190 Controlled Foreign Corporations

191 CFCs: Introduction

- **Subpart F designed to prevent deferral of portable income**
- **Applies to US Shareholders of**
- **Controlled Foreign Corporations earning**
- **Subpart F income or**
- **Having investment in US property or excess passive assets**

192 CFCs: US Shareholders

- **§951(b)**
- **Definition has significance for Subpart F only (with exceptions)**

- **US Person**
  - **§7701(a)(30) definition modified for Puerto Rico & other possessions**
- **Owning 10 % or more of vote of a**
- **Foreign corporation**

193 CFCs: Defined

- **§957(a)**

- **Any foreign corporation**
- **More than 50% owned (vote or value)**
- **By US Shareholders (above)**

194 CFCs: Ownership

- **§958**

- **Ownership means stock owned directly or through foreign entities (no minimum limit for such indirect)**
- **§318 attribution for constructive ownership**
  - **But no attribution from NRA to citizen or resident. individual**
  - **And no attrib. to a US corp., p/s, estate or trust of shares owned by non-US person**
  - **Corp., p/s, estate or trust owning more than 50% treated as owning 100%**
  - **10% threshold for attribution**

195 What Subpart F Does

- **If ownership tests met for over 30 days in year**
- **US Shareholder must include in income**
- **Pro-rata share of Subpart F income and**
- **Share of investment in US property and excess passive assets**
- **Prior inclusions are not taxable when distributed**

196 §960 Basic Rule

- **If subpart F inclusion by US corporation, then**
- **US corporation deemed to have paid taxes as if the subpart F inclusion were a dividend. See §902(c) and §904(d)(3)(B)**
- **3 tier limit, with same voting stock requirements as §902(b)**

197 §960 and PTI

- No double counting or omission of credits on distribution

198 ## Subpart F Income

  – §952(a)

- Insurance income (not covered)
- FBC Income
- Boycott income
- Illegal bribes, etc
- FSC Foreign Trade Income excluded

199 ## FBC Income

- FPHC Income
- FBC Sales Income
- FBC Services Income
- FBC Shipping Income (not covered)
- FBC Oil Related Income (not covered)

200 ## FBC De Minimis Rule

  – §954(b)(3), Reg. §1.954-1(b)(1)

- No inclusion if gross FBC income is less than
  - 5% of total gross income, and
  - $1 million
- All income must be included if gross FBC income is over 70% of total gross income

201 ## Related Person Defined

- Corporation, individual, partnership, trust or estate which controls CFC, or
- Corporation, individual, partnership, trust or estate controlled by CFC
- Control is 50% of vote of corporation or 50% of value of other entities
- Attribution under same rules as for CFC status

202 ## FPHC Income

  – §954(c), Reg. §1.954-2

- Interest
- Dividends
- Rents
- Royalties

203 ## FPHC Income

- Gains on assets producing above or no income
- Gain on sale of partnership, trust, REMIC
- Many FX and commodities gains
  - » Note: Hedging rules beyond scope of this course

204 ## FPHC Excluded Rent & Royalty

  – Definitions in Reg. §1.954-2(c) & (d): odd rules

- Received from non-relateds in

- Active conduct of trade or business from renting/leasing/licensing

205 **FPHC Rent & Royalty: Active conduct**

- Self-manufactured or self-developed prop,
- Realty if active involvement,
- Temporarily idle trade or business assets, or
- Where substantial marketing or marketing & servicing by CFC in its country
  - Facts & circumstances or mechanical 25% test
  - Example covers car rental

206 **FPHC Related Person Dividends & Interest**

Dividends & interest excluded if:

- From related person as defined which is
- Organized in same country and which uses
- Substantial part of assets in trade or business in same country
  - Trade or business in country defined in §367 regs
  - Substantial means more than 50% of FMV or adjusted basis

207 **FPHC Related Person Dividends**

Exceptions:

- Dividends excluded only if:
  - Stock owned directly or indirectly thru related person CFC, and
  - E&P accumulated while requirements on last slide met

208 **FPHCI Related Person Div.**

Sub pays a dividend to UK. Discuss effects if sub:

- Is incorporated in UK
- Is incorporated in France:
  - EU dividends directive prevents withholding tax
  - UK & France tax rates are 33%
- Is incorporated in Switzerland
  - Swiss tax rate is 20%
  - Div. w/h is 5% under treaty

