CHANGES TO C.F.C. RULES – MORE C.F.C.'S, MORE U.S. SHAREHOLDERS, MORE ATTRIBUTION, MORE COMPLIANCE

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INTRODUCTION

One of the principal revisions to U.S. tax law made by the Tax Cuts and Jobs Act ("T.C.J.A.") was a series of changes to the definition of the term Controlled Foreign Corporation ("C.F.C."). Some changes were prospective. Others were enacted retroactively as of the beginning of the 2017 tax year.

As a result, cross-border joint venture arrangements between U.S. and non-U.S. parties that contained economic and legal provisions designed to prevent the creation of a C.F.C. were unceremoniously deconstructed by the T.C.J.A., in some instances on a retroactive basis.

This article examines the T.C.J.A. changes that were made to C.F.C.'s and their "U.S. Shareholders." In so doing it discusses

- the conditions for a U.S. person[1] to be considered a U.S. Shareholder of a C.F.C.,
- the attribution rules applied to determine the ownership percentage of a U.S. person in a C.F.C. under prior law that remained unchanged, and
- the major changes introduced by the T.C.J.A. to the C.F.C. regime that expanded the scope of provisions in this respect.[2]

Generally, U.S. persons that are shareholders of foreign corporations pay U.S. tax on the earnings derived from corporate profits at the time a distribution is received. Within certain limits, shareholders may indefinitely defer their taxes by deferring distributions.

In comparison, U.S. persons that hold sufficient shares in a C.F.C. to be categorized as U.S. Shareholders are required to include in their taxable income their *pro rata* share of the C.F.C.'s Subpart F Income and taxable investments in "United States Property"

1 The term U.S. person encompasses U.S. citizens, green card holders, individuals meeting the substantial presence test, domestic partnerships, domestic corporations, estates subject to U.S. income tax and domestic trusts. Code §951(b) with reference to Code §957(c).

2 The T.C.J.A. also expanded the scope of the definition of U.S. Shareholders. According to Code §951(b), as amended by the T.C.J.A., the definition of a U.S. Shareholder applies "for purposes of this title," *i.e.*, the Code (enacted by Congress in Title 26 of the United States Code (26 U.S.C.)) and not just the Subpart F rules as under prior law.

on a current basis, without the requirement of a cash or property distribution.[3]

CHANGES TO THE C.F.C. PROVISIONS

Definition of C.F.C.

Under prior and current law, a C.F.C. is defined in the following terms: A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders, as defined.[4]

As demonstrated in Treas. Reg. §1.957-1(c), examples 8 and 9, preferred stock is counted for the purpose of determining whether a foreign corporation is a C.F.C., based on the test for value.

"A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders."

U.S. Shareholder Under the T.C.J.A. – Control by Vote or Value

Under pre-T.C.J.A. law, a U.S. Shareholder was defined as a U.S. person that owned shares of stock representing 10% or more of the total voting power of all stock of the foreign corporation.[5] Thus, a U.S. person holding non-voting preferred shares representing 10% or more of the value of all shares of the foreign corporation was not treated as a U.S. Shareholder. That U.S. person could not be taken into account for purposes of determining whether a foreign corporation was a C.F.C., and if it was a C.F.C., it was not subject to U.S. tax under Subpart F.

The T.C.J.A. expanded the definition of a U.S. Shareholder to include a U.S. person that owns shares representing 10% or more of the value of all shares of the foreign corporation.[6] As a result, U.S. person holding only non-voting preferred shares will now fall under the definition of a U.S. Shareholder.

To illustrate, assume that a U.S. person owns shares representing 5% of voting power of a foreign corporation and 3% of the value. Assume the same person owns non-voting preferred shares representing 8% of the total value of the stock of a foreign corporation. That U.S. person is not a U.S. Shareholder under prior law that looked only at voting power. However, under the T.C.J.A., it will be treated as a U.S. Shareholder because the total value of voting and non-voting shares held in the foreign corporation amounts to more than 11% of the value of all shares authorized and outstanding (value of voting shares equals 3% and value of non-voting shares equals 8%).

Whichever test is applied under the T.C.J.A., a foreign corporation is not considered to be a C.F.C. if shares representing a majority of voting power and value are owned

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[3] In the following, references to "Subpart F Income" are meant to include certain investments in the United States that are also subject to the anti-deferral rules under Subpart F of the Code. Also note in this context that applicability of the C.F.C. rules is expanded under the T.C.J.A. to new regimes such as taxation of global intangible low taxed income ("G.I.L.T.I.") and the transition tax under Code §965.

[4] Code §957(a). Vote refers to the total combined voting power of all classes of stock. Code §957(a)(1).

[5] Code §951(b) under the pre-T.C.J.A. law.

[6] Code §951(b) as amended by the T.C.J.A.; Section 14214(a) of the T.C.J.A.

by (i) foreign persons and (ii) U.S. persons that fail to own shares representing 10% of the voting power and value of the foreign corporation. This test can deceptive because shares of a foreign corporation need not be owned directly by U.S. persons for a foreign corporation to be a C.F.C.

