

# INTERNATIONAL PRACTICE UNIT: WHAT THE I.R.S. LOOKS FOR WHEN DECIDING IF A U.S. SHAREHOLDER HAS AN INTEREST IN A C.F.C.

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## Tags

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## INTRODUCTION

In the flurry of new International Practice Units published by the I.R.S. in October and November, the I.R.S. issued the “Determination of a U.S. Shareholder and C.F.C. Status” (the “Practice Unit”).<sup>1</sup> The Practice Unit is designed to identify steps for I.R.S. examiners to use when conducting an audit to determine whether a foreign corporation owned by a U.S. taxpayer is a controlled foreign corporation (“C.F.C.”) and whether the taxpayer is a “U.S. Shareholder” for purposes of Subpart F taxation. During the audit, the examiner is encouraged to inquire about ownership interests in all foreign entities owned by the taxpayer and to examine all foreign entities that wire funds to the taxpayer.

## BACKGROUND

The foregoing audit steps are encouraged in order to confirm that the profits of the foreign corporation are properly deferred until dividends are received by the U.S. taxpayer. Under U.S. tax law, a U.S. person can defer paying taxes on the profits of a foreign corporation in which it owns an interest until the time that such profits are repatriated in the form of a dividend. Where the U.S. taxpayer controls the foreign corporation, or is part of a U.S. group of major shareholders that control the corporation, this rule is cut back when (i) the foreign corporation is a C.F.C., (ii) the taxpayer is a U.S. Shareholder, and (iii) the C.F.C. has certain income that is characterized as “Subpart F Income” or it makes an “investment in U.S. Property” that creates a major tax benefit. Under the Subpart F rules, the earnings of a C.F.C. that are categorized as Subpart F Income may be taxed when and as earned at the level of its U.S. Shareholders even if no dividend is distributed.

A foreign corporation is a C.F.C. if shares representing more than 50% of its voting power or value are owned by U.S. Shareholders. A U.S. Shareholder is a U.S. person that owns shares representing 10% or more of the total combined voting power of the C.F.C.<sup>2</sup>

The Practice Unit is designed to help the examiner determine if a taxpayer is a U.S. Shareholder in a C.F.C. for U.S. tax purposes and therefore subject to certain filing requirements under Subpart F. If a taxpayer is determined to be a U.S. Shareholder of a C.F.C., certain informational returns, such as Form 5471, must be filed. If the

<sup>1</sup> “Determination of a U.S. Shareholder and C.F.C. Status,” LB&I International Practice Service Transaction Unit, 10/7/2015.

<sup>2</sup> There is a lower U.S. ownership threshold for certain foreign insurance companies. However, the tax rules applicable to foreign insurance companies that are C.F.C.’s are beyond the scope of this article.

U.S. Shareholder holds shares in a foreign corporation that is not a C.F.C., the taxpayer may have other tax reporting requirements if, for example, the foreign corporation is a P.F.I.C. In both cases, a Form 8938, Statement of Specified Foreign Financial Assets, may be required if the shareholder is an individual meeting the reporting threshold.

## ISSUES UNDER EXAMINATION

There are three primary audit issues identified in the Practice Unit with regard to determining the U.S. Shareholder and C.F.C. status for companies other than insurance companies:

1. Does the taxpayer directly, indirectly, or constructively through attribution own shares in a foreign corporation?
2. Is the taxpayer a U.S. Shareholder?
3. Is the foreign entity a C.F.C.?

The examiner is instructed to consider all of the facts and circumstances of how a U.S. person may effectively have control or ownership of the foreign corporation. The examiner will gather background information on the taxpayer and the foreign entity and will determine if the entity has C.F.C. status.<sup>3</sup> In making the decision, the examiner should consider the percentage of ownership and the citizenship and/or residency of the U.S. Shareholder and any other shareholders. Under the constructive ownership rules in which ownership of shares by one person or entity is attributed to another person a U.S. person may have an ownership interest in a foreign corporation that is greater than actual ownership. Therefore, the examiner will need to gather information on related individuals and entities in order to determine how the Subpart F rules may be applied to the taxpayer under examination.

