IS THE 100% DIVIDEND RECEIVED DEDUCTION UNDER CODE §245A ABOUT AS USEFUL AS A CHOCOLATE TEAPOT?

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INTRODUCTION

Imagine a lush green garden on a bright sunny day. A glistening teapot sits on a table in the garden. As you approach the table, you see that the teapot is made of chocolate. It doesn't make sense, does it? What is the use of a teapot that would melt in on itself by the time the hot, steaming tea is poured into a cup?

A similar question may be raised as to the relevance of the 100% dividend received deduction ("D.R.D.") under Code §245A in the context of the gain arising from the sale of the stock of a controlled foreign corporation ("C.F.C.") that is treated as a dividend for certain shareholders.[1] This article will discuss exactly that – the usefulness of Code §245A D.R.D. and the interplay between the Code §245A and Code §1248, especially in light of the enactment of the Transition Tax and Global Intangible Low-Taxed Income ("G.I.L.T.I.") regime.

GENERAL RULE FOR SALE OF AN ASSET

Let's start with the general rule. Assuming no depreciation recapture under Code § 1245 or Code §1250, the amount realized from the sale or other disposition of a capital asset in excess of its adjusted basis is taxed as a capital gain.[2] If the asset has been held for more than one year at the time of the sale, the gain is treated as long-term capital gain taxed at the rate of 20%[3] if the taxpayer is an individual or 21% for an entity taxed as a corporation. If the property were held for a year or less before the sale, the gain is treated as a short-term capital gain, which is taxed at ordinary rates, up to 37%, in the case of an individual or the same tax rate of 21% for an entity taxed as a corporation.

GAIN FROM THE SALE OF C.F.C. STOCK MAY BE TREATED AS DIVIDENDS

Generally, a U.S. Shareholder, as defined, recognizes gain or loss on the sale or exchange of stock in a C.F.C. equal to the difference between the sales price and the shareholder's adjusted basis in the stock sold or exchanged. If applicable, Code §1248 recharacterizes the gain from the sale of the stock of a C.F.C. as dividend income (instead of the default capital gain tax treatment).

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1 Governed by Code §1248.

2 Code §1001.

3 U.S. individuals are also subject to the Net Investment Income Tax of 3.8%.

Code §1248 provides that if a U.S. Person, as defined, sells or exchanges stock in a C.F.C. and that person owns[4] 10% or more of the total combined voting power of all classes stock entitled to vote, then the gain recognized on the sale or exchange of the stock must be included in the person's gross income as a dividend. The original purpose of the provision was to prevent accumulated earnings in a C.F.C. from being converted to capital gains under prior U.S. tax law, which imposed high tax on dividend income and low tax on capital gains.

Code §1248 includes a five-year look back rule that treats the gain from the sale of the stock of a foreign corporation as a divined even if it is not a C.F.C. at the time of the sale, provided the corporation was a C.F.C. at any time during the five-year period ending on the date of the sale or exchange.

"If the amount of E&P is not established, then the entire amount of gain is treated as dividends."

Also, Code §1248 does not apply to any amount of gain that is a short-term capital gain or gain from the sale of an asset that is not a capital asset.[5] Again, under prior law, such short-term gain was taxed in the hands of an individual at ordinary income rates, which often exceeded 50%.

Limitations to Dividend Treatment

The gain is treated as a dividend only to the extent of the foreign corporation's earnings and profits ("E&P") attributable to the shares of stock that are sold or exchanged. The E&P attributable to those shares of stock consist of a *pro rata* share of the earnings that were accumulated (i) after 1962, (ii) while the taxpayer held the stock, and (iii) while the corporation was a C.F.C.[6] In other words, the §1248 dividend is the lesser of two amounts:

- The actual gain recognized on the sale or exchange (which includes redemption or liquidation)
- The E&P attributable to the stock sold or exchanged

The limitation of treating the gain as dividends only to the extent of the foreign corporation's E&P attributable to the disposed stock applies only if the taxpayer establishes the amount of its E&P.[7] A taxpayer is said to have established this amount if a schedule is attached to the income tax return for the relevant taxable year clearly demonstrating the computation.[8] If the amount of E&P is not established, then the entire amount of gain is treated as dividends.[9] At a time when dividends and long-term capital gains are taxed at the same rate, the provision is somewhat of an anachronism in the context of an individual shareholder effecting the sale.