This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. Shareholders in which or with which such taxable years of a foreign corporation end.[7]

<u>30-day Rule No Longer Applicable</u>

Under the pre-T.C.J.A. law, Subpart F Income earned by a C.F.C. was not subject to U.S. taxation if the foreign corporation was not a C.F.C. for an uninterrupted period of at least 30 days.[8]

For example, assume that a foreign corporation with one class of shares and a December year end met the conditions of a C.F.C. in the last month of its taxable year because a U.S. person acquired more than 50% of all the authorized and outstanding shares of its stock on December 3rd of the tax year. The U.S. Shareholder was not subject to U.S. tax on the Subpart F Income earned during the balance of the year.[9]

The T.C.J.A. repealed this 30-day rule.[10] Thus, a U.S. Shareholder will be subject to U.S. tax on its prorated share of Subpart F Income even if the foreign corporation is only a C.F.C. for a single day in its tax year, provided the U.S. Shareholder owned the C.F.C. on the last day of the C.F.C.'s tax year.[11]

This change under the T.C.J.A. is effective for tax years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. Shareholders in which or with which those taxable years of a foreign corporation end.[12]

DETERMINING OWNERSHIP IN A C.F.C.

In determining the 10% ownership requirement for a U.S. person to be treated as a U.S. Shareholder and the more-than-50% ownership requirement for a foreign corporation to be treated as a C.F.C., stock shares of stock owned directly, indirectly, and constructively by U.S. persons are taken into account.[13] Once it

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7 Section 14214(b) of the T.C.J.A.

8 Code §951(a)(1) under the pre-T.C.J.A.

9 A similar result was achievable if a check-the-box election were made with an effective date that was 30 days after the acquisition of all outstanding shares of stock of a foreign corporation by an acquiring U.S. partnership comprised of three unrelated U.S. persons owning all partnership interests equally, *i.e.*, 33.33% each.

10 Section 14215(a) of the T.C.J.A.

11 Note that similar rules may apply under new regimes introduced by the T.C.J.A. referencing U.S. Shareholders. *E.g.*, for purposes of the new provision on a C.F.C.'s G.I.L.T.I. the inclusion is subject to the condition that the owner is treated as a U.S. Shareholder on the last day in the tax year of the foreign corporation. Code §951A(e)(2) under the T.C.J.A.

12 Section 14215(b) of the T.C.J.A.

13 Code §§951(b) and 957(a), each with reference to Code §958(b), which in turn

is determined that a U.S. person is a U.S. Shareholder and a foreign corporation is a C.F.C., the method for computing taxable income looks only to shares owned directly or indirectly, but not to shares owned constructively. Subpart F Income is included in proportion to direct and/or indirect ownership only. The stock owned constructively is ignored for the purpose of allocating Subpart F Income to the U.S. Shareholder.[14]

Direct and Indirect Ownership

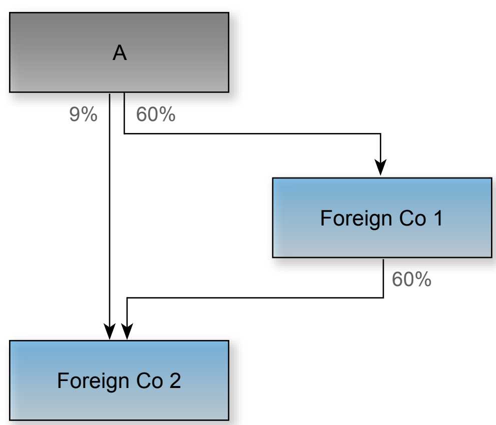
Direct ownership of shares of stock in a foreign corporation is easy to compute.

To determine whether shares of stock are owned indirectly, the shareholders of a foreign corporation, the partners of a foreign partnership, and the beneficiaries of a foreign trust or estate are considered to own proportionately the shares owned by the foreign corporation, partnership, trust, or estate under a look-thru rule.[15]

Where a shareholder owns more than 50% of the shares in a lower-tier entity, the shareholder is deemed to own all the shares owned by the lower-tier entity. This bump-up in percentage is based on the view that ownership of a majority interest in the lower-tier entity provides the shareholder with effective control all shares in other corporations owned by the lower-tier entity.[16] Consequently, it affects a determination of whether a U.S. person is a U.S. Shareholder of a C.F.C., whether a foreign corporation is a C.F.C., and whether two corporations are related.

In comparison, the bump-up in ownership percentage does not affect the amount of income that is taxed under Subpart F in the hands of a U.S. Shareholder. For that purpose, the percentages are arrived at without a bump-up in control.

This is illustrated in the following example:



references Code §318(a) with modifications.

14 An explanation by the House-Senate Committee indicates that the new downward attribution rule was not intended to result in new income allocations to 10% U.S. Shareholders who are not otherwise related (at a 50% level) with U.S. entities under the downward attribution rule (Conference Committee Report on §14213). While the text of the T.C.J.A. does not provide for language to reflect this intent, I.R.S. Notice 2018-13, includes a clarification to this effect. See also *infra* FN14.

