

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

TSB-A-87 (23.1)C  
TSB-A-88 (7.1)C  
Corporation Tax  
November 2, 1992

STATE OF NEW YORK  
COMMISSIONER OF TAXATION AND FINANCE

MODIFIED ADVISORY OPINIONS PETITION NO. C870408B  
PETITION NO. C871123A

Advisory Opinions were issued to American International Group, Inc., 70 Pine Street, 24th Floor, New York, New York 10270, on September 9, 1987 with respect to Petition No. C870408B (TSB-A-87(23)C) and on March 18, 1988 with respect to Petition No. C871123A (TSB-A-88(7)C).

The issues raised by Petitioner, American International Group, Inc., were 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. Further, does the portion that is included in entire net income constitute investment income.

After a current review of the issue of whether Subpart F income that is deemed a dividend is attributable to subsidiary capital and whether the "50 percent of dividends other than from subsidiaries" that is included in entire net income is investment income, such Advisory Opinions are modified to the extent discussed herein, for taxable years beginning on or after January 1, 1992.

Petitioner is a holding company which, through its direct and indirect 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.

Petitioner's foreign operations in many cases are conducted by its controlled foreign corporations (hereinafter "CFC") as that term is defined by section 957 of the Internal Revenue Code. Pursuant to the federal Subpart F income rules, Petitioner is required to report as taxable income certain of the earnings of its CFCs. Section 958 of the Internal Revenue Code provides that in determining CFC status, constructive ownership rules apply. Thus, Petitioner reports as Subpart F income the earnings of directly and indirectly owned CFCs.

For federal income tax purposes, Petitioner reports Subpart F income from CFCs in which it has an indirect investment in addition to the Subpart F income from CFCs in which it has a direct investment. The amount reported is in proportion to Petitioner's ownership of each CFC. In addition, section 961 of the Internal Revenue Code requires that where Petitioner includes in gross income Subpart F income that has not actually been distributed to it, Petitioner must increase its basis in the stock of its directly owned CFC by such amount. Further, when an actual distribution of earnings and profits is made by a CFC, the amount of the distribution that was previously treated as Subpart F

income is not treated as a dividend, however, Petitioner must reduce its basis in the stock of its directly owned CFC by such amount. Section 1.961-1(c) of the Treasury Regulations provides the following example:

Example (1). Domestic corporation M owns 800 of the 1,000 shares of the one class of stock in controlled foreign corporation R which owns all of the one class of stock in controlled foreign corporation S. Corporations M, R, and S use the calendar year as a taxable year. In 1964, S Corporation has \$100,000 of earnings and profits after the payment of \$11,250 of foreign income taxes, and \$100,000 of subpart F income. Corporation R has no earnings and profits. With respect to S Corporation, M Corporation is required to include in gross income \$80,000 ( $800/1,000 \times \$100,000$ ) under section 951(a), and \$9,000 ( $\$80,000/\$100,000 \times \$11,250$ ) under section 78. On December 31, 1964, M Corporation must increase the basis of each share of its stock in R Corporation by \$100 ( $\$80,000/800$ ).

As discussed in the original Advisory Opinions, 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. Further, 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 CFC, 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 208.9(a)(1) of the Tax Law.

In addition, it was determined that 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 CFC, 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.

A review, for New York State Franchise Tax purposes, of the issue of how to determine what portion of Subpart F income is attributable to subsidiary capital and what portion is investment income results in the following opinion for taxable years beginning on or after January 1, 1992.

The purpose of the federal enactment of the Subpart F rules was to meet the perceived problem of deferral of domestic tax through foreign corporate tax havens. Under federal Subpart F rules, Subpart F income is deemed a dividend paid to the domestic taxpayer even though no amount was actually distributed during the taxable year. For New York State Franchise Tax purposes, a dividend may only be paid to a shareholder. That is, the Subpart F income of the lowest tier CFC is deemed paid to the next higher tier CFC. That CFC, in turn, is deemed to have paid a Subpart F deemed dividend to the next higher tier CFC and so on, until such Subpart F deemed dividend is deemed paid by the first tier CFC which is directly owned by the taxpayer. The taxpayer's directly owned CFC is deemed to have paid a dividend to the taxpayer consisting of the Subpart F income from such CFC as well as the Subpart F income of the lower tier CFCs. Accordingly, for New York State Franchise Tax purposes, the Subpart F income that a taxpayer includes in federal

gross income is deemed a dividend received from its directly owned CFC. Where a taxpayer includes Subpart F income in federal gross income, the taxpayer increases the basis in the stock of its directly owned CFC by the amount of such deemed dividend even though a portion of such deemed dividend may be related to earnings and profits of a second or lower tier CFC. Further, where the taxpayer receives a distribution of a CFC's earnings and profits that was previously included in Subpart F income, such distribution is not treated as a dividend and taxed again, but rather the basis of the taxpayer's stock in the directly owned CFC must be reduced. This includes a distribution related to the earnings and profits of a second or lower tier CFC.

Therefore, where a taxpayer under Article 9-A of the Tax Law 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 attributable to subsidiary capital. In addition, 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 and is attributable to subsidiary capital.