Once the examiner decides that the shareholder possesses a sufficient interest in a foreign entity, the examiner will consider whether the entity is a corporation for U.S. tax purposes. Under the entity classification regulations,<sup>4</sup> certain foreign entities are always treated as corporations. These entities are known as “per se” corporations, and they tend to be entities that are authorized to issue shares that can be listed on a public exchange. Under the regulations, other foreign entities, known as “eligible entities,” are allowed to elect classification (*i.e.*, corporation or partnership, if there are two owners; disregarded entity, if there is only one owner) on Form 8832, Entity Classification Election.

The Practice Unit provides a list of information return forms that may shed light on the ownership structure of a C.F.C.:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and Instructions*
- Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*
- Form 8832, *Entity Classification Election*

<sup>3</sup> Code §§957, 958, 953.

<sup>4</sup> Treas. Reg. §§301.7701-1, 301.7701-2, 301.7701-3.



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*However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F.”*

- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships, and Instructions*
- Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and Instructions*
- Form 3520A, *Annual Return of Foreign Trust With a U.S. Owner, and Instructions*
- Form 8938, *Statement of Foreign Financial Assets*

Documents that may be requested and reviewed in order to determine the ownership of the foreign corporation include

- foreign entity stock certificates, to determine ownership or control of the entity and the percent owned by each shareholder;
- foreign entity articles of organization, to determine the type of entity and the classes of shares issued and outstanding; and
- a global organization chart, to track direct and indirect ownership of the entity’s shares and constructive ownership.

If questions remain, the examiner will consider issuing the following follow-up form and documents:

- Form 4564, Information Document Request (“I.D.R.”)
- Formal Document Requests
- Summons

The examiner should also consider using the following follow-up tools:

- Internet Research
- Integrated Data Retrieval System (“I.D.R.S.”)
- Accurint
- FinCEN Query
- YK1 Link Analysis

### **Determining Ownership**

To determine if a U.S. person is a U.S. Shareholder of a foreign corporation, the examiner will look at the person’s direct, indirect, and constructive ownership of shares in the foreign corporation. Ownership is determined under the rules applicable to each of these categories – the rules are conjunctive not disjunctive. They are applied to categorize income of a C.F.C. that may give rise to an inclusion under Subpart F. However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F.<sup>5</sup>

Shares owned directly by a foreign entity in a foreign corporation are considered

<sup>5</sup> Code §§951(a)(1), 958(a)-(b); Treas. Reg. §§1.958-1, 1.958-2.

to be owned indirectly by the shareholders, partners, or beneficiaries of that entity in proportion to the respective ownership percentages of the shareholders.<sup>6</sup> When computing indirect ownership, only shares held by a foreign entity are considered shares to be owned by another U.S. person. Shares held by domestic persons are not taken into account. These rules are illustrated in the following fact pattern:

U.S. persons A and B each own directly 50% of foreign Corporation U. Corporation U owns directly 60% of foreign Corporation V.

A and B are each a 30% indirect shareholder of V (50% x 60% = 30%).

If Corporation U were a domestic corporation, under the indirect ownership rules, neither A nor B would have any indirect ownership in Corporation V, because attribution stops with the first U.S. person in the chain of ownership from the foreign corporation.<sup>7</sup>

Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person. For example, shares owned directly or indirectly by an individual’s spouse, children, grandchildren, or parents are attributed to the individual who becomes the constructive owner of those shares for purposes of applying the Subpart F rules. As a result, constructive ownership rules apply for determining whether the U.S. person is a U.S. Shareholder and whether a foreign corporation is a C.F.C., but they are not considered in determining the amount of a U.S. Shareholder’s Subpart F inclusion.<sup>8</sup> A corporation, partnership, trust, or estate that owns more than 50% of the voting shares of a corporation is considered to own 100% of the voting shares of that corporation for purposes of computing the amount reattributed to others. Stock owned by a nonresident alien individual is not treated as owned by a U.S. person.<sup>9</sup>

More than one family member can be attributed the same shares. For example, shares owned by a child can be attributed to both a parent and a grandparent. There is no attribution between siblings, and shares that have been attributed to a family member cannot be reattributed from that family member to another person. Thus, shares actually owned by grandparents can be attributed to their children. However, the same shares cannot be reattributed from the children to the grandchildren. There is no direct attribution from grandparents to grandchildren.

