

## Controlled Foreign Corporations

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## Taxation of Deemed Dividends

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### ANTI-AVOIDANCE RULES OF SUBPART F

- **Code section 951** is the basic operative provision of subpart F of Internal Revenue Code (§§ 951-965: Subtitle A, Chapter 1, Subchapter N, Part III, Subpart F of Code).
- § 951 requires, under some conditions, that certain profits of a controlled foreign corporation (CFC) be included as a deemed dividend in the gross income of the “United States shareholders” of the CFC.
- Income currently taxed under § 951 is sometimes called “tainted income.”

## Requirements for Taxation

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### TESTS FOR TAXING UNDISTRIBUTED INCOME OF A CFC

- A shareholder of a corporation is taxable under § 951 if:
  - ▶ The corporation qualifies as a controlled foreign corporation (CFC) for an uninterrupted period of 30 days or more during the taxable year;
  - ▶ The shareholder is a U.S. shareholder (must own 10 percent or more of the voting stock); and
  - ▶ The U.S. shareholder owns its shares of stock in the CFC on the last day of the taxable year that the foreign corporation qualifies as a CFC.
- Ownership of stock is determined after application of the indirect and constructive ownership rules of § 958(a).

## Defining a CFC

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### DETERMINING WHETHER AN ENTITY IS A CFC

- A CFC is a foreign corporation — that is, a corporation organized under the laws of a foreign jurisdiction.
- A foreign corporation will be classified as a “controlled” foreign corporation under § 951 if it satisfies either the **voting-control test** or the **ownership test**.

## Defining Control

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### THE VOTING-CONTROL AND OWNERSHIP TESTS

- A foreign corporation satisfies the **voting-control test** if U.S. shareholders own more than 50 percent of the combined voting power of all classes of its voting stock on any day during its taxable year.
- The **ownership test** is satisfied if more than 50 percent of the total value of the stock of a foreign corporation is owned by U.S. shareholders on any day of the taxable year of the foreign corporation.

## United States Shareholder

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### 10-PERCENT OWNERSHIP REQUIREMENT

- A U.S. shareholder of a corporation is a “United States person” owning **10 percent or more** of the voting stock of that corporation.
- In general, a U.S. person is:
  - ▶ a citizen or resident of the United States
  - ▶ a domestic corporation
  - ▶ a domestic partnership
  - ▶ a domestic trust
  - ▶ an estate other than a foreign estate.

## Indirect Ownership Rules

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### OWNERSHIP THROUGH FOREIGN ENTITY

- Stock owned directly or indirectly by or for a foreign entity shall be treated as owned proportionally by its shareholders, partners, or beneficiaries.
- For example, if P, a U.S. corporation, owns 75 percent of the stock of R, a foreign corporation, and R owns 80 percent of the stock of S, then P will be treated as the owner of 60 percent (80% of 75%) of the stock of S.

## Constructive Ownership Rules

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### FAMILY ATTRIBUTION, ETC.

- Taxpayers are treated, for certain limited purposes, as the owners of stock held by certain trusts, corporations, and other legal entities and by certain close relatives.
- Those rules apply for purposes of determining whether
  - a foreign corporation qualifies as a CFC under § 957.
  - a U.S. person is a U.S. shareholder under § 951(b).
  - a person is a related person within the meaning of § 954(d)(3).
- The constructive ownership rules do NOT cause a person to be treated as the owner of stock for purposes of being taxed on deemed dividends.

## Constructive Ownership #2

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### SOME EXAMPLES

- **Individuals** are treated as the owner of shares of stock owned, directly or indirectly, **by their spouse, children, grandchildren, and parents.**
  - Exception: Stock owned by a foreign individual is not be treated as owned by a U.S. citizen or resident.
- Stock owned, directly or indirectly, by or for a **partnership** or an **estate** will be treated as owned proportionally by its partners or beneficiaries.
- Stock owned, directly or indirectly, by a **corporation** will be treated as owned by the U.S. shareholders of that corporation in proportion to their direct and indirect ownership interests in the corporation.

