Obama Administration’s FY 2013 Budget Targets Return-of-Basis Distributions

The Administration’s FY 2013 Budget proposes to override a fundamental feature of the taxation of corporations.¹ It would treat a shareholder as recognizing gain, in certain circumstances, when it receives a distribution from a corporation against the basis the shareholder has in the stock of the corporation. This proposal could prevent a foreign holding company from making a nontaxable return-of-basis distribution to its U.S. parent.

The provision would alter the operation of Code Sec. 301(c), which specifies the treatment of a corporation’s distribution to its shareholders. A distribution is a dividend to the extent of the corporation’s earnings and profits. A distribution in excess of earnings is applied against and reduces the basis in the shareholder’s stock (and is not subject to taxation). The portion of the distribution that is not a dividend, to the extent it exceeds the shareholder’s basis in the stock, is treated as gain from the sale or exchange of property.

For example, assume that a U.S. company owns all of the stock of a foreign holding company (“Foreign HoldCo”). The foreign holding company owns the stock of a regional holding company, which in turn owns the stock of a number of foreign operating subsidiaries.

Assume further that the U.S. parent has a $25 million basis in the stock of Foreign HoldCo. The basis may have resulted from a purchase of the stock or from contributions of property to Foreign HoldCo (e.g., cash, stock in subsidiaries or other assets).²

Foreign HoldCo borrows $10 million and distributes the same amount to its U.S. parent. If Foreign HoldCo does not itself have any current or accumulated earnings and profits, the distribution is a nontaxable return of basis.³ In other words, the distribution represents a return to the U.S. parent of a portion of its $25 million investment in the holding company. After the distribution, the U.S. parent would have a $15 million basis in the stock of Foreign HoldCo.

The $10 million distributed can be borrowed by Foreign HoldCo from an unrelated or related party, including from one of its indirectly owned operating subsidiaries. Provided that the loan is arm’s-length and is not considered in substance as equity, an intercompany loan should be respected as such for tax purposes. Receipt of the proceeds of a loan...
There is a question concerning whether basis does not give rise to income or to earnings and profits. This is the case even if funds of a subsidiary are distributed in a subsequent year to Foreign HoldCo to pay off the loan.\footnote{See Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (Feb. 2012).}

The Obama Administration proposes to eliminate the return-of-basis distribution rule under certain circumstances. If applicable, the U.S. parent's basis in Foreign HoldCo's stock would be ignored for purposes of applying Code Sec. 301. This would have the effect of treating the $10 million distributed by Foreign HoldCo as a distribution in excess of basis, resulting in U.S. parent recognizing taxable gain from the deemed sale of its stock in Foreign HoldCo.

The new rule would apply where a foreign corporation ("funding corporation") funds a second, related foreign corporation (the "foreign distributing corporation") with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder. Funding transactions to which the proposal would apply include "capital contributions, loans, or distributions to the foreign distributing corporation," and the funding transaction may occur before or after the distribution. It appears that the Administration intends for this rule to be broadly applied.

As a general rule, gain from the deemed sale of the stock in Foreign HoldCo would be capital gain. Under a recently finalized regulation, however, Code Sec. 301(c)(3) gain is subject to Code Sec. 1248.\footnote{There is a question concerning whether basis is recovered in the aggregate or on a share-by-share basis. See V.C.T. Johnson, CA-4, 71-1 ustc §9148, 435 F2d 1257. Proposed regulations would adopt a share-by-share rule on a prospective basis, but the preamble to these proposed regulations acknowledges that "[t]he tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share." REG-143686-07, 74 FR 3509, at 3,510 (Jan. 21, 2009). See also LTR 2010104048 (Dec. 30, 2009).}

Accordingly, the gain would be recharacterized as ordinary dividend income to the extent of the earnings and profits of Foreign HoldCo's directly and indirectly owned subsidiaries.\footnote{See, e.g., M. Falkoff, CA-7, 79-2 ustc ¶9569, 604 F2d 1045 (respected a return-of-basis distribution when borrowed funds were used to make the distribution); G.M. Gross, CA-2, 56-2 ustc ¶9861, 236 F2d 612 (anticipated earnings and profits are not taken into account for purposes of Code Sec. 301(c)(2)).} For example, if the foreign subsidiaries had at least $10 million of earnings and profits, the $10 million distributed by Foreign HoldCo to its U.S. parent would be treated as a distribution of those earnings and profits. Such deemed dividend should be accompanied with deemed paid foreign tax credits and the income should fall within the general foreign tax credit basket.\footnote{See W.T. Johnson, CA-4, 71-1 ustc ¶9617, 604 F2d 1045 (respected a return-of-basis distribution when borrowed funds were used to make the distribution); G.M. Gross, CA-2, 56-2 ustc ¶9861, 236 F2d 612 (anticipated earnings and profits are not taken into account for purposes of Code Sec. 301(c)(2)).}

The earnings of the lower-tier subsidiaries subject to taxation under the new rule should become previously taxed income under Code Sec. 959(e). It would seem appropriate for the new rules to provide for an increase in the basis of the stock of Foreign HoldCo similar to the rules contained in Code Sec. 961.

This proposal would modify the fundamental Subchapter C policy that shareholders should be permitted to withdraw their capital without taxation before recognizing gain with respect to stock. It appears to be an attempt to tax distributions to a U.S. shareholder made by a foreign corporation to the extent there are earnings in foreign subsidiaries within the related group. On a positive note, the proposal supports that under current law foreign corporations generally can be funded to make a return-of-basis distribution without being subject to taxation.

**ENDNOTES**

1. See Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals (Feb. 2012).
2. The U.S. parent’s basis in Foreign HoldCo would also be increased for amounts included in the U.S. parent’s income under subpart F to the extent the underlying previously taxed earnings have not been distributed. Code Sec. 961.
3. There is a question concerning whether basis is recovered in the aggregate or on a share-by-share basis. See V.C.T. Johnson, CA-4, 71-1 ustc ¶9148, 435 F2d 1257. Proposed regulations would adopt a share-by-share rule on a prospective basis, but the preamble to these proposed regulations acknowledges that “[t]he tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share.” REG-143686-07, 74 FR 3509, at 3,510 (Jan. 21, 2009). See also LTR 2010104048 (Dec. 30, 2009).
4. See, e.g., M. Falkoff, CA-7, 79-2 ustc ¶9569, 604 F2d 1045 (respected a return-of-basis distribution when borrowed funds were used to make the distribution); G.M. Gross, CA-2, 56-2 ustc ¶9861, 236 F2d 612 (anticipated earnings and profits are not taken into account for purposes of Code Sec. 301(c)(2)).
6. There is no dividends received deduction for an inclusion under Code Sec. 1248. Code Sec. 245(a)(11).
7. Alternatively, the new law might provide that the earnings and profits of the funding corporation are deemed distributed to the shareholder. Cf., Reg. §§1.304-4T and 1.956-1T(b)(4) (funding corporation’s earnings are deemed distributed under anti-abuse rules).
8. Code Secs. 865(k), 862(a)(2); Reg. §1.904-5(c)(4)(i), (iv) Ex. 2; Reg. §1.1248-1(d). To the extent the gain is capital, it generally would be U.S. source, and fall within the passive basket. Code Sec. 865(a) & (f); Reg. §§1.904-4(b)(2)(i)(A), -5(c)(4)(iv), Ex. 2.