

REQUIRED TAXABLE INCLUSIONS FROM THE LOSS OF §1248 SHAREHOLDER STATUS

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Tags

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The status of a shareholder in a foreign corporation under Code §1248 is important in both taxable and tax-free transactions. In taxable dispositions of shares of foreign corporations, Code §1248 can cause gain to be recharacterized as dividend income. In tax-free dispositions of shares of foreign corporations (such as in tax-free reorganizations), loss of Code §1248 shareholder status can trigger a taxable inclusion under Code §367.

CODE §1248: TAXABLE DISPOSITIONS

Under Code §1248, if a U.S. person sells or exchanges stock in a foreign corporation that was a controlled foreign corporation (“C.F.C.”) any time during a five-year period ending on the date of the sale or exchange, and the U.S. person owns, directly or indirectly, 10% or more of the total combined voting power of all classes of the foreign corporation’s stock entitled to vote, then the gain recognized on the sale or exchange of the stock is partly or wholly recharacterized as a dividend.

Thus, for Code §1248 to apply

- the seller must be a U.S. person,¹
- the U.S. person must own at least 10% of the foreign corporation, and
- the foreign corporation must have been a C.F.C. at some point within the past five years.²

The amount recharacterized as a dividend (the “Code §1248 amount”) is generally equal to the shareholder’s proportionate amount of the undistributed earnings generated by the foreign corporation while the shareholder owned those shares.³

Although the dividend recharacterization rule under Code §1248 was intended to be an anti-abuse rule, it tends to be beneficial for sellers that are C-corporations.⁴ In

¹ Although Code §1248 only applies to U.S. persons selling shares in foreign corporations, in 1997 Congress enacted Code §964(e), which provides a comparable dividend recharacterization rule for C.F.C.’s selling shares in foreign corporations.

² Typically, the foreign corporation is a C.F.C. at the time of the disposal. The five-year look-back rule is an anti-avoidance rule, intended to prevent taxpayers from circumventing the dividend recharacterization rule by selling shares of the foreign corporation in multiple stages.

³ Treas. Reg. §§1.1248-2, 1.1248-3, and 1.367(b)-2(c).

⁴ The recharacterization as dividends can allow the U.S. selling corporation to claim deemed paid foreign tax credits under Code §902.

addition, under current law, individuals subject to Code §1248 are generally indifferent to the recharacterization rule as long as the foreign corporation is located in a country that has an income tax treaty with the U.S.⁵ The dividend recharacterization rule tends to disadvantage individuals selling shares of foreign corporations located in countries that do not have income tax treaties with the U.S.⁶

CODE §1248: TAX-FREE TRANSACTIONS

Code §1248 generally does not apply to tax-free transactions. For example, if a U.S. person owns shares in a foreign corporation that merges into another foreign corporation in a tax-free reorganization under Code §368(a)(1)(A), no gain or loss is generally recognized. Since the U.S. person holding the shares of the foreign corporation would not recognize gain, there is no gain to be recharacterized as a dividend under Code §1248.

INCLUSION REQUIRED UPON THE LOSS OF CODE §1248 SHAREHOLDER STATUS

Treas. Reg. §1.367(b)-4 is intended to preserve the Code §1248 amount in tax-free transactions. A U.S. person is a “Code §1248 shareholder”⁷ with respect to a foreign corporation if the U.S. person owns, directly or indirectly, at least 10% of the shares of the foreign corporation and the foreign corporation is a C.F.C. If immediately before a tax-free exchange, the U.S. person is a Code §1248 shareholder with respect to a foreign corporation and, immediately after the exchange, the U.S. person is not a Code §1248 shareholder, then the U.S. person has lost his or her Code §1248 shareholder status. In this circumstance, the exchanging shareholder must include the Code §1248 amount attributable to the exchanged stock in its income as a deemed dividend.⁸

Example 1

F.C.1 is a foreign corporation that is, directly or indirectly,⁹ owned solely by foreign persons. D.C. is a domestic corporation that is unrelated to F.C.1. D.C. owns all of the outstanding stock of F.C.2, a foreign corporation. Thus, D.C. is a Code §1248 shareholder with respect to F.C.2, and F.C.2 is a C.F.C. Under Treas. Reg. §1.367(b)-2(c)(1), the Code §1248 amount attributable to the stock of F.C.2 that is held by D.C. is \$20. In a reorganization described in Code §368(a)(1)(C), F.C.1 acquires all of the assets and assumes all of the liabilities of F.C.2 in exchange for F.C.1 voting stock. The F.C.1 voting stock received does not represent more than 50% of the voting power or value of F.C.1’s stock. F.C.2 distributes the F.C.1 stock to D.C., and the F.C.2 stock held by D.C. is canceled.

⁵ Under current law, capital gains and “qualified dividend income” are both taxed at the same rates. Code §1(h)(11).

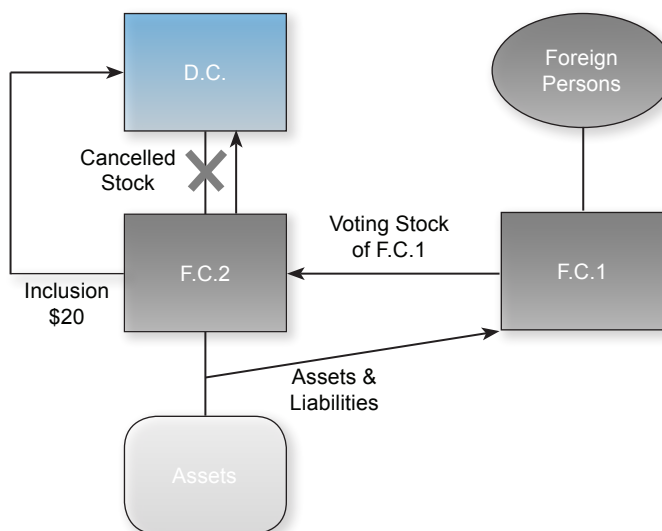
⁶ Dividends that are not “qualified dividend income” are taxed at ordinary income tax rates.