The Practice Unit presents the following fact pattern illustrate the determination of constructive ownership:

A, B, C, and D are U.S. persons. A and B are married and each owns 25% of foreign Corporation X. Additionally, C, their daughter, and D, C’s daughter, each own 25% of Corporation X. A and B are each considered to own 100% of Corporation X because they are attributed each other’s shares, as well as the shares owned by C (their daughter) and D (their granddaughter).

**“Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person.”**

<sup>6</sup> Code §958(a)(2).

<sup>7</sup> Practice Unit, p. 13.

<sup>8</sup> Code §958(b).

<sup>9</sup> Treas. Reg. §1.958-2.

C also constructively owns 100% of Corporation X, because she is attributed shares actually owned by her parents and her daughters shares. D constructively owns 50% (only her own and [through attribution] her mother's stock).

If D were a nonresident alien, A, B, and C would only constructively own 75% of Corporation X because shares of a nonresident alien is not attributed to a U.S. person.<sup>10</sup>

To determine the direct ownership by the U.S. person, the examiner is instructed to review the foreign entity's share certificates. If there is more than one owner in a foreign entity, the examiner is instructed to investigate whether the U.S. person has ownership in a foreign entity (such as a foreign corporation, foreign partnership, or foreign estate) that itself owns shares in the foreign corporation. The shares owned by the foreign entity will be attributed to its shareholders in proportion to their ownership interests in the foreign entity, under the rules and the adjustment discussed above. The examiner will also consider other ways the U.S. person may have direct, indirect, or constructive ownership in a foreign entity. For example, the taxpayer may have

- nominee ownership, which exists when shares are held for the benefit of a U.S. person through a third party (e.g., an agent, attorney, or a trustee) in order to provide that the U.S. person obtains an actual or constructive benefit;<sup>11</sup>
- signature authority, which exists when a U.S. person effectively controls the foreign entity through a power of attorney or a corporate directorship; and
- voting agreement, which exists when a U.S. person has a proxy to select a majority of the board of directors.<sup>12</sup>

The tools available to the examiners to make this determination include the following:

- Taxpayer interviews
- Internet research
- Organization charts
- Accurant
- FinCEN Query
- Contacting Exchange of Information ("E.O.I.") and/or the Joint International Tax Shelter Information and Collaboration Network ("J.I.T.S.I.C."), which are governmental collaborative groups to which the I.R.S. belongs on a global level

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<sup>10</sup> Practice Unit, p. 15. See also Code §958(b).

<sup>11</sup> Bank statements of the foreign corporation can provide evidence that may support the substantive control the taxpayer has over an entity. See *Garlock v. Commissioner*, 489 F.2d 197 (2d Cir. 1973).

<sup>12</sup> Code §958(a); Treas. Reg. §§1.958-1, 1.951-1(g)(2).

## **Determining U.S. Shareholder Status**

If, after reviewing all the documents, the examiner concludes that the U.S. taxpayer has direct, indirect, or constructive ownership, then the examiner is instructed to consider whether the taxpayer is a U.S. Shareholder.

For purposes of determining C.F.C. status, a U.S. Shareholder is a U.S. person owning shares of the foreign entity representing 10% or more of the total combined voting power of all classes of shares of the foreign entity that are entitled to vote for the entity's Board of Directors.<sup>13</sup> A U.S. person is

- a citizen of the United States,<sup>14</sup>
- a non-U.S. citizen who is a U.S. resident (including a lawful permanent resident or an individual who meets the substantial presence test),<sup>15</sup>
- a domestic partnership,<sup>16</sup>
- a domestic corporation,<sup>17</sup> or
- any estate or trust other than a foreign estate or trust.

