ANTI-DEFERRAL REGIMES: U.S. TAXATION OF FOREIGN CORPORATIONS

Author
Professor Alan I. Appel

Tags
Anti-Deferral
C.F.C.
P.F.I.C.
Subpart F

When a U.S. business expands abroad, it is frequently believed that the income of foreign subsidiary corporations will not be taxed in the U.S. until dividends are distributed to the U.S. shareholder. This is known as tax deferral, which is the general expectation of clients. However, in the U.S., tax deferral may be overridden by provisions accelerating the imposition of U.S. tax on U.S. shareholders of foreign corporations. As a result, income may be taxed before a dividend is distributed. This article describes the anti-deferral provisions of U.S. tax law that may be applicable in certain situations.

ANTI-DEFERRAL REGIMES

The Internal Revenue Code contains two principal anti-deferral regimes that may impose tax on a U.S. taxpayer on a current basis when its foreign subsidiaries generate income. These provisions reflect a policy under which Congress believes the deferral rules are being abused to inappropriately defer U.S. tax, especially if foreign tax is not imposed for one reason or another. The two regimes are the:

- Controlled Foreign Corporation ("C.F.C.") regime under Code §§951-964, also known as the "Subpart F" provisions; and
- Passive Foreign Investment Company ("P.F.I.C.") regime under Code §§1291-1298.

Controlled Foreign Corporations

Under Code §957(a), a foreign corporation is a C.F.C. if stock representing more than 50% of either the total combined voting power or the total value of shares is owned, directly, indirectly, or by attribution, by "U.S. Shareholders" on any day during the foreign corporation's taxable year. With respect to a foreign corporation, a U.S. Shareholder is defined as a "U.S. person" that owns, under the foregoing expanded ownership rules, stock representing 10% or more of the total voting power of all classes of the foreign corporation's stock that is entitled to vote.[1] A "U.S. person" includes a U.S. citizen or resident, a U.S. corporation, a U.S.

Alan I. Appel is a Professor of Law at New York Law School, where he is the Director of the International Tax Program. Prior to joining New York Law School, he was Counsel to Bryan Cave LLP for 13 years. Professor Appel is a member of Council of the A.B.A. Tax Section and responsible for overseeing the International Tax Committees.

[1] Treas. Reg. §1.951-1(g)(1).

partnership, a domestic trust, and a domestic estate.[2] Stock ownership includes indirect and constructive ownership under the rules of Code §958. Consequently, ownership can be attributed, *inter alia*, from foreign corporations to shareholders, from one family member to another, and from trusts and estates to beneficiaries, legatees, and heirs.

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Code §951 contains the basic rules for taxing a C.F.C.'s undistributed income to its U.S. Shareholders. Specifically, Code §951(a) provides that if a foreign corporation is a C.F.C. for an uninterrupted period of 30 days or more during any taxable year, every person who (i) is a U.S. Shareholder and (ii) owns, within the meaning of Code §958(a), stock in the C.F.C. on the last day of that year must include in gross income a *pro rata* share of certain classes of tainted income of the C.F.C. and certain investments made by the C.F.C. in "U.S. Property." The income is included in the taxable year of the U.S. Shareholder in which the C.F.C.'s taxable year ends.

For the anti-deferral rule to apply, the following must take place:

- The foreign corporation must be a C.F.C.;
- The shareholder must be a U.S. Shareholder; and
- The C.F.C. must derive certain types of income or must have invested its earnings in certain assets.

If Subpart F is applicable, the U.S. person must pay tax even if no dividends are distributed. This is frequently described as phantom income.

A C.F.C.'s Subpart F income consists of insurance income and foreign base company ("F.B.C.") income. For most C.F.C.'s and U.S. Shareholders, only F.B.C. income is relevant, and that income will be discussed further in this article.

F.B.C. income is the sum of four types of gross income:[3]

- Foreign Personal Holding Company ("F.P.H.C.") income,
- F.B.C. Sales Income,
- F.B.C. Services Income, and
- F.B.C. Oil Related Income, which is mentioned, but not discussed further.

F.P.H.C. income generally consists of a C.F.C.'s income in the form of:

- Dividends;
- Interest;

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[2] Code §7701(a)(30).
[3] Code §954(a).

- Annuities;
- Rents;
- Royalties;
- Net gains from the disposition of property producing any of the foregoing types of income;
- Net gains from property producing no income, such as fallow land or collectibles, provided that the property is not used in a trade or business carried on by the C.F.C.;
- Net gains from commodities transactions;
- Net gains from foreign currency transactions;
- Income from notional principal contracts; and
- Amounts received under personal service contracts related to services performed by substantial shareholders identified in such contracts.[4]

An example of gain from the sale of non-income-producing property that is considered to be F.P.H.C. income would be the sale of a piece of machinery or office equipment used in a business. An example of C.F.C. personal service income would be income that arises from a contract of a lend-a-star company that requires a shareholder performer to appear at a performance or allows the customer to identify the person that must perform under the contract.