209 **FPHC Related Person Interest**

- Exceptions:
- Interest excluded only if not apportionable to Subpart F income
  - Interest received by payor characterized first
  - Look to interest apportionment rules under 1.861-8 --14

210 **FPHC Related Person Interest**

Sub (could be sister co.) pays interest to UK. Discuss effects if:

- 50% of sub's gross income is FBC sales income
- 40% of sub's assets are used in production of FBC sales income
- 2% of sub's gross income is FPHCI
- Sub is incorporated in UK
- Sub is incorporated in Hong Kong

Compare this to rents

211 **FPHC Related Party**

Rents & Royalties

- Exclude rents & royalties from related person if:
- Corp. payor:
  - Payor is related party, and
  - Payment is for use in CFC's country of incorp.

212 FPHC Related Party Rents & Royalties

Exclude rents & royalties from related person if:

- Partnership payor treated as corp. payor if:
  - Payment gives rise to deduction, to extent allocable to related corporate partner, or
  - Other payment would be allocable to related corporate partner
- Exceptions

213 FPHC Gains

- Gain on property giving rise to FPHC income
- Gain on property that does not dive rise to income
  - Cash, bare land, etc
- Gain on interest in partnership, trust, or REMIC
- Gain equivalent to interest
- Net gain in excess of loss on FX
  - Business needs exception

214 Other FPHC Issues

- beyond the scope of this course

- Hedging gains excluded
- Income equivalent to interest (notional principal contracts) treated as interest
- Special rules for FX & commodities
- Banking & financial services exceptions

215 FBC Sales Income

- Income from
  - Buying from anyone and selling to related, or
  - Buying from related and selling to anyone
- Property
  - Made, grown, produced outside CFCs country and
  - For use or disposition outside CFCs country
    - Excludes agricultural products not commercially grown in US

216 FBC Sales Income

Excludes income from sale of goods manufactured by CFC

- Property sold in effect not same as property purchased
- Substantially transformed
- Activities substantial in nature & generally considered manufacturing
- 20% conversion cost test

217 **FBC Sales Income: Branch Rule**

- Buying, selling or manufacturing branch treated as separate subsidiary if
- Created or organized outside CFC's country of incorp. and
- Tax effect of branch is same as if it were a subsidiary

218 **FBC Sales Income: Branch Rule**

- Branch rule applies if tax rate on branch is less than 90% and 5% points less than rate on home office of CFC
- Practical effect is to treat branches outside home country as generating subpart F income if tax benefit obtained by having branch
- Applies also to 70% full inclusion rule

219 **FBC Sales Income: Branch Rule Example**

220 **FBC Services Income**

- Performance of services for or on behalf of related party, including
  - Material condition services
  - Substantial assistance
- Outside CFC's country
- Excludes services connected with sale of CFC's products

221 **FBC Services Income**

- Bare guarantee of performance by parent does not create Subpart F
- FBCSI includes services where related provided material assistance
  - Must be either providing essential elements of CFCs services, or
  - 50% or more of cost of services
  - Financial assistance at arm's length or as capital excluded

222 **High Tax Kickout**

» Reg. §1.954-1(d)

- Regs say elective, code says shall
  - Regs have consistency rule
- Applies to FPHCI as well as FBC sales & services
- Exclude income subject to tax at 90% or more of top US corporate rate
- Must establish that "item of income" was subject to such tax

223 **High Tax Kickout, cont.**

- Effective rate of tax for item is:
  - US $ amount of tax paid or accrued with respect to item, divided by
  - US $ amount of net FBC income
- Amount of tax is amount that would be deemed paid under §960
- Net income is after all allocable & apportionable deductions
  - specific references to "principles of §§861, 864, 904(d)"

224 **956: Investment in US Property**
- US Shareholder must include in income share of
- CFC's basis in investment in U.S. property in excess of
- Prior inclusions under §956
- Limited to current and accumulated E&P reduced by current distributions

225 **§956: US Property**
- Tangible property in US
- Stock of US corp
- Obligations of US person
- Rights to intangible use in US

226 **§956: US Property**

Excludes: (disclosure required)
- US government obligations, money, or bank deposits
- Property in US purchased for export
- Transportation assets used in foreign commerce
- Stock or debt of unrelated corporations
- Continental shelf exploration assets
- FSC-related

