Internal Revenue Service

Department of the Treasury

Index Number: 1248.03-00, 1366.00-00

Washington, DC 20224

199908044

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This letter is in reply to a letter dated July 14, 1998, in which a ruling was requested as to the Federal income tax consequences of a proposed transaction. Additional information was submitted in a letter dated October 26, 1998. The information submitted is substantially as set forth below.

The rulings contained in this letter are predicated on facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for the ruling. Verification of the factual information, representations, and other data may be required as a part of the audit process.

A is an individual investor who owns D percent of the stock of B and has held it in excess of one year. B is a domestic corporation that made an election to be an S corporation effective on Date I. B's sole asset is E percent of the outstanding shares of C, an F corporation, which it has held in excess of one year. Except for G percent of the shares of C owned by the spouses of the B shareholders, the remaining stock of C is held by a United States person who is unrelated to the B shareholders, applying the attribution rules of section 958. C is a controlled foreign corporation within the meaning of section 957 of the Code.

B proposes to sell its entire interest in C to an unrelated F corporation. It is anticipated that B will report some gross income with respect to this sale as a dividend under section 1248(a). The H percent interest in C owned by A's spouse is also being sold to the unrelated F corporation.

The following representations have been made in connection with the proposed transaction:

a. The stock of B in A's hands and the stock of C in B's hands each represent a capital asset within the meaning of section 1221.

b. The stock of B and the stock of C in the hands of A and B, respectively, have been held for more than one year.

c. C is a controlled foreign corporation ("CFC") within the meaning of section 957.

d. C is not a foreign investment company within the meaning of section 1246.

e. C is not a passive foreign investment company within the meaning of section 1297.

f. C is a "corporation" within the meaning of section 7701(a)(3).

Section 1248(a) of the Code provides, in general, that if a United States person recognizes gain on a sale or exchange of stock in a foreign corporation, then the gain shall be included in the gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the stock. In the case of a domestic corporate shareholder, section 1.1248-1(d)(1) of the Income Tax Regulations provides generally that the foreign tax credit provisions of sections 901 through 908 shall apply to an amount included in income as a dividend under section 1248(a). While this rule does not apply to individual shareholders, section 1248(b) and section 1.1248-4 provide for a limitation on the amount of tax required to be paid by an individual shareholder by reason of an amount included in income under section 1248(a) as a dividend. This limitation takes into account the foreign taxes paid by the foreign corporation. See generally Rev. Rul. 81-32, 1981-1 C.B. 131.

Section 1363(b)(1) provides that the taxable income of an S corporation is computed in the same manner as in the case of an individual, except that the items described in section 1366(a)(1)(A) shall be separately stated.

Section 1363(c)(1) provides that, except as provided in section 1363(c)(2), any election affecting the computation of items derived from an S corporation shall be made by the corporation.

Section 1363(c)(2)(B) provides that in the case of an S corporation, elections under section 901 (relating to taxes of foreign countries and possessions of the United States) shall be made by each shareholder.

Section 1366(a)(1)(A) provides that, in determining the tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder. Section 1366(a)(1) further provides that section 1366(a)(1)(A) includes amounts described in section 702(a)(6)(relating to taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States).

Section 1366(b) provides that the character of any item included in a shareholder's pro rata share under section 1366(a)(1) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

Section 1373(a) provides that for purposes of subparts A and F of part III, and

part V, of subchapter N (relating to income from sources without the United States), (1) an S corporation is treated as a partnership, and (2) the shareholders of such corporation are treated as partners of such partnership.

In Rev. Rul. 69-124, 1969-1 C.B. 203, the Service addressed the income tax consequences under section 1248 from a partnership's sale of its stock in a controlled foreign corporation. The Service concluded that the partnership, which is a United States person as defined in section 7701(a)(30), was required to treat the gain on the sale of the stock as a dividend under section 1248(a). The ruling further concludes that the tax attributable to amounts included as dividends in the gross income of individual partners is subject to the limitation in section 1248(b).

B must report the gain on the sale of the C stock that is subject to section 1248(a) as a separately stated item of income under section 1366(a)(1)(A). Under section 1366(b), this separately stated item of income will retain its character and be reported by the Shareholders as income subject to section 1248(a).

Section 1248 of the Code was enacted in order to impose the full U.S. tax when income earned abroad is repatriated. To effect the full United States tax, earnings and profits are, under section 1248, taxed as dividends (to the extent of any gain) at the time of sale. Under this treatment, however, an individual shareholder required to include gain as ordinary income may be subject to a greater tax than a corporation.

Section 1248(b) provides a mechanism whereby an individual shareholder will not be subject to a greater tax on the amount taxable under section 1248 than if the shareholder owned stock in a domestic corporation which owned the stock in a foreign corporation. Section 1248(b), in effect, allows an individual shareholder to continue to pay tax at the capital gains rate on the disposition of the individual's stock provided there also is paid an amount which raises the tax at the corporate level to the United States tax rate.

Based on the information submitted and representations set forth above, it is held as follows:

> To the extent that an amount is included in A's gross income as a dividend in accordance with section 1248(a) as a result of B's disposition of its C stock, the section 1248(b) limitation provisions will be applicable. To the extent that such amount included in A's gross income as a dividend in accordance with section 1248(a) is in excess of the amount described in section 1248(b)(1), such excess will be subject to taxation as gain from the sale or exchange of a capital asset held for more than one year.

No opinion is expressed as to the tax treatment of the sale of the C stock owned by A's spouse, including the application of section 1248(a) to such sale. Further, no opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transactions that are not covered by the above rulings.

A copy of this letter must be attached to any Federal income tax return to which it is relevant.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

ASSOCIATE CHIEF
COUNSEL (INTERNATIONAL)

By: Charles P. Besecky
Chief, Branch 4

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