International Income Taxation

Chapter 6: OUTBOUND TAXATION: ANTI-DEFERRAL REGIMES

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Alternative approaches to U.S. taxation of U.S. owners & foreign corporate income:

1) Complete deferral (or territorial?)
2) Partial deferral – ‘Subpart F” approach
3) Deferral, but imposition of an interest charge when income distribution occurs
4) Deferral, but tax characterization change to ordinary income when gain is received
5) No deferral – all current income recognition (or “acceleration”?)
Present/Former U.S. Anti-Deferral Tax Structures

1) FPHC – current attribution of investment income (repealed 2004)

2) Controlled foreign corporation or CFC-Subpart F provisions – partial current recognition of undistributed income.


4) Passive foreign investment company rules – PFIC – interest charge on an excess distribution or on stock sales proceeds.
Purposes for Use of “Base Country” Corp.

Foreign-Owned

- US Domestic Subsidiary
- Foreign Base Company
- Third Country Operations
- Supply Chain Transaction
- Lease Stripping Transaction
- Interest Stripping Transaction
- Royalty Stripping Transaction
- Service Stripping Transaction

Base Erosion

Subpart F Inclusion

US-Owned

- US Parent
- US Domestic Subsidiary
- Foreign Base Company
- Third Country Operations
- Supply Chain Transaction
- Lease Stripping Transaction
- Interest Stripping Transaction
- Royalty Stripping Transaction
- Service Stripping Transaction
Current income taxation to U.S. shareholders (even though income not received):

1) Must be a “controlled foreign corporation” (or CFC)

2) Must be a 10% or greater shareholder

3) Limited to certain types of movable income (not manufacturing income).
Code §§1291-1298 (TRA-1986)

“Passive Foreign Investment Company” (or PFIC) status – income must be 75% passive (or 50% of assets producing passive income).

No minimum stock ownership required.

Deferral permitted since no CFC status, but the benefit of the income tax deferral is recaptured (through an interest charge) when “excess distribution” or a stock sale.

1) Qualified electing fund
2) “Mark to Market” for PFIC stock – assuming marketable stock.
“Temporary” Dividends Received Deduction


Therefore, tax of 35% times 15% = 5.25%

Only cash dividends.

Must be extraordinary dividends (i.e., exceeding average repatriations)

Reinvestment in U.S. required – must be a dividend investment plan and funds are to be used for prescribed purposes.
Code §957(a) defines a “controlled foreign corporation” (CFC) as a foreign corporation where more than 50 percent of

(i) the vote, or

(ii) the value of all the outstanding stock is owned (or considered as owned) by “United States shareholders” on any day during the taxable year.
“United States Shareholder” Defined

Who are “United States shareholders”? See the §951(b) definition.

U.S citizens, resident aliens, corporations, partnerships, trusts or estates owning directly or indirectly or constructively (under the ownership rules of §958) 10% or more of the total combined voting power of all classes of stock or a foreign corporation.

Less than 10%: a “portfolio interest”.

1) Include a pro rata share of “Subpart F income” (§951(a)(1)(A)(i)), as determined on the last day of the year. Objective: Constructive receipt – economic power to control the income and an immediate accretion to wealth causes inclusion.

2) Include pro rata share of investment in “U.S. Property” (§956) – a deemed repatriation of profits (income type is not relevant).

3) Income attributed to the shareholder is treated as ordinary income (i.e., capital gain may be transformed into ordinary income). Relevant to an individual. Cf., branch treatment.

4) No loss pass-through to the shareholder.

5) Subsequent stock disposition gain – ordinary income to the extent of allocable profits. §1248 (i.e., no capital gain).
Indirect foreign tax credit is available for U.S. corporate shareholders when current inclusion – similar to §902. See §960.

§78 gross-up by the taxes deemed paid attributable to the deemed distribution.

§962 – elective treatment to an individual shareholder for the same treatment (i.e., availability of the deemed paid foreign tax credit and tax at corporate rates).
§959(a) – actual distributions from the CFC are sourced first from amounts already taxed under §951(a). Similar for previously taxed §956 U.S. investment amounts.

