

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-87 (23) C
Corporation Tax
September 9, 1987

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. C870408B

On April 8, 1987, a Petition for Advisory Opinion was received from American International Group, Inc., 70 Pine Street, 24th Floor, New York, New York 10270.

The issue raised is whether Subpart F income constitutes a dividend for purposes of Article 9-A and Article 33 of the Tax Law. If Subpart F income does constitute a dividend and it is attributable to an investment which qualifies as subsidiary capital, may it be excluded from entire net income. Additionally, if it is attributable to an investment that does not qualify as subsidiary capital, may 50 percent of it be excluded from entire net income.

Petitioner is a holding company which, through its subsidiaries, is primarily engaged in a wide range of insurance and insurance related activities in the United States and overseas. Petitioner's foreign operations are conducted by foreign subsidiaries and through branch operations of domestic subsidiaries. Some of Petitioner's foreign subsidiaries are owned by Article 9-A subsidiaries and others by Article 33 subsidiaries. These corporations are required, in some instances, to include Subpart F income in their gross income in determining the amounts of their federal taxable income.

The Subpart F rules of the Internal Revenue Code provide, in effect, that if a foreign corporation is a controlled foreign corporation (more than 50 percent of its voting stock or its value is owned by a United States shareholder), the United States shareholder must include in its income its pro-rata share of the foreign corporation's Subpart F income, which is defined in section 951 of the Internal Revenue Code.

Petitioner contends that for all practical purposes, Subpart F income is treated as a dividend for federal income tax purposes. For instance, the amount of Subpart F income includible by the United States shareholder is measured by the foreign corporation's earnings and profits. Section 316 of the Internal Revenue Code defines a dividend as a distribution to shareholders out of earnings and profits. In addition, section 960 of the Internal Revenue Code allows the United States shareholder of a controlled foreign corporation to claim a foreign tax credit for taxes paid by the foreign corporation to foreign jurisdictions in connection with its Subpart F income "in the same manner as if the amount so included (in the gross income of the United States shareholder) were a dividend paid by such foreign corporation . . ." (Emphasis added) Subpart F income is included in federal taxable income even if it is not distributed to the shareholder and is reported in Schedule C of Form 1120 as a dividend. As it is includible in the shareholder's income even if it is not distributed, section 959(d) of the Internal Revenue Code provides that when such amounts are distributed they shall not be treated as a dividend.

Article 9-A

Article 9-A of the Tax Law imposes a franchise tax on business corporations, which is

computed on the one of four alternative bases which yields the highest tax. One of the bases is measured by entire net income, which 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 treated as business income under section 208.8-A of the Tax Law.

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 dividends received exclusions provided in section 208.9(a)(1) and (2) of the Tax Law. However, in a memorandum dated January 18, 1966, E. A. Doran, Deputy Tax Commissioner, concluded that for franchise tax purposes, Subpart F income should be treated as a dividend.

Also, Technical Services Bureau Memorandum, TSB-M-78(17)C, dated September 7, 1978 provides that Subpart F income is deemed to be a dividend for purposes of computing entire net income under Article 32 of the Tax Law.

The United States Tax Court, in a leading Subpart F income case, expressly refers to the "increase in earnings invested in United States property" as "statutory constructive dividend doctrine". See, Albert L. Dougherty, 60 TC 917, 930 (1973).

In addition, the Supreme Judicial Court of Massachusetts held that for purposes of the Massachusetts corporate excise tax, which grants a 100% deduction for dividends received, Subpart F income should be treated as a dividend. See, Dow Chemical Co. v. Commissioner of Revenue, 378 Mass 254, 391 NE2d 253 (1979). The summary of Dow's conclusion is as follows:

"The corporate excise adopts the Federal definition of gross income but, to determine taxable net income, allows a deduction for 'dividends' included in net income for the taxable year [T]hat income is included in gross income only because it is treated federally as if it had been currently distributed; it should be similarly treated under State law and deductible as a dividend. Disallowance of a dividend deduction for undistributed Subpart F income would in fact prevent the taxpayer from ever receiving a deduction for that income since it could not be included in income when actually distributed; the disallowance would thus subvert the statutory purpose of preventing multiple taxation of corporate income." Id.