F.B.C. Sales Income is derived from transactions in goods in which a related person is either the buyer or seller.[5] Think of this as an incestuous transaction because the C.F.C. is dealing with a related party on either the buy side or the sale side of a transaction involving inventory. The income may be in the form of margin on purchases and sales or commissions derived by a sales or purchasing agent.

For income from the purchase or sale of personal property to trigger F.B.C. Sales Income, the following conditions must exist with regard to the property:

- It must not have been produced in the country in which the C.F.C. was incorporated; 6
- It must not be sold for use, consumption, or disposition in that country; and
- It must not be manufactured or produced by the C.F.C. unless the goods are produced in one country and sold through a branch in another country.[7]

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4 Code §954(c).
5 Code §954(d).
6 Treas. Regs. §1.954-3(a)(3)(i).
7 Treas. Regs. §1.954-3(b).

If the C.F.C. provides a substantial contribution to the manufacture of a product by a contract manufacturer in a third country, F.B.C. Sales Income will not exist provided that the services are of a kind described in income tax regulations and a branch of the C.F.C. is not created in the country where the contract manufacturer operates.[8]

F.B.C. Services Income means income (whether in the form of compensation, commissions, fees, or otherwise) that meets the following three conditions:

- The income is derived in connection with the performance by the C.F.C. of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services;
- The services are performed for, or on behalf of, a related person; and
- The services are performed outside of the C.F.C.'s country of incorporation.

"In Notice 2007-13, the I.R.S. announced that F.B.C. Services Income will exist only when a related U.S. person provides the substantial assistance."

The regulations identify four situations where services are considered performed for or on behalf of a related person:

- Where the C.F.C. receives compensation or benefit from a related person for performing the services;[9]
- Where the related person is or has been obligated to perform services that the C.F.C. performs;[10]
- Where a C.F.C. performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale;[11] and
- Where a C.F.C. performs services on behalf of a related person if a related person provides "substantial assistance contributing to the performance of" the services.[12] In Notice 2007-13, the I.R.S. announced that F.B.C. Services Income will exist only when a related U.S. person provides the substantial assistance. Thus, substantial assistance by a foreign related party will not trigger F.B.C. Services Income for a C.F.C.

Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person to the C.F.C. if the assistance satisfies an objective cost test. The cost test will be satisfied if the cost to the C.F.C. of the services furnished by the related U.S. person equals or exceeds 80% of the total cost to the C.F.C. of

8 Treas. Regs. §1.954-3(a)(4)(iv),
9 Treas. Regs. §1.954-4(b)(1)(i).
10 Treas. Regs. §1.954-4(b)(1)(ii). However, services are not performed on behalf of a related person merely because that person guarnatees the C.F.C.'s performance, if neither the grantor nor any other related person pays for those services or for "significant services relates to such services." Treas. Regs. §1.954-4(b)(2)(i).
11 Treas. Regs. 1.954-4(b)(1)(iii).
12 Treas. Regs. 1.954-4(b)(1)(iv).

performing these services. The term “cost” will be determined after taking into account adjustments, if any, made under Code §482.[13]

Passive Foreign Investment Companies (“P.F.I.C.”)

In addition to the C.F.C. rules described above, a U.S. shareholder of a P.F.I.C. is taxed on excess distributions received from a P.F.I.C. and on direct or indirect gains derived from the sale, exchange, or other disposition of the shares of the P.F.I.C., plus an additional interest charge based on any deferred taxes to which the distribution relates. The effect of the interest charge is intended to eliminate the benefit of the deferral with respect to the P.F.I.C.’s earnings. Of course, actual deferral is not the same as deferral determined under the P.F.I.C. provisions -- the P.F.I.C. deferral rules assume that income is generated in equal amounts daily over the course of the holding period. That assumption may have no relation to reality, especially where a passive asset such as stock held for appreciation is sold and the proceeds are immediately distributed to the P.F.I.C.’s shareholders.

There are two alternative tests for determining whether a foreign corporation is a P.F.I.C.:

- The income test. Under the income test, a foreign corporation is a P.F.I.C. if 75% or more of its gross income is passive income of a kind that would be Foreign Personal Holding Company Income were Subpart F applicable.