15 Code §958(a)(2).

16 Code §958(b)(2).

Under the foreign entity look-thru rule, U.S. corporation A would be treated as owning (i) 36% in Foreign Co 2 indirectly through Foreign Co 1 and (ii) 9% of Foreign Co 2 directly, for a total of 45% ownership. If Foreign Co 2 generates Subpart F Income, A is taxed on 45% of the resulting earnings. However, when applying the constructive ownership rules (explained below) to determine U.S. Shareholder status for A and C.F.C. status for Foreign Co 2, Foreign Co 1 is treated as owning 100% of Foreign Co 2. Accordingly, for these purposes, Foreign Co 2 would be a C.F.C. because it would be deemed to own 69% of Foreign Co 2 – 9% owned directly and 60% owned indirectly.

Constructive Ownership

Constructive ownership rules treat the deemed owner as if it were the actual stock owner of the shares for the purposes mentioned above.

For purposes of determining a U.S. Shareholder and C.F.C., the Code applies the general Code §318 attribution rules with modifications.

Family Attribution

An individual is considered to own stock that is owned, directly or indirectly, by or for

- a spouse (unless legally separated by decree of divorce or separate maintenance),
- children,
- grandchildren, and
- parents.[17]

However, the family attribution rules under Code §318(a)(1) do not treat an individual as owning stock actually owned by the individual's siblings, grandparents, great-grandparents, great-grandchildren, uncles, aunts, nephews, nieces, or cousins. In addition, stock constructively owned by applying the family attribution rules cannot be attributed a second time to another family member.[18] Thus, while shares of stock owned by a child are attributed to a parent, that stock cannot be reattributed from the parent to another child.

Family attribution rules do not exist when the owner of shares is a nonresident, non-citizen individual.[19]

These rules remained unchanged under the T.C.J.A.

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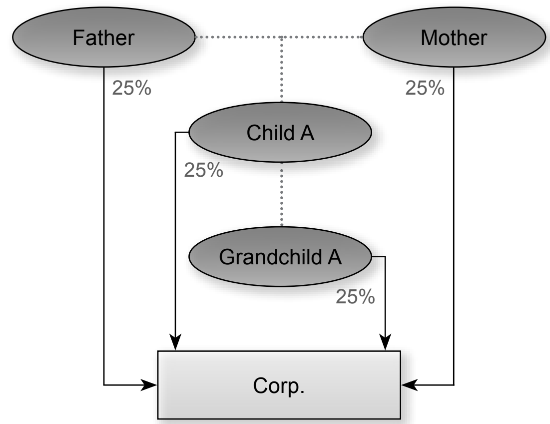
17 Code §§958(b), 318(a)(1)(A); Treas. Reg. §1.958-2(b)(1).

18 Code §318(a)(5)(B). For example, a child's stock that is attributed to a parent will not be reattributed from the parent to another child, because stock cannot be directly attributed between siblings.

19 Code §958(b)(1).

They are illustrated in the following example:



- Father, Mother, and Child A are all U.S. citizens and are each deemed to own 100% (25% directly + 75% constructively).
- Grandchild A, Child A's son and also a U.S. citizen, on the other hand, is deemed to own only 50% (25% directly and 25% constructively from his father, Child A).
- While Father and Mother, Grandchild A's grandparents, are treated as constructively owning Grandchild A's stock in Corp., Grandchild A is not deemed to own their stock.
- Because there is no attribution between siblings, if Grandchild A had a sister, no stock would be attributed from Grandchild A to his sister, directly or through their father, Child A.
- If, Mother and Father are neither U.S. citizens nor residents of the U.S., the family attribution rule does not apply to any shares they own. As a result, both Child A and Grandchild A would each be treated as owning 50% of Corp., of which 25% is owned directly and another 25% is owned through parent-child attribution.

Upward and Downward Attribution – General Rules

In addition to family attribution, constructive ownership attribution can occur in two ways, upward and downward, as follows:

- From a partnership, trust or estate, and corporation to its partners, beneficiaries, and shareholders, respectively (so-called upward attribution)[20]
- From the partners, beneficiaries, and shareholders to a partnership, trust or estate, and corporation, respectively (so-called downward attribution)

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20 Stock owned, directly or indirectly, by or for a partnership shall be considered as owned proportionately by its partners (Code §318(a)(2)(A)). Similar rules apply to estates (Code §318(a)(2)(A)) as well as 10%-owned corporations (Code §318(a)(2)(C) as modified by Code 958(b)(3)). Stock owned, directly or indirectly, by or for a trust shall be considered as owned by its beneficiaries in proportion to their actuarial interests in the trust (Code §318(a)(2)(B)(i)). In the case of a grantor trust described in Code §§671 through 679, the person taxable on trust income is the constructive owner of stock owned by the trust (Code §318(a)(2)(B)(ii)).

