IRS notes in AM 2015-001 that US shareholder must increase earnings and profits in the year of a Section 951(a)(1) inclusion

Executive summary

In Generic Legal Advice Memorandum 2015-001 (the GLAM), issued 13 February 2015, the IRS concluded that a US shareholder must increase its earnings and profits (E&P) by the amount of its income inclusion with respect to a foreign subsidiary under Section 951(a)(1) in the year of the inclusion, regardless of whether the US parent receives distributions from the foreign subsidiary in the same year. The fact pattern at issue in the GLAM involved a domestic corporation (USP) that was the US shareholder of a foreign subsidiary (FS) treated as a controlled foreign corporation (CFC), and FS earned subpart F income and held United States property. As a result, USP had income inclusions under Section 951(a)(1)(A) and (B) respectively (Section 951 inclusions). In that same year, FS made no actual distributions to USP. The GLAM concludes that, in the absence of any statutory or regulatory rules on Section 951 inclusions that would deviate from the general rules regarding E&P under Section 312, subpart F inclusions are subject to the general rule for when items are taken into account for purposes of E&P under Treas. Reg. Section 1.312-6. As such, the IRS determined that USP must increase its E&P by the amount of the Section 951 inclusion in the year of the inclusion, regardless of whether USP receives distributions from FS in that year.
Detailed discussion

Acknowledging that E&P is not defined in the Internal Revenue Code, the GLAM notes that Treas. Reg. Section 1.312-6 states that, “among the items entering into the computation of corporate earnings and profits for a particular period are ... all items includible in gross income under Section 61.” Further, the GLAM states that Section 61 makes clear that gross income means “all income from whatever source derived,” and is not limited to the items enumerated in the statute. Therefore, Section 951 inclusions would be includible in gross income under Section 61. Finding that Treas. Reg. Section 1.312-6(a) provides the general rule that a domestic corporation’s E&P increases when it takes the corresponding item of income into account in computing taxable income, and that there is no specific regulatory or statutory provision to the contrary for Section 951 inclusions, the GLAM concludes that those inclusions are subject to Treas. Reg. Section 1.312-6 and are included in the computation of E&P for the tax year in which they are included in the domestic corporation’s gross income.

The GLAM cites to case law such as Commissioner v. Wheeler and Bangor & Aroostok v. Commissioner, as support affirming the principle of Treas. Reg. Section 1.312-6, that E&P generally follows taxable income and also that the operation of basis provisions within the framework governing income and E&P ensure that items of gross income are neither duplicated nor excluded from taxable income or E&P. The GLAM notes that these cases demonstrate that, if income will be taken into account for federal tax purposes, the E&P inclusion generally occurs at the same time. Moreover, the interaction of basis provisions, income inclusions and E&P illustrated by these two cases is also reflected in the statutory provisions of Sections 959 and 961, which address the consequences of Section 951 inclusions. The GLAM describes the increases in previously taxed income (PTI) accounts and basis under Sections 959 and 961(a) when there is a Section 951 inclusion noting that, when the CFC distributes its earnings, the shareholder does not include the earnings in income again, but reduces its basis in the CFC stock under Section 961(b), as well as reducing the PTI account. Thus, the US shareholder only includes its share of subpart F income once. Further, referring to Section 312(f)(2), which generally provides that a nontaxable distribution in which stock basis is decreased does not increase E&P, the GLAM states that a US shareholder should not increase its E&P when it receives a distribution to which Sections 959 and 961(b) apply. Considering the relationship between basis provisions, the timing of income inclusions and the rules under Section 312, the GLAM points out that, if the E&P were not increased when the income is recognized and basis is increased, that income might never be properly taken into account for E&P purposes. For example, the GLAM notes that, if a shareholder sells stock after a Section 951 inclusion has increased the basis in the stock but before an actual distribution has decreased the basis, and the E&P was not taken into account at the time of the Section 951 inclusion, the E&P increase would be permanently avoided.

