FP, a corporation organized under the laws of foreign country B, owns all the stock of FS1 and FS2, corporations organized under the laws of foreign country C. FS2 owns all the stock of DS, a domestic corporation. All four corporations have a calendar taxable year. DS is not and never has been a real property holding corporation as defined in section 897(c). Neither FS1 nor FS2 is engaged in a trade or business in the United States. As of the close of the 1991 taxable year, FS1 had earnings and profits of $90x and DS had earnings and profits of $110x. The United States and C have not entered into a tax convention.

FS2 sold all the DS stock to FS1 for its fair market value of $200x on December 31, 1991. Because FS2 controlled both DS and FS1 (through attribution), the sale of the DS stock by FS2 to FS1 is a transaction described in section 304(a)(1). The $200x received by FS2 therefore is treated as a distribution in redemption of the FS1 stock. The distribution received by FS2 is treated as a dividend by reference to the earnings and profits of FS1 and DS. The distribution received by FS2 is a dividend of $200x, of which $90x is considered paid directly to FS2 by FS1 out of its earnings and profits, and $110x is considered paid directly to FS2 by DS 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 $110x of the $200x deemed dividend is from U.S. sources and taxable under section 881(a)(1). The remainder of the dividend, $90x, 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. Although FS1 is a foreign person, it is the person in control of the payment to FS2 and therefore the person required under section 1442 of the Code to withhold the U.S. income tax. See Rev. Rul. 80-362, which provides that a foreign corporation is required to withhold U.S. tax on royalties from U.S. sources paid to a foreign person. In Situation 2, there is no income tax treaty between the United States and C, the country under whose laws FS2 was organized and is a resident. Accordingly, the $110x deemed dividend from DS is subject to the U.S. statutory withholding tax rate of 30 percent.

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