For purposes of determining C.F.C. status, Code §958(b) changes the upward attribution rules in two ways:

- The attribution of ownership from a corporation to its shareholders applies with respect to any shareholder that owns, directly or indirectly, 10% or more of the value of the corporation's stock.[21]

- As mentioned above, if a partnership, trust or estate, or corporation owns, directly or indirectly, more than 50% of the voting power of the stock of a particular corporation, Code §958(b)(2) treats that partnership, trust or estate, or corporation as owning all of the voting stock of the particular corporation (for purposes of the upward attribution rules).[22]

As will be shown in the Case Study, this rule may cause a person with a beneficial interest in a foreign corporation of less than 10% to be a U.S. Shareholder.[23] Further, this rule may create a C.F.C. even if U.S. persons have less than 50% beneficial ownership of the foreign corporation.[24]

The downward attribution rules attribute

- stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate to the partnership or estate,

- stock owned, directly or indirectly, by or for a beneficiary or owner of a trust to the trust, and

- stock owned, directly or indirectly, by of for a 50% or more shareholder of a corporation to the corporation.

Stock attributed to an entity from certain of its partners, beneficiaries, or shareholders will not be reattributed to other partners, beneficiaries, or shareholders unless the attribution could have been made directly.[25]

DOWNWARD ATTRIBUTION UNDER THE T.C.J.A.

Under the pre-T.C.J.A. law, stock in a foreign corporation owned by a foreign person was not treated as constructively owned by a U.S. person.[26]

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21 Code §958(b)(3); Treas. Reg. §1.958-2(c)(1)(iii).

22 Treas. Reg. §1.958-2(c)(2).

23 For example, a U.S. person holding a 6% beneficial interest could be a U.S. Shareholder under this rule. See also Treas. Reg. §1.958-2(f)(2), Ex. 2.

24 *Cf*. Treas. Reg. §1.958-2(f)(2), Ex. 2; explained under "Direct and Indirect Ownership" above.

25 Code §318(a)(5)(C). For example, if two unrelated individuals are beneficiaries of the same trust, stock held by one that is attributable to the trust under the downward attribution rule of Code §318(a)(3)(B) is not reattributed from the trust to the other beneficiary. However, stock attributed from an entity to an individual under the *upward* attribution rule of Code §318(a)(2) may be reattributed from the individual to *another* entity under the *downward* attribution rule. Thus, if all the stock of corporations X and Y is owned by an individual, I, stock of corporation Z held by X is attributed to Y through I (Treas. Reg. §1.318-4(c)(1)).

26 Code §958(b)(4) (repealed by the T.C.J.A.).

For example, shares of stock of a foreign subsidiary owned by a foreign parent were not attributed from the foreign parent to a U.S. subsidiary. Therefore, the foreign subsidiary was not treated as a C.F.C. with respect to the U.S. subsidiary.

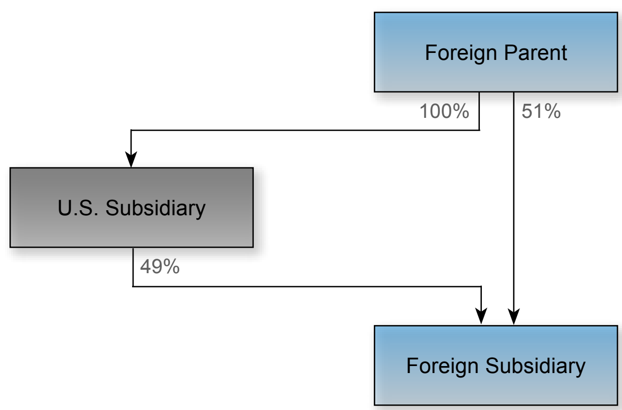
The T.C.J.A. removed this limitation thereby permitting downward attribution.[27] Consequently, a U.S. subsidiary of a foreign parent will be treated as constructively owning stock in a foreign subsidiary of that parent.

Such constructive ownership does not, however, result in a Subpart F Income inclusion for the U.S. subsidiary because, as discussed above, Subpart F Income is included in the gross income of the U.S. Shareholder only to the extent of direct and/or indirect ownership.[28] As long as no U.S. Shareholder owns stock in the C.F.C. other than by means of downward attribution, this new rule should not impose increased reporting requirements on the (constructive) U.S. Shareholder.[29]

"As long as no U.S. Shareholder owns stock in the C.F.C. other than by means of downward attribution, this new rule should not impose increased reporting requirements on the (constructive) U.S. Shareholder."

According to the Conference Committee Report, this change is intended to stop de-control plans. By taking advantage of the anti-downward attribution rule under pre-T.J.C.A. law, a foreign parent acquired a greater than 50% interest in a C.F.C. of its U.S. subsidiary and, thus, caused the C.F.C. to be a non-C.F.C. This converted former C.F.C.'s to non-C.F.C.'s, despite continuous ownership by U.S. Shareholders.[30]

The fact pattern is illustrated in the following example:



27 Section 14213(a) of the T.C.J.A.

28 Note that for determining the hypothetical distribution under Code §951(a)(2)(A) for purposes of calculating the *pro rata* share of Subpart F Income constructive stock ownership is not taken into account. Code §951(a)(2)(A) only referring to Code §958(a) but not Code §958(b).