227 **§956: Related Person Debt**
- Trade receivables from relateds excluded if
  - ordinary & necessary and
  - outstanding only for trade terms
- Pledge of CFC stock or guarantee by CFC in support of US loan is considered investment in US of amount of loan
  - But pledge of 2/3 of stock only is OK

228 **Factoring**
- US receivables factored from related parties considered US property
- Income (spread of realized over discount) considered US source for basketizing

229 **Limits on FBCI: No Loss Rule**

» Reg. §1.954-1(c)(1)(iii)
- Allocation and apportionment not allowed to cause loss in any category of FBCI
- Prevents loss in one category from offsetting income in another
- However, deductions in excess of gross income reduce E&P and may limit Subpart F income
  - But FBCI loss effectively offsets non-FBCI first

230 **§952: E&P Limitations: Overview**

– §952(c); Reg. §1.952-1 & 2; Prop. Reg. §1.952-1(e) & (f)
- Subpart F income limited to current E&P

- Prior year deficits in other than FPHCI reduce current E&P
- Deficits of lower tier members may offset E&P (chain deficit rule)
- Recapture of reductions for deficits
- (Subpart F income excludes US ECI)

231 §952: Basic E&P Limit

- Aggregate Subpart F income limited to current E&P
- Subpart F income may also be limited by prior E&P
  - WATCH OUT: Regs, which predate 1986 change, imply that all deficits count

232 §952: Prior Deficits

- Only deficits in E&P from "qualified activities" taken into account
- Qualified deficit is all deficits for sales & services income, but only post-86 for shipping & oil
- Qualified activities are all Subpart F activities except FPHCI

233 Chain Deficit Rule

- May elect to reduce Subpart F income from a qualified activity for deficit of:
  - Qualified chain member, from
  - Same qualified activity
- Qualified chain member is any CFC
  - Organized in same country and either
  - 100% owned by the CFC or
  - The CFC is 100% owned by it (directly or indirectly)
    - Directors qualifying shares excluded in computing 100%

234 §952: Ordering Rules

- Prop. Reg. §1.952-1(e)

- Reduce Subpart F income for excess of Subpart F over E&P:
  - First to each separate §904 category with loss or zero E&P
  - Second to each separate category with profits
  - Third to other separate categories
- Allocate to Subpart F categories within 904 categories
- Income retains character for §904

235 §952: Subsequent Recharacterization

- §952(c)(2), Prop. Reg. §1.952-1(f)

- Recapture of excluded Subpart F income from subsequent E&P under rules similar to §904(f)(5), the basket loss reallocation rules

236 Subpart F & Dividends

- §959

- No double inclusion: dividends are considered first from previously taxed under Subpart F, and to extent thereof are excluded
- Tricky ordering rules
- FX gain/loss on distribution

237 No Double Inclusion

- Amounts that have been included in a shareholder's income under §951(a)
- Are not again included when
  - Distributed or
  - Otherwise includable under §§956, 956A

- In income of that shareholder or another shareholder who acquired the shares

238 ## No Inclusion in Sub's Income

- Amounts that have been included in a shareholder's income under §951(a)
- Are not included in gross income of another CFC when distributed up chain

239 ## Ordering Rule

- For purposes of §959, §316(a) is applied by using current then accumulated E&P and allocating:
- First to aggregate 956 and 956A inclusions (allocated between these proportionately)
- Then to other subpart F inclusions (but reduced by 956 and 956A amounts that were excluded under the no-double inclusion rule)
- Then to other E&P

240 ## Basis Adjustment

- Basis of shares increased for Subpart F inclusions
- Basis reduced by amount excluded under §959 as previously taxed

241 ## Look Thru--Subpart F

- Treat as separate basket to extent in CFC's separate basket
- Rules that kick income out of passive basket apply before this rule
- Exclusions under Subpart F 90% high tax kickout considered general basket
- Subpart F full inclusion rule has no effect on baskets

242 ## §1248 Gain (overview)

- Gain on sale of CFC shares
- Recharacterized as dividend
- To extent of non-previously taxed E&P
- Special rules for individual shareholders

243 ## Threshold to §1248

- Sale or exchange
  - or distribution treated under §§302, 331 as exchange
- US person selling
- Seller held over 10% at some time in prior 5 years
- Gain recognized
  - No 1248 if no gain or nonrecognition applies