§961(a) – an increase in tax basis is made for shares by the amount included in gross income under §951(a). Reduction of tax basis is made for untaxed distributions. §961(b).
1) “Foreign base company income” – diversion of passive (and other) income to a low-tax jurisdiction.

2) Income from insurance activities.

3) International boycott-related income.

4) Illegal bribes and kickbacks.

5) Bad country income.
Categories of FBC Income:

1) Foreign personal holding company income (FPHCI)

2) Foreign base company sales income (FBC sales income).

3) Foreign base company services income (FBC services income).

4) Foreign base company oil related income. **Not active business income; formerly, also, foreign base company shipping income.**
1) §954(b)(3) de minimis rule (5%) but, also, a 70% full inclusions rule.

2) §952(c)(1) provides limit on CFC’s Subpart F income to “earnings and profits” for that year.

3) §952(b) excludes from Subpart F income certain U.S. source income – ECI with a U.S. trade or business (currently subject to U.S. income tax).
§957 – more than 50% vote or value of the corp. stock is owned by U.S. shareholders.

§958 specifies direct, indirect and constructive ownership rules.

§958(a)(2) – indirect ownership rules

§958(b) – constructive ownership rules concerning attribution between family members and between (i) entities and (ii) their shareholders, partners or beneficiaries. Cf., §318 (Subchapter C).
Zeus, a Swiss corporation, has 1,000 shares of a single class of stock outstanding. Jupiter, a widely held U.S. corporation, owns 460 shares and the remaining 540 are owned equally by six unrelated U.S. individuals.

<table>
<thead>
<tr>
<th>Jupiter</th>
<th>US Person #1</th>
<th>US Person #2</th>
<th>US Person #3</th>
<th>US Person #4</th>
<th>US Person #5</th>
<th>US Person #6</th>
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<tbody>
<tr>
<td>460</td>
<td>90</td>
<td>90</td>
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Result: None of the individuals is a “U.S. shareholder” because none owns 10% and Zeus is not a CFC.

§957(a) and §951(b).
The number of shareholders is reduced from six to five. Each individual shareholder then owns more than 10 percent (10.8%, or 108/1000).

Result: Each individual would be a “U.S. shareholder”.

Therefore, Zeus would be a CFC (more than 50% of its stock is owned by “U.S. shareholders”).
A partnership (one of six shareholders each owning 9%) owns 90 shares and a partner owns 90 shares. The partner’s shares are attributed to the partnership and the partnership, therefore, holds 180 shares. Zeus is a CFC (when including Jupiter’s shares). §958(b) and §318(a)(3)(A).

180 plus 460 (640) is more than 50 percent.

Is the partner a U.S. shareholder? No, §318(a)(2) (5% of 90 shares = 4.5 shares).
Two of the individuals are husband and wife. Each spouse’s shares are attributed to the other under §958(b) and §318(a)(1)(A)(i).

Each spouse is deemed to own 180 share (90 actually and 90 by attribution) and each spouse is a U.S. shareholder.

Therefore, Zeus is a CFC (when the 180 shares are combined with the 460 Jupiter shares = 640).
Problem 5
Nonresident Alien Status

Two of the individual shareholders are husband and wife. One spouse is a nonresident alien.

No attribution occurs (under §318(a)(1)(A)) to/from a nonresident alien spouse. See §958(b)(1).

Therefore, Zeus is not a CFC.
Two of the individuals are brother and sister.

No attribution occurs between siblings under §318(a)(1)(A).

Therefore, Zeus is not a CFC.

What if Father is still alive and is a US citizen? Arguably Zeus would be a CFC via attribution of shares to Father. Cf., §554(a)(2) of the (former) foreign personal holding company provisions.
One of the individuals (owning 90 shares owns 50 percent of the stock of Jupiter Corporation (which owns 46% of Zeus).

Two Methods:

**Method #1:** All of the individual’s 90 shares are attributed from individual to Jupiter Corp. and Jupiter then owns 550 shares (460 + 90). §318(a)(3)(C). Zeus is a CFC.

**Method #2:** 50% of Jupiter’s shares are to individual partners (yes, ½ of 460 shares). §318(a)(2)(C). U.S. Person #1 constructively owns 320 shares (230 plus 90 = 320).

