

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-02(5)C
Corporation Tax
May 31, 2002

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. C010612C

On June 12, 2001, a Petition for Advisory Opinion was received from Peter L. Faber, McDermott, Will & Emery, 50 Rockefeller Plaza, New York, New York 10020-1605.

The issue raised by Petitioner, Peter L. Faber, is whether income that is taxable to a United States corporation under Subpart F of the Internal Revenue Code (“IRC”) is income from subsidiary capital within the meaning of section 208.9(a)(1) of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

U.S. Parent, a corporation organized under the laws of Delaware, owns 100 percent of the stock of U.S. Subsidiary, a corporation also organized under the laws of Delaware. U.S. Parent is engaged in an active business. U.S. Subsidiary is a holding company. U.S. Subsidiary owns 100 percent of the stock of U.K. Parent, a corporation organized and headquartered in the United Kingdom. U.K. Parent is a holding company. It owns 100 percent of the stock of U.K. Subsidiary, a corporation organized under the laws of the United Kingdom. For federal income tax purposes, U.K. Parent and U.K. Subsidiary are considered to be “controlled foreign corporations” (“CFCs”) under section 957 of the IRC.

From time-to-time U.K. Subsidiary may have Subpart F income that is taxed currently to U.S. Subsidiary under section 951(a)(1)(A) of the IRC and it may make investments in United States property within the meaning of section 956 of the IRC (including loans to U.S. Parent) that result in the current taxation of all or a portion of its earnings and profits under section 951(a)(1)(B) of the IRC.

Discussion

Federal Treatment

Subpart F (sections 951 through 964) of the IRC contains the provisions for the treatment of CFCs, and provides that every person who is a U.S. shareholder of a CFC shall include in that person’s gross income certain types of income generated by a CFC, regardless of whether such income is actually repatriated.

Section 957 of the IRC provides that a CFC is any foreign corporation if more than 50 percent of –

(1) the total combined voting power of all classes of stock of such corporation entitled to vote, or

(2) the total value of the stock of such corporation,

is owned (within the meaning of section 958(a) of the IRC), or is considered as owned by applying the rules of ownership of section 958(b) of the IRC, by U.S. shareholders on any day during the taxable year of such foreign corporation.

Section 951(b) of the IRC provides that the term “U.S. shareholder” means with respect to any foreign corporation, a U.S. person (as defined in section 957(c) of the IRC) who owns (within the meaning of section 958(a) of the IRC), or is considered as owning by applying the rules of ownership of section 958(b) of the IRC, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. A U.S. person for purposes of section 957(c) of the IRC, has the same meaning as assigned to it by section 7701(a)(30) of the IRC, with certain exceptions applicable to persons in Puerto Rico, Guam, American Samoa or the Northern Mariana Islands.

Section 951(a) of the IRC provides that if a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a U.S. shareholder of the CFC, and who owns stock in the CFC on the last day, in such year, on which it is a CFC shall include in the U.S. shareholder’s gross income –

(A) the sum of –

(i) the shareholder’s pro rata share (determined under section 951(a)(2) of the IRC) of the CFC’s subpart F income for such year,

(ii) the shareholder’s pro rata share (determined under section 955(a)(3) of the IRC as in effect before the enactment of the Tax Reduction Act of 1975) of the CFC’s previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) the shareholder’s pro rata share (determined under section 955(a)(3) of the IRC) of the CFC’s previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

(B) the amount determined under section 956 of the IRC with respect to such shareholder for the year (but only to the extent not excluded from gross income under section 959(a)(2) of the IRC).

Section 956(a) of the IRC provides that in the case of any CFC, the amount determined under such section with respect to any U.S. shareholder for any taxable year is the lesser of –

(1) the excess (if any) of –

(A) such shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year, over

(B) the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or

(2) such shareholder's pro rata share of the applicable earnings of such CFC.