In its in-depth analysis of the dividend issue, the Dow court employed the following rationale:

"The Subpart F provisions of the Code describe a dividend which is deemed to have been distributed in the taxable year. Indeed, Subpart F income is included in gross income only because it is treated as a dividend. This is made

plain by the text of Code 951.... Subpart F income is the amount 'which would have been distributed with respect to the stock,' and so forth ... In the legislative history, Subpart F income is described as a dividend to the United States shareholders, and it is on this basis that it is included in gross income. Other provisions of the Code conform in this understanding. Under 952(c), Subpart F income may not exceed "the earnings and profits" of the foreign corporation in that taxable year. The amount of Subpart F income must, under 951(a)(2)(B), be reduced by actual dividend distributions received by any person, other than the taxpayer, who had owned the taxpayer's stock during some part of the taxable year. And the foreign tax credit provisions, applicable to actual dividends, are applied in similar form to Subpart F income. 960... The view we take accords with Commonwealth v. Emhart Corp., 443 Pa. 397 (1970), cert. denied, 404 US 981 (1971), the only case cited in which the issue has been raised. There the taxpayer sought to deduct Subpart F income under a statutory provision authorizing a deduction for 'dividends received from any other corporation'.... The Commonwealth of Pennsylvania contended that the deduction should be limited to dividends 'received' and should not embrace deemed distributions not actually received by the taxpayer. In Emhart, as here, intercorporate dividends could not be deducted unless they were included in Federal gross income. The court noted that 'if a corporation fails to take the deduction in the year it included the dividend in its federal return, it is unclear whether the corporation can ever take advantage of the deduction in a later year, for while the corporation will have "received" the dividend, it will not have included that sum in its federal return--a prerequisite for the [State] deduction.' Id. at 408. The court found that failure to permit the deduction for Subpart F income could not be reconciled with the 'clear legislative determination that a corporation at some point is entitled to a deduction for dividends received from other corporations, presumably to avoid a double tax at the corporate level.' Id.

To conclude, although the Commissioner properly required inclusion of Subpart F income in gross income, she erred in failing to allow a deduction under G.L. c. 63, 38(a)(1)." 378 Mass. at 267-272. (Footnotes omitted.)

The reasoning adopted by the Massachusetts and Pennsylvania courts is persuasive for the instant dividend question. The rationale of Dow, Emhart and Dougherty support the policy of the Tax Department adopted in 1966, that is, to treat Subpart F income as a dividend under Article 9-A.

Accordingly, for purposes of Article 9-A of the Tax Law, it is appropriate, as shown above, to deem Subpart F income to be a dividend that is directly related to ownership of stock.

For purposes of Article 9A of the Tax Law, the term "subsidiary" is defined in section 208.3 as "... a corporation of which over fifty per centum of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer". In addition, "subsidiary capital" is defined in section 208.4 as "... investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of property held primarily for sale to customers, whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under articles nine-a, nine-b, nine-c, thirty-two or thirty-three of this chapter. ..."

When determining whether a corporation is a subsidiary, guidance is given in section 3-6.2 of the Business Corporation Franchise Tax regulations which further defines the term "subsidiary" as follows:

"(a) The term 'subsidiary' means a corporation which is controlled by the taxpayer, by reason of the taxpayer's ownership of more than 50 percent of the total number of the shares of stock of such corporation, issued and outstanding, which entitle the holder of the shares to vote at elections of its directors or trustees. The determination of whether or not particular shares of a corporation's stock entitles the holders of such shares to vote for the election of directors or trustees of the corporation depends on the actual legal situation with respect to voting rights, as it exists from time to time.

* * *

(b) The test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation. A corporation will not be considered to be a subsidiary because more than 50 percent of the shares of its voting stock is registered in the taxpayer's name, unless the taxpayer is the actual beneficial owner of such stock. However, a corporation will not be considered a subsidiary if more than 50 percent of the shares of its voting stock is not registered in the taxpayer's name, unless the taxpayer submits proof that it is the actual beneficial owner of such stock.