**Bottom Line:** Method #1 trumps since it creates greater ownership. See Treas. Reg. §1.958-2(f)(2)
One of the individuals (owning 90 shares) owns 10% (not 50%) of the stock of Jupiter Corporation (which owns 46% of Zeus) and becomes U.S. shareholder.

Analysis:
1. No attribution to Jupiter from US Person #1 because Jupiter is less than 50% owned by US Person #1. See §318(a)(3)(C).
2. Attribution from Jupiter to US Person #1 of 46 shares so that US Person #1 is considered a US shareholder. §318(a)(2)(C) modified by §958(b)(3).

Bottom Line: The 2 US Shareholders (Jupiter & US Person #1) own together 550 shares (i.e., Jupiter owns 460 and US Person #1 owns 90).
One of the individuals (owning 90 shares) owns 5% of the stock of Jupiter Corporation (which owns 46% of Zeus).

Analysis:
1. No attribution from US Person #1 to Jupiter because US Person #1 owns less than 50% of Jupiter. See §318(a)(3)(C).
2. The Jupiter shares are not attributed to US Person #1 since US Person #1 owns less than 10% of Jupiter. See §318(a)(2)(C) & §958(b)(3).

Bottom Line: Zeus is not a CFC since Jupiter is the only “U.S. shareholder”.

Zeus
Swiss Corp

US Person #1

Jupiter
US Corp

US Person #2

US Person #3

US Person #4

US Person #5

US Person #6

460

90

90

90

90

90

5%
410 shares of Zeus are owned by Jupiter Corp. and 90 shares are owned by a U.S. citizen who (1) also owns 3% of the shares of Juno B.V. (a Dutch corporation) that (2) owns 500 Zeus shares (i.e., U.S. citizen indirectly owns 15 additional shares of Zeus or a total of 105).

Analysis:
1. Neither §318(a)(2)(C) or §318(a)(3)(C) would provide attribution.
2. But, §958(a)(2) has a special attribution rule for foreign entities. US Person #1 is deemed to actually own its pro rata share of Juno’s shares in Zeus, so 105 total shares (90 + 3% of 500).

Bottom Line: 105 shares plus 410 shares means Zeus is a CFC.
CCA, Inc.  P. 505   Old CCA owned all of the issued and outstanding stock of AG (Swiss). AG was exporter of CCA products from the United States. Also, AG had exclusive right to use CCA trademarks. AG had manufacturing plants in other European jurisdictions.  After 1962, an objective to “decontrol” AG.

Accomplished here? Yes. Why?
KOS, a Panamanian sub, operating as a wholly owned sub of the U.S. parent corporation. Voting control transferred to Newton Chambers, an English company. Purchase of cumulative voting preferred stock having 55% of the vote.

See Reg. §1.957-1(b)(2) re shifting of formal voting power. But, KOS treated as a CFC. Why?
Problem 4
Avoiding CFC Status

Still possible to decontrol foreign corp.?

Yes, but preferred stock must have vote and value (see §957(a)(2)) equal to at least 50%, and:

1) Restrictions re no transfer to U.S. person
2) 50 percent of the Board of Directors as preferred share representatives.
3) No commitment to redeem preferred.
4) No means to resolve the deadlocks, etc.
Holdings in (1) the U.S. and (2) the foreign corporations can only trade as a unit.

“Stapling” to avoid the applicability of the Subpart F rules for the foreign corp. and sufficiently wide distribution of shares of the foreign corporation to not be a CFC.

§269B specifies that the foreign corporation when stapled is treated as a U.S. corporation. Cf., a nonstapled corp.
Transformation of a U.S. publicly traded corporation into a subsidiary of a foreign corporation. After the transaction the U.S. shareholder ownership is widely dispersed and the foreign corporation is not a CFC.

Stripping profits from the U.S. sub to foreign parent would then be enabled. May be treated as a U.S. corp. See §7874.
Base the corporate residency status determination on where the primary corporate officers reside (rather than the place of organization)?

Cf., other foreign country tests of the place of “management and control” for determining the situs of a corporation.

Different from the place where corporate business is conducted?
§951(a)(1) – gross income inclusion if corporation is a CFC for a 30 day period.