The amount taken into account under section 956(a)(1) above with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

Section 1.956-1(a) of the Treasury Regulations provides that the amount of a CFC's earnings invested in U.S. property at the close of any taxable year is the aggregate amount invested in U.S. property to the extent such amount would have constituted a dividend if it had been distributed on such date.

Section 1.956-1(b) of the Treasury Regulations provides that the amount of a CFC's earnings invested at the close of its taxable year in U.S. property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 of the IRC and sections 1.316-1 and 1.316-2 of the Treasury Regulations if it had been distributed on such closing day. For purposes of such section 1.956-1(b), the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) of the IRC.

Article 9-A Treatment

Section 209.1 of Article 9-A of the Tax Law imposes an annual franchise tax on domestic or foreign corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property in a corporate or organized capacity, or maintaining an office in New York State for all or any part of each of its fiscal or calendar years. The tax is imposed on the basis of the corporation's entire net income base, or upon such other basis (capital base, minimum taxable income bases or the fixed dollar minimum), as may be applicable, as determined under section 210 of the Tax Law.

The starting point for computing a corporation's entire net income base is the corporation's federal taxable income with certain modifications. The modification set forth in section 208.9(a)(1) of the Tax Law provides that entire net income shall not include income, gains and losses from subsidiary capital except for such amounts from a former DISC which are treated as business income under section 208.8-A of the Tax Law. Section 208.9(a)(2) of the Tax Law provides that entire net income shall not include 50 percent of dividends, other than from subsidiaries or amounts treated as business income under section 208.8-A of the Tax Law.

TSB-A-02(5)C
Corporation Tax
May 31, 2002

The provisions of Article 9-A of the Tax Law do not specifically provide that Subpart F income is to be treated as a dividend eligible for the exclusions provided in section 208.9(a)(1) and (2) of the Tax Law. However, in American International Group, Inc., Adv Opns Comm T&F, TSB-A-87(23) and (23.1)C and TSB-A-88(7) and (7.1)C, it was determined that, for purposes of Article 9-A of the Tax Law, Subpart F income is deemed to be a dividend that is directly related to ownership of stock. If a taxpayer is the owner of more than 50 percent of the voting stock of a CFC, the taxpayer's pro rata share of such CFC's Subpart F income is deemed to be a dividend from such CFC and is considered as being in the nature of a dividend from subsidiary capital. When computing entire net income, 100 percent of the dividend may be deducted from the taxpayer's federal taxable income pursuant to section 208.9(a)(1) of the Tax Law. In addition, if the taxpayer is the owner of 50 percent or less of the voting stock of a CFC, the taxpayer's pro rata share of such CFC's Subpart F income is deemed to be a dividend that is attributable to the stock of such CFC and such dividend is investment income, 50 percent of which may be deducted from the taxpayer's federal taxable income pursuant to section 208.9(a)(2) of the Tax Law.

American International Group, id., provides further that where such CFC is a shareholder of another CFC (second-tier CFC), the taxpayer's pro rata share of the second-tier CFC's Subpart F income is deemed to be a dividend that has been paid to the first-tier CFC. This dividend, in turn, is deemed to have been paid by the first-tier CFC to the taxpayer. Since the taxpayer's pro rata share of the second-tier CFC's Subpart F income is deemed paid by the first-tier CFC to the taxpayer, such deemed dividend is attributable to the taxpayer's ownership in the first-tier CFC. Where the taxpayer owns more than 50 percent of the voting stock of the first-tier CFC, the deemed dividends from the second-tier and any lower tier CFC are attributable to subsidiary capital. Where the taxpayer owns 50 percent or less of the voting stock of the first-tier CFC, the deemed dividends from the second-tier and any lower tier CFC are attributable to investment capital.