## Relief from Double Taxation

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### SUBPART F RELIEF RULES

- Amounts previously (or currently) taxed to a shareholder as a deemed dividend are excluded from income when actually distributed. § 959
- U. S. shareholders may increase the basis of their CFC stock by the amount of the deemed dividend. § 961(a)
- Domestic corporations taxable on a deemed dividend from a CFC are allowed to claim a foreign tax credit for foreign income taxes paid by the CFC. § 960(a)(1)
- The subpart F income of a CFC does not include ECI from sources within the United States. § 952(b)

## Special Relief Provisions

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### RULES GIVING SOME SUBPART F RELIEF

- A U.S. shareholder's pro rata share of the subpart F income taxable as a deemed distribution cannot exceed its pro rata share of the earnings and profits of the CFC. § 952(c)(1)(A)
- An individual U.S. shareholder may elect to be taxed on deemed dividends at the rates applicable to domestic corporations. § 962(a)(1).
- U.S. taxpayers may avoid being taxed on a deemed dividend if an actual distribution would not have been permitted under the laws of a foreign country.

## Subpart F Income

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### CATEGORIES OF INCOME CURRENTLY TAXED

- Subpart F income as the sum of the following five categories of income obtained by a CFC (§ 952(a)):
  - ▶ (1) insurance income;
  - ▶ (2) foreign base company income;
  - ▶ (3) income attributable to compliance with an international boycott (international boycott income);
  - ▶ (4) illegal payments made to an official, employee, or agent of a foreign government (foreign bribe income); and
  - ▶ (5) income arising in certain unfriendly foreign countries (unfriendly foreign country income)

## Foreign Base Company Income

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### TAXING INCOME THAT IS EASILY DEFLECTED TO A TAX HAVEN

- A “base company” is typically a holding company or similar corporate shell organized in a tax haven jurisdiction for the purpose of receiving income deflected from business operations or investment activities conducted in other countries.
- FBCI includes:
  - ▶ Foreign personal holding company income
  - ▶ Foreign base company sales income
  - ▶ Foreign base company services income
  - ▶ Foreign base company oil related income

## FPHC Income

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### FOREIGN PERSONAL HOLDING COMPANY INCOME

- The following are types of FPHC Income
  - ▶ Dividends, interest, royalties, rents, and annuities
  - ▶ Net gains derived from the sale or exchange of certain investment property, including gains from assets producing FPHC income (or no income)
  - ▶ Net gains from transactions in commodities and in foreign currency
  - ▶ Income equivalent to interest and income from notional principal contracts
  - ▶ Payments in lieu of dividends (e.g., from lending of stock)
  - ▶ Personal service contract income

## Exceptions to FPHC Income

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### CERTAIN INCOME OF A CFC EXCLUDED

- Dividends received by a CFC that have **previously been taxed** under subpart F (no double tax)
- Rents and royalties that a CFC receives from **unrelated persons** in the active conduct of its trade or business.
- Rents and royalties received by a CFC from a **related person** received **for the use of property within the country in which the CFC is organized**
- Certain dividends and interest received from a related person when the CFC and the related person are organized under the laws of the **same country**
- Income earned by a financial services business from the active conduct of a banking, financing, or similar business

## Look-thru rule for related CFCs

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### APPLIES TO DIVIDENDS, INTEREST, RENTS, AND ROYALTIES

- Dividends, interest, rents, and royalties received by a CFC from a related person are not foreign personal holding company income if they are paid from income that is **not**:
  - Subpart F income or
  - Effectively connected income.
- Rule does not apply if the effect is to create or increase a deficit that would reduce the subpart F income of the payor or another CFC.
- This rule expired for taxable years beginning after December 1, 2012. Lots of pressure to extend the rule to future years.

## Definition of Related Person

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### DEFINITION BASED ON VOTING CONTROL

- A corporation, trust, partnership or estate is a related person with respect to a CFC if that person **controls or is controlled** by the CFC.
- A corporation, partnership, trust, or estate is a related person with respect to a CFC if that person is controlled by the same person or persons that control the CFC.
- An individual (whether or not a U.S. citizen or resident) is a related person with respect to a CFC if he/she controls the CFC.