Every person who is a U.S. shareholder must include his/her/its pro rata share of Subpart F income at year-end.

Pro rata share of includible Subpart F income is determined by reference only to direct and indirect CFC ownership (but not to constructive ownership).
If CFC for only part of the year – pro rata allocation. §951(a)(2)(A).

Reduction of Subpart F income amount if dividends actually received earlier in same year by prior owner. §951(a)(2)(B).

Note: How negotiate a corporate acquisition transaction with this Subpart F income consideration? Dividend or no dividend treatment? Consider the FTC situation.
If multiple classes of stock outstanding, how allocate the Subpart F income among the several classes? Allocation based on E&P amounts allocable to each class.

How allocate income if directors have discretionary power to allocate income among the several classes of stock? Based on relative values of the shares.

If multiple tiers of corporations, how determine the shareholder’s Subpart F income amount? Use the “hopscotch method” for Subpart F income from lower corps.

Eligibility for (indirect) foreign tax credit? Yes

Gross-up Subpart F income amount under §960.

Shareholder increases tax basis for above tier corps.

What happens when 1st tier corporation sells shares of 2nd tier corporation? Tax basis increase for holding in 2nd tier sub. §961.
§960 – similar to §902 concerning availability of the indirect FTC.

Indirect credit available down to 6th tier foreign corporation is a controlled foreign corporation. §902(b)(2).

At least 10% ownership of voting stock at each level.

No indirect FTC below the 6th tier.
Two NRAs and a U.S. corporation organize Irish Foreign Base Company, Inc. (FBC). On August 8 NRA Molly gets a “green card”.

FBC has net income of $400,000 for year one – ½ being Subpart F income. FBC paid $80,000 in foreign income tax on pre-tax foreign net income of $480,000 (16% rate). FBC becomes a CFC on August 8 when FBC has a 40% and a 30% U.S. shareholder. For the year, $200,000 is Subpart F income (§954(b)(5)). Proportionate allocation of Subpart F income to be made to the period during which the corporation is a CFC – 40% (146/365) of the year, times $200,000 ($80,000), equals $32,000 inclusion for Widgets (40%) and $24,000 for Molly (30%).

Molly tax basis adjustment for her stock: $30,000 plus $24,000 Subpart F income - $54,000. No indirect FTC (since an individual), assuming no §962 election.

Widget’s tax basis increase for stock: $40,000 plus $32,000 Subpart F income = $72,000 basis. Widgets gets §960 deemed paid credit: 32,000/400,000 x 80,000 = 6,400. No tax basis increase for the 6,400 amount (since used as a FTC).
Year two distribution of dividends from FBC:

$20,000 to Widgets and $15,000 to Molly and Sam. FBC breaks even for 2nd year.

Sam (foreigner) is not subject to U.S. tax.

Under §959 no tax to Widgets and Molly since paid out of earnings previously taxed (under §951). See §959(c) ordering rules.

Under §961(b) share basis is reduced (prior increase upon the earlier income inclusion).
§952(b) exclusion from Subpart F.

Assumption of net basis income taxation in the United States.

No exclusion from Subpart F, however, where trade or business income in U.S. (1) is entitled to exclusion (e.g., no P.E.) under tax treaty, or (2) has a reduced rate of tax under income tax treaty.
§952(c)(1)(A) – Subpart F income limited to current “earnings and profits”.

Some CFC current losses may reduce CFC’s Subpart F income. Possible subsequent recharacterization when excess of current earnings and profits realized over Subpart F income.

§952(c)(2). A timing rule.
Accumulated deficits do not reduce Subpart F income for the current year, except as permitted in §952(c)(1)(B) (i.e., “qualified activity”).

Deficits in related companies cannot be used to reduce Subpart F income except where the same “qualified activity” is conducted by a “qualified chain member”.

Definition of FBCI in §954(a):

1) Foreign personal holding company income. Same country exceptions.

2) Foreign base company sales income.

3) Foreign base company services income.

4) Foreign base company oil related income.

FBCI formerly included foreign base company shipping income.
Defining Foreign Personal Holding Company Income

General Rule set forth in in §954(c) – FPHCI includes interest, dividends, rents, royalties, annuities and gains from the sale of stock or securities.

