# C-CORPS EXEMPT FROM FULL SCOPE OF FOREIGN INCOME INCLUSION

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On October 31, 2018, the I.R.S. proposed regulations affecting controlled foreign corporations ("C.F.C.'s") and U.S. corporations that are considered to be U.S. Shareholders, as defined, when a C.F.C. makes an investment in U.S. property. In substance, the proposed regulations adopt a simple exception to U.S. tax exposure for a U.S. corporation that is a U.S. Shareholder of a C.F.C. – if the C.F.C. were to distribute a hypothetical dividend to the U.S. Shareholder that would benefit from the 100% D.R.D. upon receipt, the taxable investment in U.S. property will be reduced by an amount that is equivalent to the D.R.D. allowed in connection with the hypothetical dividend.[1]

## Background Definitions

A foreign corporation is a C.F.C. under one of two tests.[2] The first is that stock representing more than 50% of the total combined voting power of all classes of stock entitled to vote is owned by one or more U.S. Shareholders on any day during the taxable year. The second is that stock representing more than 50% of the total value of all stock of the foreign corporation is owned by one or more U.S. Shareholders on any day during the taxable year. The ownership may be direct,[3] indirect through foreign entities,[4] or constructive[5] for this purpose.

A U.S. Shareholder is a U.S. person that owns directly or indirectly, or is considered to own under the constructive ownership rules mentioned above, either

- stock representing 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or
- stock representing 10% or more of the total value of shares of all classes of stock of the foreign corporation.[6]

In general,[7] a U.S. person is a citizen or resident of the U.S., a domestic partnership, a domestic corporation, a domestic estate and a domestic trust.[8]

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1 Prop. Treas. Reg. §1.956-1(a)(2).

2 Code §957(a). A special rule applies in the context of an insurance company. There, the ownership level is reduced to more than 25%.

3 Code §958(a)(1).

4 Code §958(a)(2).

5 Code §958(b).

6 Code §951(b).

7 Code §957(c). Special rules apply when a U.S. citizen owns shares in a corporation organized in Guam, American Samoa, the Northern Mariana Islands, or the Commonwealth of Puerto Rico.

8 Code §7701(a)(30).

“If the C.F.C. were to distribute a hypothetical dividend to the U.S. Shareholder that would benefit from the 100% D.R.D. upon receipt, the taxable investment in U.S. property will be reduced.”

Subject to a series of exceptions, U.S. property consists of the following four items:

- Tangible property located in the U.S.
- Stock of a domestic corporation
- An obligation of a U.S. person
- Any right to the use in the U.S. of a patent or copyright, an invention, model or design (whether or not patented), a secret formula or process, or any other similar property right, which is acquired or developed by the C.F.C. for use in the U.S.

The exceptions generally are intended to promote certain U.S. businesses carried on by third parties.[9]

## Investment in U.S. Property Rules

Code §956 was enacted as part of the Subpart F regime to ensure that a C.F.C.’s earnings not subject to immediate tax under Subpart F when earned would be taxed when repatriated, either through a dividend or an effective repatriation arrangement not considered to be a dividend. Hence, it was crafted to prevent the repatriation of income to a U.S. Shareholder in a manner that is not immediately taxable. Examples of items that would not be taxed at the level of a shareholder but for the application of Code §956 include, but are not limited to, acquisitions of stock or debt obligations of a related U.S. person or its domestic affiliates.

Both investments make funds available for use by the U.S. Shareholder of a C.F.C. and, for that reason, constitute an effective repatriation of earnings that should be taxed. Each of these investments serves as the functional equivalent of a dividend and should be taxed as a dividend. In sum, Code §956 ensures functional symmetry in the tax treatment of repatriations through dividends and equivalent transactions.

## 100% D.R.D. Eliminates Need for Anti-Abuse Rule

Prior to the enactment of the T.C.J.A. (Tax Cuts and Jobs Act of 2017), U.S. citizens, U.S.-resident individuals, and domestic corporations were taxed on dividends received from foreign corporations. This parity of tax treatment for individuals and corporations was broken by the enactment of Code §245A. Code §245A provides certain domestic corporations with a 100% deduction for the foreign-source portion of dividends received from specified 10%-owned foreign corporations, provided that certain conditions are met:

- The domestic corporation must meet the ownership threshold to be a U.S. Shareholder and must have the status of a taxable C-corporation. As a result, a registered investment company, a real estate investment trust, and an S-corporation cannot benefit from the 100% D.R.D.
- The foreign corporation must be a specified 10%-owned foreign corporation. This is any foreign corporation other than a passive foreign investment company.[10]

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[9] Code §956(c)(2).