29 According to Notice 2018-13 the instructions for Form 5471 should be amended to provide an exception from Category 5 filing (the C.F.C. filing requirement) for a U.S. person that is a U.S. Shareholder with respect to a C.F.C. if no U.S. Shareholder (including that U.S. person) owns, within the meaning of Code §958(a), stock in the C.F.C., and the foreign corporation is a C.F.C. solely because that U.S person is considered to own the stock of the C.F.C. owned by a foreign person by means of the downward attribution rule (Code §318(a)(3)).

30 Conference Committee Report on §14213.

Pre-T.C.J.A., if a foreign parent owned 51% of a foreign subsidiary and a U.S. subsidiary (of the foreign parent) owned the remaining 49%, the foreign subsidiary would not be a C.F.C. Because Code §958(b)(4) prevented the U.S. subsidiary from being attributed ownership of the foreign parent's 51% interest, the U.S. subsidiary would not meet the 50% C.F.C. threshold. As a result of the repeal of this limitation, under these facts, the U.S. subsidiary would, for purposes of determining U.S. Shareholder and C.F.C. status, be treated as owning all of the foreign parent's stock in the foreign subsidiary. Consequently, the foreign subsidiary would be a C.F.C. Nevertheless, the U.S. subsidiary's inclusion of Subpart F Income would be limited to its directly held stock, and any stock indirectly held through foreign entities as determined under Code §958(a).

Although the legislative history suggests that a downward attribution is applicable between related parties, no provision to this effect has been incorporated into the Code. Thus, as will be shown in the Case Study an unrelated party can have C.F.C. status under the new downward attribution rules.

Contrary to the foregoing modifications, the change of the downward attribution rule under the T.C.J.A. applies retroactively, *i.e.*, to the last taxable year of the foreign corporation beginning before January 1, 2018. For a foreign parent corporation using the calendar year, downward attribution was effective January 1, 2017, at which time its U.S. subsidiaries were deemed to own all foreign subsidiaries of the foreign parent corporation.[31] While no taxable event would occur for those subsidiaries in the absence of ownership of any stock of a foreign sister corporation, all joint venture corporations owned by the foreign parent corporation and one or more unrelated U.S. Shareholders could cause the U.S. Shareholders to recognize income under Subpart F in appropriate circumstances.

CASE STUDY – PUTTING IT ALL TOGETHER

Facts

The Case Study looks at a typical global family that invests together in several countries through several trusts and corporations of various kind to illustrate the interplay of pre-T.C.J.A. legislation and the new rules under the T.C.J.A.

Family

Father is a nonresident individual with regard to the U.S. and not a U.S. citizen. Rather, he is a national of Country X and has resided in Country X all his life. Father has three adult children, Child A, Child B, and Child C. Like Father, Child A is a nonresident individual with regard to the U.S. and not a U.S. citizen. Also, like Father, Child A is a national of Country X and a has resided in Country X all his life. In comparison, Child B and Child C hold dual nationality. Each is a U.S. citizen and at the same time a national of Country X.

Trusts

Father has arranged for the settlement of Trust 1, which is domiciled and resident in Country X. Trust 1 is an irrevocable trust created under Country X law. For U.S. tax purposes, Trust 1 is a foreign trust. Trust 1 grants the trustee broad discretion

31 Section 14213(b) of the T.C.J.A.

in determining the timing, the amount, and the beneficiary of income distributions. Father is the only person who has received trust distributions during the period of Trust 1's existence. Those distributions are paid annually. Regarding capital, each beneficiary is ultimately entitled to set portions. Father's portion is 10%, and the portion for each child is 30%. No capital distribution within the meaning of Country X trust law has ever been made by Trust 1.

Father has arranged for the settlement of Trust 2. Similar to Trust 1, Trust 2 is an irrevocable trust created under Country X law. The beneficiaries are Father, Child B, and Child C. While the trust is discretionary, the trust instrument provides that during the lifetime of Father, only Father can receive distributions of income and capital. For that reason, Trust 2 is a grantor trust for U.S. income tax purposes, and Father is treated as the owner of the income and assets of the trust. Nonetheless, for purposes of Country X tax law, Trust 2 is recognized as any other trust formed and domiciled in that jurisdiction.

Companies

Father and Trust 1 are the sole shareholders of XCO 1, an entity that was formed under the laws of Country X. XCO 1 provides limited liability for all its shareholders. Father owns 100% of the voting common shares of XCO 1, and Trust 1 owns 100% of the non-voting preference shares of XCO 1. The preference relates to capital distributions at liquidation and a cumulative preferred dividend of 10% of the face value of the preferred shares. The preference shares do not participate in profits beyond the coupon. No dividends are paid on the voting common shares. The preferred share dividends are equal to 99% of the XCO 1 earnings, and virtually all capital in XCO 1 is reflected in the preferred shares.