The allocation of the C.F.C.'s E&P to the shares of stock being sold can be explained with the help of the following example.

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[4] Either directly or indirectly under Code §958(a) or constructively under Code §958(b).

[5] Code §1248(g)(2)(C); Treas. Reg. §1.1248-1(e).

[6] Code §1248(a).

[7] Code §1248(h).

[8] Treas. Reg. §1.1248-7(a)(1)(i).

[9] Treas. Reg. §1.1248-7(a)(1).

Example 1:[10]

On May 26 of Year 1, Ms. Green, a U.S. individual, purchases 100 outstanding shares of the only class of stock of a C.F.C., F.C., at a price that is the fair market value foreign currency equivalent of $25. She sells 25 of the shares on January 1 of Year 3. Ms. Green did not include any amount in gross income under Code §951 during the period in which the shares were held. The E&P accumulated by F.C. is $10,000 for Year 1, $13,000 for Year 2, and $11,000 for Year 3.

The E&P of F.C. attributable to 25 shares of F.C. stock is as follows:

E&P Attributable to Ms. Green's Shares	
Year 1	219 / 365 * $10,000 = $6,000
Year 2	$13,000
Year 3	$11,000
Total	$30,000
E&P attributable to 25 shares of F.C. stock	30,000 * 25 / 100 = $7,500

Example 2:

D.C., a domestic corporation, purchases 25 shares of the single class of stock of a foreign corporation, F.C., at the beginning of Year 1. Mr. A, a U.S. citizen, owns 20 shares of F.C., and Mr. B, a nonresident alien, owns 55 shares. No other shares of F.C. are issued and outstanding. D.C. purchases ten of Mr. B's shares at the beginning of Year 2 and purchases ten of Mr. A's shares at the beginning of Year 3. At the beginning of Year 4, D.C. sells the F.C. stock it owned at a gain of $400. F.C. has E&P of $100 for each of the first three years.

The E&P attributable to F.C. stock held by D.C. is as follows:

- None of Year 1's earnings is attributed to F.C. stock held by D.C. because F.C. is not a C.F.C. in Year 1. This is because only 45% of the stock of F.C. is held by U.S. Shareholders (25% by D.C. and 20% by Mr. A).
- In the beginning of Year 2, F.C. becomes a C.F.C. because more than 50% of the total voting power is owned by U.S. Shareholders. In Year 2, the aggregate ownership of D.C. (35%) and A (20%) increased from 45% to 55%.
- In the beginning of Year 3, D.C. bought ten shares from A, and therefore, its total ownership interest in F.C. was increased to 45%. F.C. continues to remain a C.F.C. for Year 3 since more than 50% of the total voting power is owned by U.S. Shareholders.
- The E&P attributable to D.C.'s shareholding is the *pro rata* share of the E&P of F.C. accumulated after 1962 while D.C. held the stock and while F.C. was a

[10] Treas. Reg. §1.1248-2(e)(4), ex. 1.

C.F.C. The E&P attributable to D.C.'s shareholding in F.C. is $80, calculated as follows:

- ○ $0 of the E&P for Year 1
- ○ $35 (35% of $100 of E&P) for Year 2
- ○ $45 (45% of $100 of E&P) for Year 3

- The Code §1248 dividend amount on D.C.'s stock sale is $80, *i.e.*, the lesser of the actual gain ($400) and the E&P attributable to F.C. stock owned by D.C. ($80). The tax treatment of the Code §1248 dividend recognized by a corporate U.S. Shareholder is different from the treatment of one recognized by an individual U.S. Shareholder, which is discussed in a later section.
- The remaining gain of $320 is taxed to D.C. as capital gain at the rate of 21%, the same rate as ordinary income for a corporation.

Adjustments to E&P

In the above examples, F.C.'s E&P was given for each year, and the E&P attributable to the shares of stock was calculated for all shares sold. However, the real question is what are the rules for computing the foreign corporation's E&P for the purposes of Code §1248? Let's take a step back and dig deeper to determine how E&P of a C.F.C. is computed for Code §1248 purposes.