⁷ Treas. Reg. §1.367(b)-2(b).

⁸ Treas. Reg. §1.367(b)-4.

⁹ Code §958.

“Although the dividend recharacterization rule under Code §1248 was intended to be an anti-abuse rule, it tends to be beneficial for sellers that are C-corporations.”



In the foregoing example, F.C.1 is not a C.F.C immediately after the exchange. As a result, D.C. is no longer a Code §1248 shareholder and must include in income, as a deemed dividend from F.C.2, the \$20 Code §1248 amount attributable to the F.C.2 stock that D.C. exchanged.

However, if D.C. were to receive voting stock of F.C.1 that represented more than 50% of the voting power of F.C.1's stock, then D.C. would remain a Code §1248 shareholder, and Treas. Reg. §1.367(b)-4(b) would not apply to require an inclusion in income of the Code §1248 amount. This would be because F.C.1 would be a C.F.C. and D.C. would maintain its Code §1248 shareholder status immediately after the exchange.

Example 2

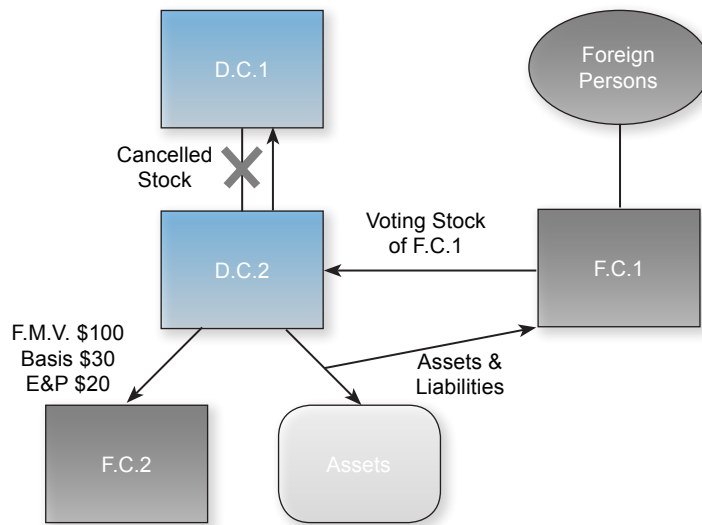
D.C.1, a domestic corporation, owns all of the outstanding stock of D.C.2, a domestic corporation. D.C.2 owns various assets, including all of the outstanding stock of F.C.2, a foreign corporation. The stock of F.C.2 has a value of \$100, and D.C.2 has a basis of \$30 in the stock. The Code §1248 earnings and profits attributable to the F.C.2 stock held by D.C.2 is \$20. D.C.2 does not own any stock other than the F.C.2 stock.

F.C.1 is a foreign corporation that is unrelated to D.C.1, D.C.2, and F.C.2. In a reorganization described in Code §368(a)(1)(C), F.C.1 acquires all of the assets of D.C.2 in exchange for the assumption of D.C.2's liabilities and voting stock of F.C.1 representing 20% of the outstanding voting stock of F.C.1.

D.C.2 distributes the F.C.1 stock to D.C.1 under Code §361(c)(1), and the D.C.2 stock held by D.C.1 is canceled. D.C.1 properly files a gain recognition agreement that satisfies the conditions of Treas. Reg. §§1.367(a)-3(e)(6) and 1.367(a)-8 to qualify for non-recognition treatment under Code §367(a) with respect to D.C.2's transfer of the F.C.2 stock to F.C.1. (F.C.1 is not a surrogate foreign corporation – within the meaning of Code §7874 – because D.C.1 does not hold at least 60% of the stock of F.C.1 by reason of holding stock of D.C.2).



“A U.S. person is a ‘Code §1248 shareholder’ with respect to a foreign corporation if the U.S. person owns, directly or indirectly, at least 10% of the shares of the foreign corporation and the foreign corporation is a C.F.C.”



D.C.2, the exchanging shareholder, is a U.S. person and a Code §1248 shareholder with respect to F.C.2, the foreign acquired corporation. D.C.2’s inclusion of the Code §1248 amount attributable to the F.C.2 stock depends on whether, immediately after the Code §361 exchange of the F.C.2 stock for F.C.1 stock, the two foreign corporations are C.F.C.’s with respect to which D.C.2 is a Code §1248 shareholder:

- If immediately after the Code §361 exchange, F.C.1 and F.C.2 are both C.F.C.’s with respect to which D.C.2 is a Code §1248 shareholder, then D.C.2 is not required to include the Code §1248 amount attributable to the F.C.2 stock in its income, under Treas. Reg. §1.367(b)-4(b)(1)(i).
- Alternatively, if immediately after the Code §361 exchange, either F.C.1 or F.C.2 is not a C.F.C. with respect to which D.C.2 is a §1248 shareholder, then D.C.2 must include the Code §1248 amount attributable to the F.C.2 stock in its income.

In the example illustrated above, since F.C.1 continues to be 80% owned by foreign persons, neither F.C.1 nor F.C.2 will be C.F.C.’s, and D.C.2 will be required to include the Code §1248 amount with respect to its F.C.2 shares in its income.