Trust 1 and the three adult children are the shareholders of XCO 2, also an entity that was formed under the laws of Country X. It has the same attributes as XCO 1 so that no shareholder is responsible for its obligations. Trust 1 holds all of the preferred shares of XCO 2. The preferred shares represent 99.99% of the capital of XCO 2 and entitles the holder to a cumulative 2% dividend on the stated amount of the preferred capital. The preference shares do not participate in profits beyond the coupon. Child A owns 80% of voting common shares in XCO 2. The remaining 20% of voting common shares are held by Child B and Child C in equal portions (*i.e.*, 10% each). XCO 2 is very profitable and each year distributes a cash dividend that equals at least 10% of the total capital of the company.

XCO 1, XCO 2, and Trust 2 own all the authorized and outstanding shares of HoldCo, a private limited company formed under the laws of Country X. HoldCo has one class of voting common shares authorized and outstanding. No other class of shares exists. XCO 1 and XCO 2 each own 20% of the voting common shares of HoldCo, and the remaining 60% are owned by Trust 2.

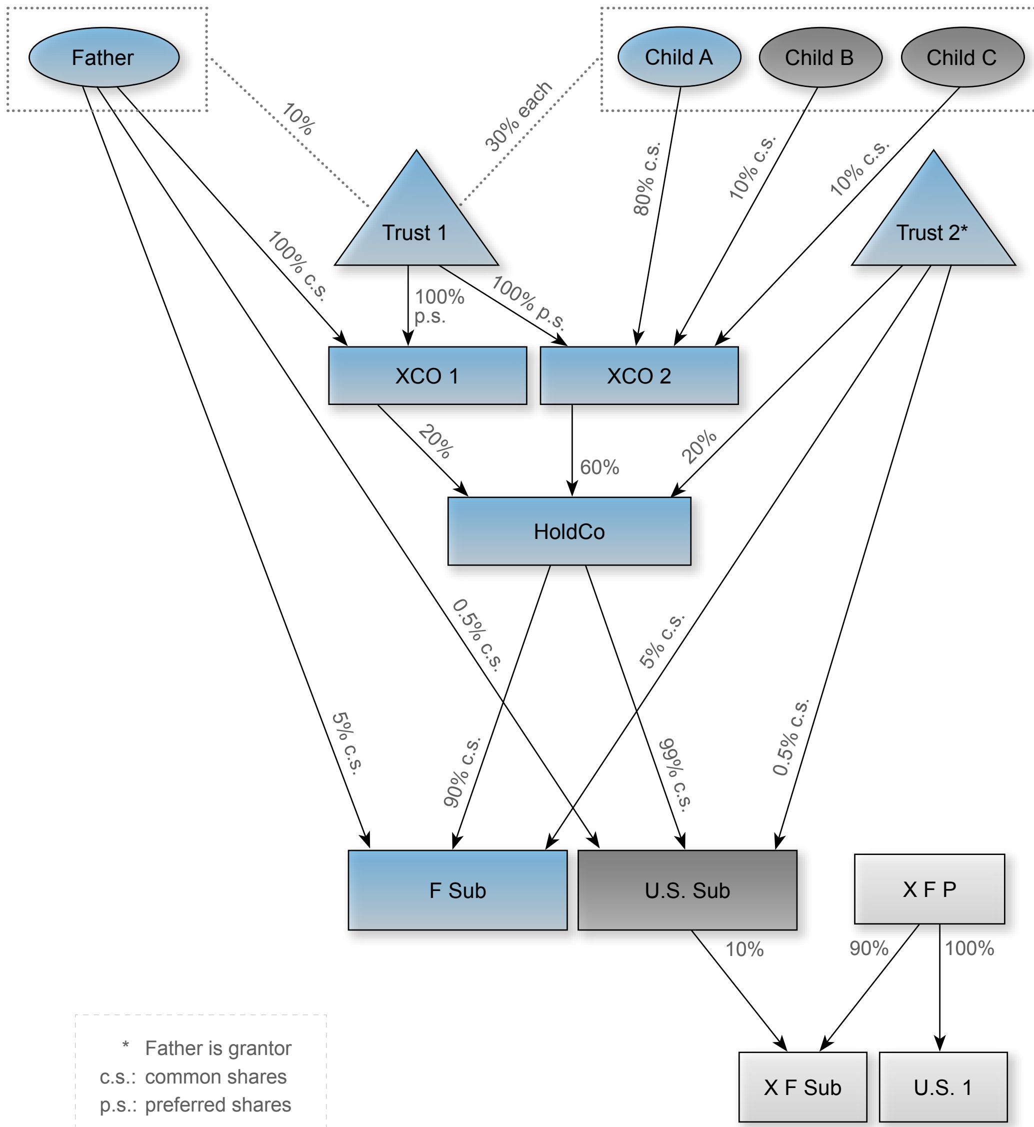
Father, HoldCo, and Trust 2 own all the authorized and outstanding shares of FSub, a private limited company formed under the laws of Country X. FSub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. Father and Trust 2 each own 5% of the voting common shares, and the remaining 90% are owned by HoldCo.