## FBC Sales Income

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### SALES INCOME DEFLECTED TO A THIRD COUNTRY

- A CFC may generate FBC sales income from the following four types of transactions:
  - (1) the purchase of personal property from a related person and its sale to any person;
  - (2) the sale of personal property to any person on behalf of a related person;
  - (3) the purchase of personal property from any person and its sale to a related person; and
  - (4) the purchase of personal property from any person on behalf of a related person.

## Example of FBC Sales Income

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### PURCHASE FROM OR TO, OR ON BEHALF OF, A RELATED PERSON

- LCo is a CFC organized under the laws of Country L, a low-tax country. LCo purchases goods manufactured by FCo, a related party, in Country F and sells those goods to unrelated customers in Country G.
  - ▶ The profits earned by LCo from the purchase and sale are FBC sales income.
  - ▶ If LCo had sold the goods for FCo on commission, LCo's commission fees would be FBC sales income.
  - ▶ If LCo bought goods from UCo, an unrelated party, and sold the goods in Country G to GCo, a related party, its profits would be FBC sales income.

## Exceptions to FBC Sales Income

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### "SAME COUNTRY" EXCEPTIONS

- Income of a CFC arising from a sale or purchase of personal property will not constitute FBC sales income if:
  - ▶ The personal property sold or purchased is manufactured, produced, grown, or extracted within the country in which the CFC is **created or organized**.
  - ▶ The CFC is organized in the country where the property is sold. The country of sale is determined by employing a **destination test**.
  - ▶ The CFC is the manufacturer or producer of the goods that it sells.

## Branch Rule

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### TREATING A BRANCH AS A RELATED PERSON

- A branch or similar establishment of a CFC located outside the country of incorporation of the CFC may be treated as if it were a wholly owned subsidiary of the CFC, organized under the laws of the country where the branch is located.
- A branch rule is triggered if the use by a CFC of a sales branch or a manufacturing branch "has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation" of the CFC (e.g., the branch is not taxed or taxed at a low rate).
- Test: Tax is less than 90% of rate on CFC (0r 5 percentage points lower).

## Sales Branch

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### USE OF FOREIGN BRANCH TO DEFLECT INCOME TO TAX HAVEN

- A branch of a CFC that is located outside the country where the CFC is organized and that carries on purchasing or selling activities will be treated as a separate corporation (i.e. a related person) for purposes of applying the FBC sales rules.
- *Example.* MCo, a CFC organized in Country M, has a branch office in Country L, a tax haven jurisdiction. Country M does not tax income earned by the foreign branches of its domestic corporations (e.g., The Netherlands). MCo manufactures goods in Country M, which it sells outside of Country M and Country L through its branch office in Country L. The branch will be treated as a separate corporation that bought the goods manufactured by MCo, and its income would be FBC sales income, subject to current taxation under subpart F.

## Manufacturing Branch

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### THE COMPANY SELLS AND THE BRANCH MANUFACTURES

- The manufacturing branch rule is designed to prevent a CFC that is manufacturing goods through a branch located outside the country where the CFC is organized from avoiding taxation under subpart F.
- *Example.* LCo, a CFC organized in Country L, a tax haven jurisdiction, has a manufacturing branch located in Country M. The branch manufactures products in Country M (and is taxed on the mfg profits only), and LCo sells the products to unrelated persons. Under the branch rule, LCo is treated as having purchased from a related person (the mfg branch), and its income is taxable under subpart F.

## Contract Manufacturing

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### HIRING A SEPARATE COMPANY TO DO THE MANUFACTURING

- A contract manufacturer is a related or unrelated party that produces goods (typically) under a cost-plus contract.
- The game is to have the CFC that hires the contract manufacturer treated as the manufacturer and thereby qualify for an exception to the definition of FBS sales income.
- The IRS has argued and lost that the contract manufacturer is a branch of the CFC. Now it argues that the CFC is not a manufacturer.