American International Group, id., makes clear that the amount of Subpart F income, as defined in section 952 of the IRC, and included in the taxpayer's federal gross income pursuant to section 951(a)(1)(A) of the IRC, is treated as a dividend for purposes of Article 9-A of the Tax Law. The same treatment under Article 9-A should be given to the amount of the increase in earnings that is invested in U.S. property, as determined under section 956 of the IRC, and included in the taxpayer's federal gross income pursuant to section 951(a)(1)(B) of the IRC. A U.S. shareholder's pro rata share of the amount of the CFC's earnings invested in U.S. property that the U.S. shareholder includes in the shareholder's gross income pursuant to section 951(a)(1)(B) of the IRC, as determined under section 956 of the IRC and section 1.956-1 of the Treasury Regulations, is treated like a dividend for federal income tax purposes. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, 7th Edition, ¶15.62(4)(a) at 15-162, which states, with respect to section 956 of the IRC, that "[t]he increase in U.S. investments is instead imputed to the shareholder on a very different theory that the CFC's earnings have been repatriated pro tanto, even though not distributed by a formal dividend." See also, Albert L. Dougherty, 60 TC 917, 930, where the United States Tax Court referred to the provisions of section 951(a)(1)(B) of the IRC as "statutory constructive dividend doctrine."

TSB-A-02(5)C
Corporation Tax
May 31, 2002

Accordingly, both the Subpart F income that is included in the taxpayer's computation of federal taxable income pursuant to section 952(a)(1)(A) of the IRC, as well as the income that is included pursuant to section 951(a)(1)(B) of the IRC, is treated as a dividend for federal income tax purposes. Therefore, for purposes of computing entire net income under Article 9-A of the Tax Law, it is appropriate to treat as a dividend, the taxpayer's pro rata share of both (1) the amount of Subpart F income defined in section 952 of the IRC that is included in the taxpayer's federal gross income pursuant to section 951(a)(1)(A) of the IRC, and (2) the increase in earnings that is invested in U.S. property as determined under section 956 of the IRC and included in the taxpayer's federal gross income pursuant to section 951(a)(1)(B) of the IRC.

Therefore, in this case, U.K. Subsidiary is a wholly owned subsidiary of U.K. Parent and both are CFC's under section 957 of the IRC. U.K. Parent is a wholly owned subsidiary of U.S. Subsidiary. Following American International Group, id., when U.S. Subsidiary computes its entire net income under section 208.9 of the Tax Law, the amounts that are treated as a dividend from U.K. Parent for federal income tax purposes, and included in U.S. Subsidiary's federal gross income pursuant to both section 951(a)(1)(A) of the IRC (defined subpart F income) and section 951(a)(1)(B) of the IRC (the increase in earnings that is invested in U.S. property), are treated as a dividend from U.K. Parent to U.S. Subsidiary for purposes of Article 9-A of the Tax Law. Since U.K. Parent is a wholly owned subsidiary of U.S. Subsidiary, such deemed dividend is treated as a dividend from subsidiary capital that is excluded from U.S. Subsidiary's entire net income under section 208.9(a)(1) of the Tax Law.

Further, the amounts that are treated as a dividend from U.K. Subsidiary for federal income tax purposes, and included in U.S. Subsidiary's federal gross income pursuant to both section 951(a)(1)(A) of the IRC (defined subpart F income) and section 951(a)(1)(B) of the IRC (the increase in earnings that is invested in U.S. property), are treated as a dividend from U.K. Subsidiary to U.K. Parent, and then as a dividend from U.K. Parent to U.S. Subsidiary for purposes of Article 9-A of the Tax Law. See, American International Group, id. Since U.K. Parent is a wholly owned subsidiary of U.S. Subsidiary, such deemed dividend that is passed through from U.K. Subsidiary to U.K. Parent to U.S. Subsidiary, is treated as a dividend from subsidiary capital that is excluded from U.S. Subsidiary's entire net income under section 208.9(a)(1) of the Tax Law.

DATED: May 31, 2002

/s/
Jonathan Pessen
Tax Regulations Specialist IV
Technical Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.