Father, HoldCo, and Trust 2 also own all the authorized and outstanding shares of U.S. Sub, a domestic corporation that is subject to full corporate tax in the U.S. U.S.

Sub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. HoldCo owns 99% of the common shares, and Father and Trust 2 each own 0.5% of the common shares.

XFP is a corporation formed outside the U.S. that is unrelated to Father and the three children. XFP and U.S. Sub own all the authorized and outstanding shares of XF Sub, a private limited company formed under the laws of a country other than the U.S. XF Sub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. U.S. Sub owns 10% of the shares of XF Sub, and XFP owns the remaining 90%. XFP also owns 100% of U.S. 1.

The facts are illustrated in the following diagram.



Analysis Under C.F.C. Rules

To reiterate, as demonstrated in Treas. Reg. §1.957-1(c), Ex. 8 and 9, preferred stock is counted for the purpose of determining whether a foreign corporation is a C.F.C. As discussed above, under T.C.J.A., preferred stock which does not carry any voting rights is counted in the determination of whether a U.S. person is a U.S. Shareholder.

This begs the following question: Does the combination of Child B and Child C's U.S. citizenship and their interests in Country X entities cause any of the Country X companies directly or indirectly owned by Father to be C.F.C.'s?

XCO 1

- Under pre-T.C.J.A. law that looks only to voting power when deciding if a U.S. person is a U.S. Shareholder, XCO 1 could not be a C.F.C. because Father owns all the voting shares in XCO 1. Hence, no U.S. Shareholders exist.

- As a result of the T.C.J.A., voting power and value are taken into account when determining the status of a foreign corporation. In the facts set forth, the voting power is embodied in the shares of common stock owned by Father. However, the value of the company is embedded in the preferred shares owned by Trust 1.[32] Under Code §318(a)(2)(B)(i), stock in XCO 1 owned by Trust 1 is constructively owned by the beneficiaries of Trust 1 in proportion to their actuarial interests in such trust.

- Nonetheless, the trust instrument does not mandate specific distribution patterns, and actuarial tables may be inappropriate where trust distributions are discretionary.

- In Private Letter Ruling 9024076, which involves a similar fact pattern, the I.R.S. looked to facts and circumstances to determine the extent to which trust beneficiaries would be deemed to own shares of stock actually owned by a trust. These included (i) patterns of past distributions, (ii) appropriate mortality assumptions, (iii) the trustee's fiduciary duties, and (iv) the relationships among the trustees and beneficiaries. In looking at facts and circumstances, the purpose of the tax law provision being applied must be taken into account.[33] Artificial arrangements were ignored.

- Because Father is the only person who received distributions from Trust 1 and there is no indication that the Trustee will exercise his discretion in a different manner during the lifetime of Father, none of the shares of XCO 1 owned by Trust 1 likely will likely be attributed to any beneficiary other than Father.

- If, however, the Trust 1 instrument called for mandatory distributions to Father and the three children in line with capital interests, Child B and Child C would be deemed to own shares representing 60% of the value XCO 1. In that case, the indirect interests of Child B and Child C in XCO 1 would be

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[32] Because no dividends have been paid on the voting common shares, no earnings have been retained, and virtually all capital in XCO 1 is reflected in the preferred shares, the value of the preferred shares should exceed the value of the common shares.

[33] Treas. Reg. §1.958-1(c)(2).

sufficient to make each child a U.S. Shareholder of XCO after the enactment of the T.C.J.A. Moreover, because U.S. Shareholders would be deemed to own 60% of XCO, XCO would be a C.F.C.

XCO 2

- Under pre-T.C.J.A. law, XCO 2 could not be a C.F.C. because Child A owns 80% of the voting shares in XCO 2 and there is no attribution of ownership among siblings and no attribution of ownership from a nonresident, non-citizen individual to a U.S. person. Consequently, the U.S. Shareholder group composed of Child B and Child C own shares representing a combined 20% of the voting power in XCO 2.

- In addition, the shares of XCO 2 owned by Trust 1 are attributable to its beneficiaries in proportion to their actuarial interest in the trust or based on facts and circumstances. The value of the preferred shares is added to the value of the common shares. Assuming that valuation is determined based on discounted cash flows over a period of time, the disparity between the coupon rate on the preferred shares and the dividend rate on the common shares suggests that the common shares may be worth five times the value of the preferred shares.

- Using a facts and circumstances method of valuing trust interests as followed in Private Letter Ruling 9024076, none of the children constructively own the preferred shares actually owned by Trust 1 because all distributions of Trust 1 are paid to Father. As a result, by applying the rules of attribution, Father and Child A together own at least 83% of the value of the XCO 2, while the U.S. Shareholder group would own shares representing 17% of the value.