A C.F.C.'s E&P for Code §1248 purposes is generally computed by following the rules applied to determine E&P of a domestic corporation.[11] However, several adjustments are provided under the regulations. Essentially, the adjustments are made to ensure that the income that has already been subject to U.S. tax under Code §951 is not given dividend treatment. Stated differently, the E&P attributable to the disposed interest is the E&P that is not previously taxed income ("P.T.I."). One of the more practical and important adjustments to determine a foreign corporation's E&P is discussed in the next segment of this article.

Amounts Included in Gross Income Under Code §951

Code §1248(d)(1) provides that E&P previously included in the gross income of the selling shareholder under Code §951 ("Subpart F P.T.I.") is excluded from the foreign corporation's E&P when determining the E&P attributable to the disposed stock.[12] Therefore, E&P attributable to Subpart F income under Code §951 does not turn a gain into dividend income on the later sale of stock. Moreover, if the selling shareholder included amounts in income under Code §951 but then received distributions, that amount is added back to the foreign corporation's E&P. Without the add-back, the E&P would be reduced twice: once for the Subpart F inclusion and a second time for the dividend distribution.

It should also be noted that the G.I.L.T.I. amount determined under Code §951A is also treated as Subpart F Income for purposes of Code §1248(d)(1).[13] Similarly, the amount subject to the Transition Tax determined under Code §965 is treated as

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[11] Code §1248(c)(1).

[12] Code §1248(d)(1).

[13] Code §951A(d)(1).

Subpart F Income (“Code §965 P.T.I.”) and is included in the gross income of a U.S. Shareholder under Code §951(a).[14] Thus, Code §965 P.T.I. is likely to be treated in the same manner as Subpart F Income for purposes of Code §1248(d)(1).

Example 3:[15]

Assume the same facts as in Example 1. Additionally, Ms. Green includes in gross income under Code §951 the aggregate amount of $2,800 for Year 1 and Year 2. F.C. distributed $2,300 to Ms. Green on January 15 of Year 3. The actual distribution is excluded from gross income under Code §959(a)(1).

The E&P attributable to F.C. stock held by Ms. Green is as follows:

- Before any adjustments for Subpart F Income inclusions and actual distributions, E&P is $7,500, as computed in Example 1.
- After the adjustments, Subpart F income inclusions, and actual distributions, E&P is $7,000, computed as follows:

Adjustments to E&P Attributable to Ms. Green’s Shares	
E&P attributable before any adjustments	$7,500
E&P attributable to income taxed under Code §951	($2,800)
Distributions excluded from gross income under Code §959(a)(1)	$2,300
E&P attributable after adjustments	$7,000

Example 4:

On January 1, 2017, Ms. A, a U.S. Person, incorporated a foreign corporation, F.C. Ms. A owned 100 shares of the only class of stock of F.C. She sells all of the stock of F.C. on January 1, 2019, at a gain of $2,500. For 2017, F.C.’s total E&P is $11,000, out of which Ms. A included $ 5,000 in gross income as Subpart F Income taxable under Code §951. The untaxed undistributed foreign E&P of F.C. subject to the Transition Tax under Code §965 for 2017 is $6,000 (*i.e.*, $11,000 - $5,000). The Transition Tax was paid in 2018; the election to defer the payment of the Transition Tax was not made. The E&P for 2018 is $14,000, all of which is properly characterized as foreign-source income. The qualified business asset investment is $10,000. Therefore, the tested income for G.I.L.T.I. purposes for 2018 is $13,000 (tested income of $14,000, less $1,000 attributable to 10% of the qualified business asset investment).[16]

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[14] Code §965(a).

[15] Treas. Reg. §1.1248-2(e)(4), ex. 2.

[16] The G.I.L.T.I. computation is too simplistic. For detailed analysis on the computation of the G.I.L.T.I. rules, see “A Deep Dive into G.I.L.T.I. Guidance,” Insights 5, no. 10 (2018) and “A New Tax Regime for C.F.C.’S: Who Is G.I.L.T.I.?” Insights 5, no. 1 (2018).