244 ## §1248 E&P Exclusions

Following are excluded from E&P:

- Prior Subpart F inclusions
- Prior PFIC inclusions
- US ECI
- US FDAPI of corporation engaged in US business
- FSC income
- Amounts taxed under §1247

245 ## §1248 Exceptions

- Distributions under §303 (death taxes)

- **Amounts treated as:**
  - **Dividends**
  - **Ordinary income**
  - **Short term capital gain**

246 §1248 Anti-avoidance

- **Sale of shares of domestic corp. formed or availed of to hold foreign corporations treated as sale of foreign corp.**
- **Taxpayer must demonstrate E&P or all gain treated as E&P**

247 Deemed Paid Taxes

- **§960 (Reg. §1.960-1 to -5 largely obsolete)**

- **Similar to §902, but**
- **Limited to current tax and current E&P**
- **1986 act replaced much of old §960 with reference to §902**
- **New post-1993 rules coordinating receipt of previously taxed E&P**

248 PFIC Overview

- **Shareholders of PFICs must either**
- **Include their share of PFIC earnings and capital gains in their income currently, or**
- **When earnings are included (either as earnings or gain) pay interest and tax (but no penalty) as if they had been included and just omitted from return**

249 PFIC Defined

- **Passive Foreign Investment Company is**
- **ANY foreign corporation**
- **Meeting either asset or income test:**
  - **Over 75% of gross income is FPHCI or**
  - **Over 50% of assets produce FPHCI**

250 PFIC Look-Thru

- **Assets of 25% or more subsidiary of a foreign corporation**
- **Considered proportionately owned by the foreign corporation, and**
- **The shares of stock are ignored as an asset**

251 PFIC Startup Rule

- **Foreign corporation not considered a PFIC for its first year it has gross income if**
  - **No predecessor was a PFIC,**
  - **Shareholder satisfies the IRS that it won't be a PFIC in either of the following 2 years, and**
  - **It isn't a PFIC in either of the following 2 years**
- **Similar rule for changing businesses**
- **Trap for unwary: 1st year, not 1st 12 months**

252 PFIC Effects: QEF

- **Shareholder may elect to treat PFIC as a Qualified Electing Fund**
- **Results in shareholder including share of ordinary earnings & capital gains**

currently
- Requires disclosures, election, and promise to deliver records

253 **PFIC Effects: non-QEF**
- Shareholder receiving “excess distribution” must
- Pro-rate distribution over entire period of ownership
- Compute tax as if earnings so allocated to each post-1986 year had been distributed
- Compute interest on such tax
- Exclude the post-1986 portion from current taxable income
- Include tax and interest on post-1986 as current tax

254 **QEF Elections**
- Pedigreed vs. non-pedigreed
- Straight: effective from point elected
- Deemed sale: recognize gain as if sold at FMV, pay tax (& interest)
- CFC deemed dividend inclusion: include all post-86 E&P as if actual dividend

255 **PFIC Pitfalls**
- An active business can be a PFIC
- Non-pedigreed QEF can be problem for CFC

256 **Choice of Entity**

257 **Choice of Entity**
- Partnership: income, deductions & credits flow through directly
- Corporation: no flow through except character for FTC
- Hybrid: entity that is treated one way in one jurisdiction and another way in another jurisdiction

258 **Check the Box**
- U.S. rules allow an entity to elect corporate or flow through treatment
  - Except entities treated, per se, as corporations, such as U.S. corporations or foreign publicly traded entities
- Election made by filing Form 8832 and “checking the box” for the desired treatment
- Election may be revoked
  - Time limits on electing & revoking

259 **What’s a Hybrid Entity**
» §7701(a)(3), Reg. §301.7701-2
- Entity treated as corporation locally and partnership or branch for US purposes (or vice versa)
- Per se entities
  - per IRS list
  - U.S. corporations
  - publicly traded type of entity in most countries
- Otherwise: choice of taxpayer

FDU: U.S. International Corporate Tax

260 Subpart F Branch Rule & Check the Box

- Checking the box on a sales or mfg. sub causes branch treatment
- Branch rule may defeat check the box

261 **Basic Hybrid Structures**

262 **CV/BV**

263 **Double Dutch**

264 **Impact of Structures**

- **Foreign tax credit**
- **Timing of income**
- **Taxability of intra-group payments**
- **Whether reorganizations are real for tax purposes**