- If, however, the Trust 1 instrument called for mandatory distributions to Father and children in line with capital interests, Child B and Child C would be deemed to own shares representing 60% of the value of the preferred shares of XCO 2. Based on the assumption that valuation is determined based on discounted cash flows over a period of time, the preferred shares of XCO 2 are worth approximately 16.7% of total value of the company. Child B and Child C would own approximately 10% of the value of SCO 2 by attribution and 20% of the value of the voting common shares, assuming no minority discount. As the value of the common shares is approximately 83% of the total value of the company, Child A and Child B would own directly shares having an additional 16.6% of value of XCO 2. Because U.S. Shareholders would own approximately 33.33% of the value of the shares of XCO 2, XCO 2 is not a C.F.C. The status of XCO 2 is not changed by the T.C.J.A. It does not become a C.F.C. because the allocation of value remains unchanged by the new provision.

HoldCo

- Under pre-T.C.J.A. law, HoldCo is not a C.F.C. because XCO 1, XCO 2, and Trust 2 own all issued and outstanding shares.

- Regarding shares owned through XCO 1, the conditions that prevent XCO from being a C.F.C. also prevent attribution of HoldCo shares to Child B and Child C. Father owns the only voting shares of XCO 1. Consequently, no voting shares in HoldCo held by XCO 1 can be attributed to Child B and Child

C. Moreover, the history of Father receiving all distributions from Trust 1 with no likelihood of a change in the distribution pattern, would prevent Child B and Child C from being considered owners of HoldCo through XCO.

- Regarding shares owned through XCO 2, Child B and Child C, together, own 17% of the value of XCO 2 and 20% of the voting shares. Such limited ownership in XCO 2 filters down to indirect ownership in HoldCo.

- The answer should not change as a result of the T.C.J.A. The limited degree of ownership in XCO 2 combined with the absence of ownership by attribution under the principles of Private Letter Ruling 9024076 limits the degree of ownership through Trust 1.

- Even if the Trust 1 instrument called for mandatory distributions to Father and the children in line with capital interests, the answer would not change. Child B and Child C would be deemed to own shares representing 60% of the value XCO 1. Under the changes made by the T.C.J.A., Child B and Child C would be U.S. Shareholders and because they would be viewed to be in control of XCO 1, the 20% ownership of XCO 1 in HoldCo would be attributed to them in full under the constructive ownership rules of Code § 958(b).

- As mentioned above, Child B and Child C together would be deemed to own 33.33% of the value of XCO 2. This is not sufficient to provided control of XCO 2. Consequently the U.S. children will own 33.33% of HoldCo through their ownership of shares in XCO 2. 2 owns 60% of HoldCo, the U.S. children would own 20% of HoldCo through XCO 2.

XF Sub

- Under pre-T.C.J.A. law, XF Sub could not be a C.F.C. because XF P, a foreign corporation with no foreign ownership, owns 90% of its shares. Those shares could not be attributed from XF P to U.S. 1.

- Now that the attribution rule has been changed by the T.C.J.A., the shares of XF Sub can be attributed from XF P to U.S. 1, causing XF Sub to be a C.F.C. and U.S. 1 to be a U.S. Shareholder.

- Note that aside from reporting obligations placed on U.S. 1, the principal effect of the attribution is to cause the unrelated U.S. Sub – a company owned indirectly by Father and his children – to become a U.S. Shareholder in a C.F.C. for all purposes of Subpart F.

- In comparison, the absence of direct or indirect ownership in XF Sub by U.S. 1 will limit the adverse tax consequences of being a U.S. Shareholder to information reporting on Form 5471.

- If XF P owned 100% of the shares of XF Sub, the obligation to file Form 5471 would have been eliminated. In §5.02 of Notice 2018-13, the I.R.S. advised that it intends to provide an exception from the Form 5571 filing obligation for a U.S. Shareholder of a C.F.C. if the following conditions are met:

    - No U.S. Shareholder (including a U.S. subsidiary of a foreign parent) owns, directly or indirectly within the meaning of Code §958(a), stock in a C.F.C.

- The foreign corporation that is deemed to be owned by a U.S. subsidiary of a foreign parent is a C.F.C. solely because the U.S. subsidiary is considered to own the stock of the C.F.C. that is actually owned by its foreign parent.

CONCLUSION – TWO STEPS FORWARD, ONE STEP BACK

The changes made to the Subpart F rules of U.S. tax law were meant to broaden the definition of a C.F.C. To some extent, the "high tax" exception under Subpart F[34] may soften the blow now that U.S. corporate tax has been reduced to 21%.[35] Several results are certain to occur: More foreign corporations will be categorized as C.F.C.'s, and greater compliance costs will be placed on global business. Whether more tax is raised is an open issue.

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34 Under the high tax exception of Code §954, Subpart F Income is not taxed in the hands of a U.S. shareholder if such income is subjected, in the country of incorporation, to an effective income tax rate greater than 90% of the U.S. maximum corporate tax rate. A C.F.C. and its U.S. Shareholder may be able to wriggle out of the C.F.C. status if the effective tax rate in the foreign jurisdiction is greater than 18.9% (*i.e.*, 90% of 21%).

35 Code §11(b) as amended by the T.C.J.A. Contrary to most of the other provisions introduced by the T.C.J.A., this rule is not subject to sunset.