The E&P attributable to F.C. stock owned by Ms. A is as follows:

E&P Attributable to Ms. A's Shares	
2017	$11,500
2018	$14,000
Total E&P attributable before any adjustments under Code §1248(d)	$25,000
Adjustments under Code §1248(d)	
Subpart F Income under Code §951	($5,000)
Untaxed undistributed foreign earnings subject to Transition Tax, treated as included in gross income under Code §951	($6,000)
G.I.L.T.I. inclusion under Code §951	($13,000)
E&P attributable after adjustments	$1,000

To recap, the above computation of E&P attributable to F.C. stock is relevant to determine the portion of the gain arising from the sale of F.C. stock that will be treated as dividends under Code §1248(a). In the above example, Ms. A earned $2,500 from the sale of F.C. stock, but only $1,000 is E&P attributable to F.C. stock. Therefore, $1,000 will be treated as dividends taxed at ordinary rates,[17] and the balance of $1,500 will be treated as capital gain taxed at 20%. The amount treated as dividend income is properly characterized as foreign-source income for foreign tax credit purposes. The source of the amount treated as capital gain will be based on Ms. A's residence, as determined under Code §865(a).

It should be noted that the enactment of the Transition Tax and the G.I.L.T.I. provisions has the effect of substantially reducing the amount of gain attributable to the Code §1248 dividends. Only non-P.T.I. is treated as Code §1248 dividends. With the Transition Tax and G.I.L.T.I., virtually 100% of the foreign corporation's E&P is P.T.I.

Other Adjustments

Other exclusions from E&P of the foreign corporation include (i) the E&P accumulated from effectively connected income ("E.C.I.") of the C.F.C., provided that the tax on the income is neither reduced nor eliminated by a tax treaty and (ii) the E&P previously included in the taxpayer's gross income under the rules for passive foreign investment companies that are also qualified electing funds, exclusive of the portions of these earnings that have been distributed to the taxpayer in nontaxable distributions of P.T.I.[18]

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17 Here, since A is an individual, the limitation under Code §1248(b) will apply in determining the tax on §1248 dividends.

18 Code §§1248(d)(4), (6).

ARE CODE §1248 DIVIDENDS REALLY 100% EXEMPT FROM U.S. TAXATION?

The tax treatment of the Code §1248 dividends depends on whether the taxpayer is an individual or a C-corporation. In the case of an individual, the Code §1248 dividends are taxed at ordinary rates or long-term capital gains rates, if qualified.[19] However, the tax liability is limited under the provisions of Code §1248(b).[20] In the case of a C-corporation, the provisions of Code §245A apply. The portion of the gain recharacterized as a Code §1248 dividend is treated as a dividend for the purposes of Code §245A.[21] Code §245A provides for a 100% deduction of the foreign-source portion of dividends received from a foreign corporation by a domestic corporation that owns 10% or more of the voting rights or total value of the foreign corporation. The 100% D.R.D. is available only if the taxpayer is a domestic C-corporation (and not a regulated investment company or real estate investment trust). Further, no foreign tax credit is allowed pursuant to Code §901.[22] In other words, the Code §1248 dividends are 100% exempt from U.S. tax in the hands of a corporate U.S. Shareholder if the conditions of Code §245A are met.

Holding Period Requirement

Code §245A has a holding period requirement. The domestic corporation must hold the shares of stock of the foreign corporation for more than 365 days during the 731-day period beginning 365 days before the date on which the share becomes ex-dividend.[23] A day is counted towards the holding period only if the domestic corporation's interest in the foreign corporation does not fall below 10% (by vote or by value).[24] Stated differently, if the domestic corporation holds at least a 10% interest in the foreign corporation for more than 365 days during a period of two years, which begins one year before the ex-dividend date, the domestic corporation will be entitled to a 100% deduction of the foreign-source portion of the dividends received.

Determining the Foreign-Source Portion of the Dividend

The foreign-source portion of the dividend received is calculated as follows:[25]

Foreign-Source Dividend Calculation
Dividend Received * $\frac{\text{Undistributed Foreign Earnings}}{\text{All Undistributed Earnings}}$

[19] Code §1(h)(11).

[20] Code §1248(b) limits the tax under Code §1248(a) to the hypothetical tax that would have been paid at the corporate level and the individual level if the U.S. person were to have invested in a U.S. corporation rather than a foreign corporation.

[21] Code §1248(j).