Where a taxpayer under Article 9-A of the Tax Law owns less than 50 percent of the 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, that is attributable to the stock of such CFC and such dividend is investment income. In addition, 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 and is investment income.

When computing entire net income, 100 percent of the Subpart F income that is deemed to be a dividend that is attributable to subsidiary capital may be deducted from the taxpayer's federal taxable income pursuant to section 208.9(a)(1) of the Tax Law.

Where the taxpayer is the owner of less than a majority of the voting stock of a CFC, the Subpart F income cannot be considered to be attributable to a subsidiary of the taxpayer, but is 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. The remaining 50 percent of the deemed dividend that is included in entire net income is investment income.

Since Article 33 of the Tax Law is regarded as being in pari materia with Article 9-A of the Tax Law with regards to Subpart F income, the principles outlined herein, with respect to Subpart F income under Article 9-A, also apply to Article 33 of the Tax Law.

The following example sets forth, for New York State Franchise Tax purposes, the application of the principles outlined herein.

Example

Corp A is a domestic corporation that is an Article 9-A taxpayer. Corp A owns 100% of the voting stock of CFC-B, 40% of the voting stock of CFC-C and 10% of the voting stock of CFC-D. CFC-B owns 20% of the voting stock of CFC-D, and CFC-C owns the other 70% of the voting stock of CFC-D. For taxable year 1992, CFC-B has Subpart F income of \$50, CFC-C has Subpart F income of \$10 and CFC-D has Subpart F income of \$100.

CFC-D's Subpart F income that is deemed a dividend paid to CFC-B is \$20 ( $\$100 \times 20\%$ ). The \$20 deemed dividend and CFC-B's own Subpart F income of \$50, a total of \$70, is deemed to have been paid by CFC-B to Corp A ( $\$70 \times 100\%$ ).

CFC-D's Subpart F income that is deemed a dividend paid to CFC-C is \$70 ( $\$100 \times 70\%$ ). The portion of CFC-C's own Subpart F income of \$10 and the \$70 deemed dividend from CFC-D that is deemed to have been paid by CFC-C to Corp A is \$32 ( $\$80 \times 40\%$ ).

CFC-D's Subpart F income that is deemed a dividend paid directly to Corp A is \$10 ( $\$100 \times 10\%$ ).

Since CFC-B is a subsidiary of Corp A pursuant to section 208.3 of the Tax Law, the Subpart F deemed dividend of \$70 from CFC-B is attributable to subsidiary capital and 100 percent of the deemed dividend may be deducted from the taxpayer's federal taxable income pursuant to section 208.9(a)(1) of the Tax Law.

Corp A does not own more than 50 percent of the stock of CFC-C. Therefore, CFC-C is not a subsidiary pursuant to section 208.3 of the Tax Law, and the Subpart F deemed dividend of \$32 from CFC-C is not attributable to subsidiary capital. Section 208.9(a)(2) of the Tax Law provides that 50 percent of the deemed dividend of \$32 from CFC-C may be deducted from Corp A's federal taxable income. The remaining \$16 that is included in entire net income is investment income.

Corp A does not own more than 50 percent of the stock of CFC-D. Therefore, CFC-D is not a subsidiary pursuant to section 208.3 of the Tax Law, and the Subpart F deemed dividend of \$10 from CFC-D is not attributable to subsidiary capital. Section 208.9(a)(2) of the Tax Law provides that 50 percent of the deemed dividend of \$10 from CFC-D may be deducted from Corp A's federal taxable income. The remaining \$5 that is included in entire net income is investment income.

Therefore, for taxable years beginning on or after January 1, 1992, when Petitioner or its domestic subsidiary includes Subpart F income in its computation of federal taxable income, such

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Subpart F income is deemed to be a dividend for purposes of computing entire net income under both Article 9-A and Article 33. If Petitioner or its domestic subsidiary is the owner of more than 50 percent of the voting stock of a CFC, the Subpart F income that is deemed a dividend from such CFC (including Subpart F income such CFC is deemed to have received from a second-tier CFC, or lower tier CFC through the second-tier CFC) is attributable to subsidiary capital and 100 percent of such deemed dividend may be deducted from Petitioner's or its domestic subsidiary's federal taxable income pursuant to section 208.9(a)(1) of the Tax Law.

For taxable years beginning on or after January 1, 1992, when Petitioner or its domestic subsidiary is the owner of less than a majority of the voting stock of a CFC, and Petitioner or its domestic subsidiary has Subpart F income that is deemed a dividend from such CFC (including Subpart F income such CFC is deemed to have received from a second-tier CFC, or lower tier CFC through the second-tier CFC), 50 percent of such deemed dividend may be deducted from the subsidiary's federal taxable income pursuant to section 208.9(a)(2) of the Tax Law. The 50 percent taxable portion of such deemed dividend is attributable to Petitioner's or its domestic subsidiary's ownership of the CFC and is investment income.

It should be noted, that the opinion rendered herein represents the treatment of Subpart F income for New York State Franchise Tax purposes and does not necessarily represent the treatment of such income for federal income tax purposes.

DATED: November 2, 1992

s/PAUL B. COBURN  
Deputy Director  
Taxpayer Services Division

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