* * *

(d) In any case where the record holder of shares of voting stock of a corporation is not the actual beneficial owner of the stock, or where the right to vote such stock is not possessed by the record holder or by the actual beneficial owner of the stock, a full and complete statement of all relevant facts must be submitted."

The concept of beneficial ownership of stock does not apply to situations involving three or more tier corporate structures unless there has been some transfer of rights in the stock, for example, where there has been a transfer of stock without transfer of legal title or where the transferee of the stock is not yet the holder of record on the books of the corporation or where there has been a transfer to a trustee. See Matter of Sears Industries, Inc., State Tax Commission Decision, July 26, 1985, TSB-H-85(33)C; Matter of Armour & Company, State Tax Commission Decision, April 4, 1985, TSB-H-85(12)C; and Matter of Texas Instruments Incorporated, State Tax Commission Decision, June 27, 1980, TSB-H-80(23)C.

Accordingly, in the instant case, if a taxpayer under Article 9-A of the Tax Law is the owner of more than 50 percent of the voting stock of a controlled foreign corporation, the Subpart F income should be considered as being in the nature of a dividend from subsidiary capital. In addition, 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.

If a taxpayer under Article 9-A of the Tax Law is the owner of less than a majority of the voting stock of a controlled foreign corporation, the Subpart F income cannot be considered to be attributable to a subsidiary of the taxpayer but should be treated as a dividend 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.

Article 33

Article 33 of the Tax Law was added by the Laws of 1974, Chapter 649, effective May 30, 1974. Section 12 of such Chapter provided that Article 33 "... shall be construed so that the provisions of such article which are the same as or are substantially identical with those in article nine-a of the tax law shall be regarded as being in pari materia and shall be construed in a like manner."

Section 1501 of Article 33 of the Tax Law imposes a franchise tax on insurance corporations which is computed on the one of four alternative bases which yields the highest tax. One of the bases is measured by entire net income, which is the insurance corporation's federal taxable income with certain modifications. The modification set forth in section 1503(b)(1)(A) of the Tax Law provides that entire net income shall not include income, gains and losses from subsidiary capital. Section 1503(b)(1)(B) of the Tax Law provides that entire net income shall not include 50 percent of dividends other than from subsidiaries.

For purposes of Article 33 of the Tax Law, the term "subsidiary" is defined in section 1500(g) as "... a corporation of which over fifty percent of the number of shares of stock entitling

the holders thereof to vote for the election of directors or trustees is owned by the taxpayer." In addition, "subsidiary capital" is defined in section 1500(h) as "... investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of property held primarily for sale to customers, whether or not evidenced by a written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under any article of this chapter. ..."

Since, under Article 33 of the Tax Law, the franchise tax base measured by entire net income and the pertinent dividend modifications and the definitions of subsidiary and subsidiary capital are substantially identical to those contained in Article 9-A, Article 33 shall be regarded as being in pari materia with Article 9-A with regards to Subpart F income. (Laws of 1974, Chapter 649, section 12). Therefore, it is appropriate that the conclusion under Article 33 be the same as under Article 9-A.

Accordingly, for purposes of Article 33 of the Tax Law, Subpart F income is deemed to be a dividend. In addition, if a taxpayer, under Article 33 of the Tax Law, is the owner of more than 50 percent of the voting stock of a controlled foreign corporation, the Subpart F income should be 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 1503(b)(1)(A) of the Tax Law.

If a taxpayer, under Article 33 of the Tax Law, is the owner of less than a majority of the voting stock of a controlled foreign corporation, the Subpart F income cannot be considered to be attributable to a subsidiary of the taxpayer, but should be treated as a dividend, 50 percent of which may be deducted from the taxpayer's federal taxable income pursuant to section 1503(b)(1)(B) of the Tax Law. It should be noted, that in the case of a life insurance company, such 50 percent deduction applies only with respect to the life insurance company's share of such dividends, which share means the percentage determined under section 812(a)(1) of the Internal Revenue Code.

DATED: September 9, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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