[22] Code § 245A(d)(1).

[23] Code §246(c)(1)(A); Code §246(c)(5)(A).

[24] Code §246(c)(1)(B).

[25] Code §245A(c)(1).

The undistributed earnings of a foreign corporation is its E&P as of the close of the taxable year during which the dividend is distributed, without a reduction for the dividends actually distributed during the taxable year.[26] In addition, all undistributed earnings are treated as undistributed foreign earnings, except the earnings attributable to E.C.I., as alluded to above. Also excluded from undistributed earnings are dividends received by the foreign corporation from a domestic corporation in which 80% of the shares of stock (measured by vote or value) are owned by the foreign corporation.[27]

The I.R.S. has not issued any guidelines explaining the meaning of "undistributed earnings." However, the New York State Bar Association published a report on Code §245A, dated October 25, 2018, suggesting that the undistributed foreign earnings appear to include all U.S.-source income other than E.C.I. that is fully taxed and portfolio dividend income.

Is the 100% D.R.D. Under Code §245A Relevant or Is It a Mere Pacifier?

With the introduction of the Transition Tax and G.I.L.T.I., it may be argued that the relevance of the 100% D.R.D. under Code §245A has been diminished in the context of Code §1248.

"If a foreign corporation does not have any non-P.T.I. then Code §245A appears to be a mere formality."

The one-time Transition Tax imposed for 2017 had the effect of converting a foreign corporation's untaxed undistributed E&P accumulated through the close of tax year 2017 into P.T.I. ("Code §956 P.T.I."). Effective 2018, the T.C.J.A. imposed a G.I.L.T.I. tax on an ongoing basis which, for trading companies or internet companies, is imposed on almost the entire income of the foreign corporation not already taxed in the U.S. in its hands or at the level of its U.S. Shareholders. Stated differently, the untaxed post-2017 foreign-source income of a foreign corporation is subject to the G.I.L.T.I. regime and becomes P.T.I. ("Code §951A P.T.I.") as a result. Therefore, subject to proposed regulations issued June 21, 2019, which are discussed below, a foreign corporation subject to the one-time Transition Tax and G.I.L.T.I. on an ongoing basis may be left with relatively little non-P.T.I.

If a foreign corporation does not have any non-P.T.I. then Code §245A appears to be a mere formality because, in the absence of non-P.T.I., no amount of gain will be treated as dividends for the purposes of the 100% D.R.D. under Code §245A.

The few instances where a foreign corporation may have non-P.T.I. and, therefore, Code §245A may be beneficial to the U.S. taxpayer include the following:

- The net tested income of one C.F.C. is offset by the net tested loss of another C.F.C., and therefore, no G.I.L.T.I. is imposed.
- Part of the deduction is not subject to G.I.L.T.I. (*i.e.*, the amount equivalent to the net deemed tangible income return, which is 10% of the qualified business assets investment).
- The C.F.C. is resident in a foreign jurisdiction that imposes corporate income tax at an effective rate in excess of 18.9%. If the quotient derived from dividing (i) the U.S. dollar amount of tax paid by (ii) the U.S. dollar amount of G.I.L.T.I. exceeds 18.9%, under proposed regulations issued June 21,

[26] In essence, this means that tax imposed under Code §1248(a) is applied to all E&P before tax on dividend income is computed.

[27] Code §245A(c)(2)-(3).

2019,[28] the foreign corporation may elect to be exempt from G.I.L.T.I. The proposed regulations will be effective for C.F.C. taxable years beginning on or after the date the final regulations are published in the Federal Register. Likely, publication will be later this year, and the final regulations will be effective for tax year 2020.

Example 5:

A domestic corporation, D.C., owns stock in a C.F.C., F.C., with an initial basis of $100 on January 1 of Year 1. On January 1 of Year 2, D.C. sold F.C. stock for $250. For Year 1, F.C.'s E&P is $65. F.C.'s Subpart Income for Year 1 is $50 and foreign-source income subject to G.I.L.T.I. is $10. Other foreign-source income not subject to U.S. tax is $5.