The IRS also addresses and debunks certain counterarguments. The GLAM notes that USP might argue that Section 951 inclusions do not increase its ability to make dividend distributions since no cash or other property has actually been received. In response, the GLAM notes that E&P is not simply a measure of cash flow and that a corporation’s E&P may increase even when an income inclusion does not coincide with the receipt of cash or other property. Acknowledging that generally a shareholder’s E&P increases (and a corporate subsidiary’s E&P decreases) when the subsidiary corporation distributes its E&P as a dividend, this general rule does not always apply to corporate shareholders and GLAM references the rules applicable in the context of filing a consolidated return to support its position. Despite its “superficial appeal,” the GLAM asserts, the argument that E&P cannot be in two places at once is not strong enough to overcome the general rules of Section 312. Accordingly, the GLAM concludes that, under
Treas. Reg. Section 1.312-6, E&P includes all items includible in gross income under Section 61, including Section 951 inclusions, irrespective of whether the E&P attributable to such amounts are distributed.

Implications

The GLAM provides guidance to taxpayers on determining E&P when there is a Section 951 inclusion, concluding that increasing a US shareholder’s E&P in the year of the Section 951 inclusion is consistent with the guidance on E&P. Moreover, certain arguments against this result, including the argument that E&P cannot be in two places at once, are discussed but summarily dismissed in the GLAM. Taxpayers should consider whether their treatment of E&P in relation to Section 951 inclusions is consistent with the conclusions reached in the GLAM, as the amount of a corporation’s E&P will be important for such purposes as determining whether a distribution by that corporation is considered to be a dividend or should be characterized as a return of basis or capital gain.

Endnotes

1. 324 US 542 (1945).
2. 16 T.C. 578 (1951).
3. To support this, the GLAM cites Snap-Drape, Inc. v. Commissioner, 98 F.3d 194 (5th Cir. 1996), Henry C. Beck Co. v. Commissioner, 52 T.C. 1 (1969), aff’d per curiam, 433 F.2d 309 (5th Cir. 1970), Section 1272(a)(1), and Treas. Reg. Section 1.312-6.
4. Under Section 959(d) earnings and profits of a CFC are reduced upon the distribution of PTI.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services, Washington, DC**

- Arlene Fitzpatrick  
  +1 202 327 7284  
  arlene.fitzpatrick@ey.com
- Peg O’Connor  
  +1 202 327 6229  
  margaret.oconnor@ey.com
- Preya Patel Saroop  
  +1 202 327 7476  
  preya.patel@ey.com
- Min Yu  
  +1 202 327 7396  
  min.yu@ey.com

**International Tax Services**

- Global ITS, **Alex Postma**, London
- ITS Director, Americas, **Jeffrey Michalak**, Detroit
- National Director of ITS Technical Services, **Jose Murillo**, Washington

**Member Firm Contacts, Ernst & Young LLP (US)**

- Northeast
  **Johnny Lindroos**, McLean, VA
- Financial Services
  **Phil Green**, New York
- Central
  **Mark Muktar**, Detroit
- Southeast
  **Scott Shell**, Charlotte, NC
- Southwest
  **Amy Ritchie**, Austin
- West
  **Frederick Round**, San Jose, CA
- Canada - Ernst & Young LLP (Canada)
  **Albert Anelli**, Montreal
- Israel - Kost Forer Gabbay & Kasierer (Israel)
  **Sharon Shulman**, Tel Aviv
- Mexico - Mancera, S.C. (Mexico)
  **Koen Van ’t Hek**, Mexico City
- Central America - Ernst & Young, S.A.
  **Rafael Sayagues**, San José
- South America - Ernst & Young Serviços Tributários S.S.
  **Gil F. Mendes**, São Paulo
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

International Tax Services
About Ernst & Young's International Tax Services practices

Our dedicated international tax professionals assist our clients with their cross-border tax structuring, planning, reporting and risk management. We work with you to build proactive and truly integrated global tax strategies that address the tax risks of today's businesses and achieve sustainable growth. It's how Ernst & Young makes a difference.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CM5227

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com