[10] If the P.F.I.C. is a C.F.C. and a C-corporation is a U.S. Shareholder of the C.F.C., the P.F.I.C./C.F.C. overlap rule treats the foreign corporation as if it is

- The shares of the 10%-owned foreign corporation must meet a period-of-ownership threshold in the hands of the C-corporation. The shares must be held for at least 365 days during the 731-day period beginning on the date that is 365 days before the ex-dividend date.[11]
- The domestic corporation must not be under an obligation to make related payments with respect to positions in substantially similar or related property.[12]
- The dividend must not be a hybrid dividend,[13] which broadly means that the dividend cannot give rise to a deduction for the specified foreign corporation, nor can it trigger another tax benefit for the specified foreign corporation.[14]

In light of the D.R.D. allowed to C-corporations, the I.R.S. determined that broad application of Code §956 to corporate U.S. Shareholders of C.F.C.'s is inconsistent with the purposes of that section now that certain dividends can be received from a C.F.C. without any tax. In the absence of the proposed regulations, a U.S.-parented group in many cases would need to engage in complex and costly restructuring upon the acquisition of a foreign corporation that owns domestic subsidiaries, because the foreign corporation would become a C.F.C. and the stock of its domestic subsidiaries would represent U.S. property. Absent the proposed regulations, Code §956 could also serve as a "trap for the unwary'' for any domestic corporation that fails to recognize that, notwithstanding the deduction under Code §245A for actual dividends, Code §956 inclusions would continue to be fully subject to U.S. tax.

Similar considerations are absent in the context of individuals and certain corporations that are not entitled to claim the D.R.D.

## Proposed Regulations

In general, under Code §245A and the proposed regulations, neither an actual dividend to a corporate U.S. Shareholder nor an amount determined under Code §956 to a corporate U.S. Shareholder will be taxed.

To achieve this result, the proposed regulations provide that the amount otherwise determined under Code §956 with respect to a U.S. Shareholder for a taxable year of a C.F.C. will be reduced to the extent that the U.S. Shareholder would be allowed a deduction under Code §245A if the U.S. Shareholder received a hypothetical distribution from the C.F.C. in an amount equal to the amount determined under Code §956. Due to the broad application of Code §245A, in many cases a corporate U.S. Shareholder will not have a Code §956 inclusion as a result of a C.F.C. holding U.S. property under the proposed regulations. The proposed regulations provide special rules with respect to indirect ownership.

As mentioned above, Code §956 will continue to apply without modification to U.S. Shareholders other than C-corporations to ensure that, consistent with the purposes of Code §956, an investment in U.S. property that is substantially the equivalent of

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not a P.F.I.C. but does so only because the U.S. Shareholder faces immediate taxation under Subpart F with regard to the C.F.C.'s Subpart F Income.

[11] Code §§246(c)(1) and (5).

[12] Code §246(c)(1)(8).

[13] Code §245A(e)(1).

[14] Code §245(e)(4).

a dividend will be treated in a manner that is similar to an actual dividend. This treatment will apply to individuals even if they make an election under Code §962 to be taxed as a corporation. Individuals making the election are not eligible for the D.R.D. when an actual dividend is received. Similarly, Code §956 will continue to apply fully to registered investment companies, or R.I.C.'s, and real estate investment trusts, or R.E.I.T.'s, because neither is allowed the dividends received deduction under Code §245A.[15]

## Effective Date

The proposed regulations will apply (i) to taxable years of a C.F.C. beginning on or after the date the U.S. Department of the Treasury decision adopting final regulations are published in the Federal Register and (ii) to taxable years of a U.S. Shareholder in which or with which such taxable years of the C.F.C. end. With respect to taxable years of a C.F.C. beginning before the publication date in the Federal Register, a taxpayer may rely on the proposed regulations for taxable years of a C.F.C. beginning after December 31, 2017, and taxable years of a U.S. Shareholder in which or with which such taxable years of the C.F.C. end, provided that the corporate taxpayer and all related persons apply the proposed regulations on a consistent basis with respect to all C.F.C.'s in which they are U.S. Shareholders.

Hence, the proposed regulations remove U.S. C-corporations from the full scope of Code §956 when actual dividends are not otherwise taxable. On the other hand, the full scope of Code §956 continues to apply to R.I.C.'s, R.E.I.T.'s, S-corporations, citizen and resident individuals, U.S. domestic estates, and U.S. domestic trusts.

[15] Code §§852(b)(2)(c) and Code 857(b)(2)(A).

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