This is illustrated in the following chart:

	Year 1	Year 2
Adjusted Basis	$100	$160
E&P	$65	
Subpart F Income	$50	
G.I.L.T.I.	$10	
Other Foreign-Source Income (non-P.T.I.)	$5	
Sale of F.C. Stock		$250

- D.C. will include $50 of Subpart F Income in its gross income in Year 1 under Code §951(a).
- D.C. will also include $10 of G.I.L.T.I. in its gross income in Year 1 under Code §951A(a).
- D.C.'s adjusted basis in the stock of F.C. at the end of Year 1 will be $160 ($100 + $50 + $10) under Code §§961(a) and 951A(f)(1)(A).
- Because D.C. sold the stock of F.C. for $250, the taxable gain from the sale of the stock is $90 ($250 - $160).
- The amount already included in D.C.'s gross income under Code §§951 and 951A is $60 (Subpart F P.T.I. of $50 + Code §951A P.T.I. of $10).
- E&P attributable to the stock sold by D.C. for the purposes of Code §1248 is $5 ($65 - $60) after making adjustments for amount already included in gross income under Code §951.
- Code §1248(a) will recharacterize the gain from the sale of the stock of F.C. to dividends, but only to the extent of E&P attributable to the stock sold (also

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[28] See Prop. Treas. Reg. §1.951A-2(c)(6).

regarded as non-P.T.I. E&P). Therefore, out of the total gain of $90, only $5 will be treated as dividends.

- The $5 recharacterized as a dividend is eligible for the D.R.D. under Code §245A, subject to the satisfaction of its requirements.
- The balance of the gain is $85 ($90 - $5); it would be subject to a 21% corporate tax of $17.85 ($85 * 21%).

Some interesting observations from Example 5 are as follows:

- Because of G.I.L.T.I., D.C.'s adjusted basis in the F.C. stock has increased by $10. In the pre-T.C.J.A. era, the adjusted basis in F.C. stock would have been $150 ($100 + $50 of Subpart F Income already included in the gross income) instead of $160. Thus, the net gain would have been $100 ($250-$150). Out of the $100 gain, $15 ($65 - $50 of Subpart F P.T.I.) would have been treated as dividends. The non-Subpart F P.T.I. portion would have been taxed as dividends at the rate of 35% (subject to foreign tax credits), and the capital gain would have been subject to a tax of $29.75 ($85 * 35%).
- The dollar amount of the capital gain remains the same in the example before and after the enactment of the T.C.J.A. However, for tax years beginning in 2018, even though D.C. paid the $1.05 G.I.L.T.I. charge ($10 * 10.5%), D.C. is better off in the aggregate because of the reduced capital gain tax rate of 21%. The total tax liability is $18.90 ($17.85 + $1.05)
- The 100% D.R.D. under Code §245A may be beneficial if the C.F.C. is actively engaged in a trade or business outside the U.S. and the U.S. Shareholders are not subject to G.I.L.T.I. – likely beginning in 2020. This is because the foreign corporation's E&P will include a substantial amount of non-P.T.I., and the gain from the sale of the corporation's stock, to the extent it is non-P.T.I., will be exempt under Code §245A.
- The D.R.D. under Code §245A is available only to a corporate shareholder. Therefore, if the shares in this example were held by an individual U.S. Shareholder, Code §245A would be inapplicable. In such a case, $5 of the dividend would be subject to tax at ordinary rates or long-term capital gains tax rates if treated as a qualified dividend, while the balance $85 would be treated as long-term capital gain. In addition to income tax, a 3.8% Net Investment Income Tax will be due. Here, that total amount would be $20.23.

IT'S ONLY THE BEGINNING

While the T.C.J.A. amended the definition of the term "U.S. Shareholder" under Code §951(b) to include a U.S. Person owning 10% or more of the total value of a C.F.C., Code §1248(a) remains untouched. Code §1248 continues to be applicable only to those U.S. Persons (not U.S. Shareholders) who own 10% or more of the total combined voting power of all classes of stock entitled to vote (and not 10% or more of the total value). Thus, a U.S. Person who owns nonvoting common or preferred stock constituting 10% or more of the total value of a C.F.C. will be treated as a U.S. Shareholder for Subpart F purposes but will not be governed by the provisions of Code §1248. Therefore, Code §245A will not be applicable either. The tax treatment for those shareholders will be discussed in a subsequent edition of *Insights*.