## FBC Services Income

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### DEFLECTING INCOME FROM SERVICE CONTRACTS TO A TAX HAVEN

- The foreign base company (FBC) services income of a CFC is the gross income that it derives from the performance of services, for, or on behalf of, a related person, outside the country where the CFC is organized.
- Services income includes income from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services

## FBC Oil Related Income

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### MODIFIED FORI DEFLECTED TO A TAX HAVEN

- FBC oil related income is a modified version of FORI (foreign oil related income). FORI includes:
  - ▶ Income derived from the processing of crude oil or gas into their primary products.
  - ▶ Income derived from the transportation or sale of oil or gas primary products.
  - ▶ Income derived from the disposition of assets used in the processing, transportation, or sale of oil or gas primary products .
  - ▶ Income from the performance of services related to the processing, transportation, or disposition of oil or gas primary products.
  - ▶ Dividends, interest, and certain other distributions from certain foreign entities to the extent that the distributions are attributable to FORI .

## Deductions from FBC Income

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### SUBPART F INCOME IS NET INCOME

- The U.S. shareholders of a CFC are taxable on their **net** foreign base company income, although base company income is identified from gross income.
- In general, subpart F income is broken into categories of income and deductions are allocated and apportioned to those categories of income and then subtracted in computing net foreign base company income.

## Subpart F Insurance Income

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### MOSTLY ABOUT REINSURANCE INCOME SHIFTED TO TAX HAVENS

- In general, tainted insurance income is insurance income that has been deflected to a corporation organized outside the country where the insurance risks are located.
- For captive insurance companies, “control” is satisfied if U.S. persons own 25% or more of the stock of the captive (by vote or value).

## Special Measures

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- The subpart F rules do not apply if the tax haven income has been taxed by some foreign government at an effective income tax rate greater than 90 percent of the top U.S. corporate tax rate.
- *De minimis*. A CFC will be treated as having no tax haven income for the taxable year if the sum of its gross FBC income and its gross subpart F insurance income for that year is less than \$1 million and less than 5 percent of its total gross income.
- *De maximis*. The entire income of the CFC will be taxed currently if more than 70 percent of its gross income is tainted income.

## Investments in U.S. Property

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### DISGUISED REPATRIATION OF CFC PROFITS

- A U.S. shareholder of a CFC is taxable on its pro rata share of the CFC’s average amount of U.S. property held at the close of each quarter of its taxable year, reduced by the CFC’s earnings and profits previously included in the U.S. shareholder’s income. § 956
- Example. FCo, a foreign affiliate of PCo, a U.S. corporation, loans PCo \$1 million. Assuming FCo has adequate E&P, the loan is treated as a repatriation of profits and is taxable to PCo.

## Definition of U.S. Property

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### DEFINITION IS BROAD BUT HAS NARROWED SOME

- **U.S. Property** includes:
  - ▶ Tangible property located in the United States, with exceptions for certain export-related assets.
  - ▶ Stock of U.S. corporations that are U.S. shareholders of the CFC.
  - ▶ Stock of any U.S. corporation if 25 percent or more of its voting stock is held either by the CFC or by its U.S. shareholders.
  - ▶ Certain obligations, such as a debt, of a United States person. Obligations of the United States and deposits with persons carrying on the banking business are excluded from this category.
  - ▶ Any right to use in the United States certain intangible property, such as a patent, a copyright, an invention, or a secret formula

## Dispositions of CFC Stock

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### DENYING CAPITAL GAINS TREATMENT TO GAINS ON STOCK SALES

- Certain U.S. taxpayers must treat a portion of the gain realized on the disposition of stock in a CFC as a dividend rather than as capital gain. § 1248
- With respect to corporations, IRC § 1248 now operates primarily to provide tax benefits to U.S. persons, since there is no corporate capital gains preference.
- The rule does trigger recognition of gain in some cases — certain liquidations and reorganizations.

## PFIC Provisions

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### PASSIVE FOREIGN INVESTMENT COMPANY RULES

- These rules generally take the tax benefit out of off-shore mutual funds.
- They used to have a major impact on MNEs that have accumulated large sums in CFCs and decline to repatriate the funds.
- The rules tax income on a market to market basis on in various other ways, generally at the option of the taxpayer.
- The PFIC rules apply whether or not the U.S. person had control of the foreign corporation.