaty between the United States and A, FP is not using section 304 as an attempt to obtain any benefits under the dividends article of the U.S.-Z treaty. On other facts, a different conclusion may be appropriate. See Rev. Rul. 84-152 and Rev. Rul. 84-153. The U.S.-Z income tax convention limits U.S. tax to 10 percent of the gross amount of dividends paid by a domestic corporation to a foreign corporation that owns at least 10 percent of the voting stock of the paying corporation. Dividends paid to all other shareholders are taxed at 20 percent. Ownership of 50 percent or more of the DX stock is attributed to FX for section 304 purposes. Solely by reason of the application of section 304, FX will be considered to own at least 10% of the voting stock of DX for purposes of Article 10, paragraph 2, of the U.S.-Z income tax treaty. Accordingly, the $90x deemed dividend from DX, pursuant to section 304, is subject to U.S. withholding tax at the reduced U.S.-Z treaty rate of 10%. See H.R. Conf. Rep. No. 98-861, Rev. Rul. 91-5, supra, and Rev. Rul. 92-86.