- The asset test. Under the asset test, a foreign corporation is a P.F.I.C. if 50% or more of the average value of its assets (on a gross value basis) consists of assets that ordinarily produce passive income,[14]

When a foreign corporation meets either of these tests, its U.S. shareholders become subject to the P.F.I.C. provisions of the Code. Note that in comparison to the C.F.C. rules that require ownership of a certain percentage of C.F.C. shares, the P.F.I.C. rules contain no distinction with respect to the treatment of large and small shareholders. Provided that the P.F.I.C. is not a C.F.C., or if it is, provided that the shareholder is not a U.S. Shareholder, the P.F.I.C. rules apply no matter how small the percentage owned by a U.S. person.

It is relatively easy to expect that an investment fund formed outside the U.S. will be a P.F.I.C. However, the definition is extremely broad and will often cover a personal services firm formed outside the U.S. in which a U.S. individual is a minority member. Typically, cash balances on the asset measurement dates will exceed 50% of the total assets of the entity and cash is treated by the I.R.S. as a passive asset. Consulting firms and professional services firms rarely have significant amounts of hard assets on their balance sheets.

It should be noted that to the extent a foreign corporation is a C.F.C. and a P.F.I.C. it is not treated as a P.F.I.C. with regard to U.S. persons that are U.S. Shareholders in relation to the foreign entity. These are persons that own stock amounting to

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[13] Notice 2007-13.
[14] Code §1297(a).

10% or more of the voting power in the entity. The good news is that if a C.F.C does not have Subpart F income, the U.S. Shareholders do not need to be concerned with the P.F.I.C. rules. However, U.S. Persons owning less than 10% of the shares will be fully subject to the P.F.I.C. rules. Note that if the U.S. Shareholder is a U.S. domestic partnership, all partners benefit from the treatment of the entity as a C.F.C., even those having an indirect interest of less than 10% in the C.F.C./P.F.I.C.

At first glance, the P.F.I.C. rules do not appear to be an anti-deferral mechanism since the taxable event is not accelerated for the U.S. shareholder. Rather, a penalty tax regime applies at the time an "excess distribution" is received or the shares of the P.F.I.C. are sold or otherwise disposed of at a gain.[15] The excess distribution and the gain are each "thrown back" to every day of the holding period of the P.F.I.C. shares.[16] To the extent that the foreign corporation was a P.F.I.C. in the earlier throw-back year, the amount allocated to that year is taxed at the highest rate of tax imposed on ordinary income for that year, and that tax is deemed paid late. Consequently, late payment interest is imposed for each such year.[17] If the foreign corporation is not a P.F.I.C. in the throwback year, there is no interest charge, but the distribution or gain is taxed as ordinary income. The same rule applies to income or gain allocated to the current year.

The tax and interest imposed under the "throwback rules" may exceed the amount of the distribution. This treatment encourages a U.S. taxpayer to voluntarily forego deferral and to include the income as if the P.F.I.C. were tax transparent. This treatment is achieved by electing to treat the P.F.I.C. as a qualified electing fund ("Q.E.F.").[18] A shareholder making this election is required to include in income its *pro rata* share of the ordinary earnings and net capital gain of the P.F.I.C. when and as earned by the P.F.I.C. The income and gains retain their character, but deferral of tax is eliminated.

To make the election, the P.F.I.C. must agree to provide information to its U.S. investors on a timely basis so that U.S. tax can be computed.[19] Many foreign investment funds refuse to take on that obligation and consequently, a Q.E.F. election cannot be made. Where, however, the foreign fund is publicly traded, a U.S. investors\ may elect to include income on a marked-to-market basis, taking into income the increase in market value of the shares each year.[20] If this election is made, reductions in value may give rise to recognized losses until the original purchase price is reached. Losses that reduce basis below the original purchase price are disallowed.

15 Code §1291(b).
16 Code §1297(a)(1)(A).
17 Code §1297(c)(3).
18 Code §1295.
19 Treas. Regs. §1.1295-1(f).
20 Code §1296.

REPORTING REQUIREMENTS

The U.S. Shareholders of a C.F.C. and the U.S. investors in a P.F.I.C. are required to provide certain financial information in respect to such foreign corporations. This information is reported on I.R.S. Form 5471 for the shareholders of a C.F.C., and I.R.S. Form 8621 for the shareholders of a P.F.I.C. [21]

CONCLUSION

The U.S. anti-tax deferral regime aims to insure that income generated outside the U.S. by a foreign corporation may become subject to U.S. tax in the hands of its U.S. Shareholders if the entity in question has the status of a C.F.C. and the income of the C.F.C. is categorized as Subpart F income. Similar treatment is provided for investors in a P.F.I.C. that makes a Q.E.F. election to avoid the penalty taxes imposed under the P.F.I.C. provisions of the law. In both instances tax may be due prior to the time that cash dividends are actually distributed.

[21] Code §§1298(f), 964(c)(1), Treas. Regs. §1.964-3.