If a U.S. person owns the requisite percentage of shares, the U.S. person has the status of a U.S. Shareholder, meaning that an inclusion in income is possible if the foreign entity is a C.F.C. and the C.F.C. derives Subpart F Income or makes an investment in U.S. property. The following actions are suggested in making such a determination:

- The examiner may request documents of how and when the taxpayer acquired ownership (e.g., Form 926, *Return by U.S. Transferor of Property to a Foreign Corporation*; Articles of Organization; organization chart).
- The examiner may obtain foreign records from E.O.I. or treaty requests, or utilize the assistance of the I.R.S. Tax Attaché covering a particular country, J.I.T.S.I.C., or the Information Gathering I.P.N.
- The examiner may gather information on related parties to consider how ownership of shares may be attributed to the taxpayer.
- The examiner may use internet research to look for articles or documents associating the taxpayer to foreign entities.

## **Determining C.F.C. Status**

Once the examiner determines that a taxpayer is a U.S. Shareholder, the examiner is instructed to examine whether the foreign entity is a C.F.C.

As mentioned above, the foreign entity must be a corporation for U.S. tax purposes in order to be treated as C.F.C. The regulations provide a list of corporations that are “per se” corporations for U.S. tax purposes. Other foreign entities can qualify as

<sup>13</sup> Code §957(c).

<sup>14</sup> Code §7701(a)(30).

<sup>15</sup> Code §7701(b)(3).

<sup>16</sup> Code §7701(b)(7).

<sup>17</sup> Code §951(b).

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corporations under default rules if unlimited liability exists for one or more members, and if not, the entity can make a check-the-box election.

A foreign corporation is a C.F.C. for a particular year if, on any day during such year, U.S. Shareholders own shares representing more than

- 50% of the total combined voting power of all classes of shares entitled to vote, or
- 50% of the total value of the shares.<sup>18</sup>

Usually, if a corporation is organized in a U.S. commonwealth territory, or possession, it will be considered a foreign corporation and may be treated as a C.F.C.

A U.S. Shareholder is subject to the current inclusion rules of Subpart F only if the foreign corporation was a C.F.C for an uninterrupted period of 30 days or more during the taxable year and the U.S. Shareholder owned shares in the foreign corporation on the last day of such taxable year.<sup>19</sup>

In addition to considering the mere number of votes that a U.S. Shareholder is entitled to cast, the examiner is also instructed to look the U.S. Shareholder’s substantive voting power with regard to

- electing, appointing, or replacing a majority of the board of directors (or corresponding governing group under local law);
- electing exactly half of the members of the board of directors and breaking a deadlock, or exercising managerial powers during a deadlock; and/or
- electing the person who exercises the powers ordinarily exercised by the board of directors.

The examiner is instructed to investigate and determine whether any arrangements exist to shift formal voting power away from a U.S. Shareholder.<sup>20</sup> These arrangements will not be given effect if in reality voting power is retained. For example, if there is an agreement that a shareholder owning 50% or less of the voting power will exercise power normally possessed by a majority of shareholders, the agreement should be disregarded. If the constitutive document of an entity calls for supermajority votes on specific issues, that should not be a disguised voting arrangement as the U.S. Shareholder owns only a veto power.

To help to make a decision, the examiner is instructed to perform internet research and conduct taxpayer interviews. The examiner can also request and review the following documents:

- Organization charts
- Corporate minutes
- Foreign country Articles of Organization
- Shareholder Agreements

<sup>18</sup> Code §957; Treas. Reg. §1.957-1(b).

<sup>19</sup> Code §§951(a)(1), 7701(a)(3).

<sup>20</sup> Treas. Reg. §1.957-1(b)(2).

Once the examiner determines that the taxpayer is a U.S. Shareholder and the foreign entity is a C.F.C., the Subpart F income of the C.F.C., if any, will be attributed to the U.S. Shareholder to the extent of its interest in the foreign entity.

## CONCLUSION

The Practice Unit provides a roadmap for an examiner looking to determine whether an inclusion of income under Subpart F is appropriate when reviewing a tax return of a U.S. taxpayer owning shares in a foreign corporation. But, by doing so publicly, it alerts U.S. taxpayers to the level of detail involved in an examination of a tax return with foreign items. The examiner is encouraged to look at original documents, global structure charts, public sources of information, tax treaty information exchange channels, and global governmental collaborative groups to which the I.R.S. belongs in order to test the veracity of the information on a Form 5471. The I.R.S. has investigative tools at its disposal, and it will use them more and more in the course of an examination.