Principle: Passive income can be earned anywhere, so there should not be a tax advantage to make this easily portable income to be earned in a foreign subsidiary where the need for the foreign subsidiary as the investor is slight. The possible competitiveness argument for deferral of “active business income” does not apply to passive investments.

continued
Exception #1: Active Rents and Royalties Exception of §954(c)(2)(A)(i). FPCHI does not include rents & royalties from unrelated persons when derived in the active conduct of a business - §954(c)(2)(A).

Principle: Active business income is not the portable income that we are concerned about. The possible competitiveness argument for deferral of “active business income” applies with more force here.
Exception #2: Active Banking, Financing, or Similar Business of §954(h). FPCHI does not include includes interest, dividends, rents, royalties, annuities and gains from the sale of stock or securities if earned as part of an active banking or financing business.

 Principle: Active business income is not the portable income that we are concerned about. The possible competitiveness argument for deferral of “active business income” applies with more force here. Some argue that this exception allows G.E. & others a significant opportunity to completely end-run the FPHCI rules.

continued
Exception #3: Related party “Same Country Exception” of §954(c)(3). FPCHI does not include certain interest & dividends (incorporation test) and certain rents & royalties (country of use test) that meet the “same country” requirements. Gain on sale by CFC of another CFC stock (including §311(b) gain) is treated as a “dividend” per §954(c)(3)(C)/§964(e).

Principle: These same country payments are not the type of “tax haven” activities that motivated curtailment of the deferral privilege.

Exception to Exception #3: Same country exception doesn’t apply to related party payments that reduce the payor’s Subpart F income. See §954(c)(3)(B).
Exception #4: Hybrid Entity Structures.
FPHCI only applies to payments that are treated as interest, dividends, rents and royalties for US tax purposes. A hybrid entity is a separate entity for foreign tax purposes but (2) a conduit/branch/disregarded entity for U.S. income tax.

Principle: Payment from a disregarded entity (a “non-entity” for US tax purposes) are “non-events” for US tax purposes and thus are not payments of “interest,” “rents,” “royalties,” or “dividends.”
Possible Exception #5?: The “Temporary” CFC Exception of §954(c)(6). FPHCI includes dividends, interest, rents and royalties paid between CFCs that are not incorporated in the same country, but §954(c)(6) has allowed an exception from 2004 to 2011. Will this exception be extended further?????

Principle: Once Congress chose to not attack the check-the-box exception, Congress found it difficult to argue against this exception. At present, this provision has expired for 2012, but it had also expired in 2011 and was extended in November 2011, so it may be re-extended again in 2012.
Sale of receivable to a “factor” at a discount.

§864(d)(1) – discount income from factoring with a related person is treated as “interest” income from a loan.

Also, a loan to a purchaser from a related party is treated as a receivable purchase for this rule. §864(d)(6).

A same country exception is available in some situations. §864(d)(7).
Other Foreign Personal Holding Company Income

Foreign currency gains. §954(c)(1)(D). Hedging exception is applicable.

Income from commodity transactions. §954(c)(1)(C). Hedging exception available. §954(c)(5)(A).

Income derived from the sale of property producing (1) passive income or (2) no income. §954(c)(1)(B).
The “Check & Sell” Plan
The Dover Case

CFC’s sale of stock (including the stock of a 2\textsuperscript{nd} tier foreign subsidiary) produces capital gain which is FPHC income.

Sale of assets produces no FPHCI but may cause foreign country gains tax.

Option: Use “check the box” entity characterization rules (assuming an “eligible entity”) to cause a deemed liquidation of the foreign corp.

**Case #1: FPHCI Stock Gain**

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<tr>
<th>US Parent</th>
<th>Foreign Base Company</th>
<th>Unwanted Subsidiary</th>
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**Case #2: No FPHCI Stock Gain**

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<tr>
<th>US Parent</th>
<th>Foreign Base Company</th>
<th>Unwanted Subsidiary</th>
</tr>
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Nonsubpart F

Subpart F
§954(d). **Two Part Test**

Income derived from the purchase and the sale of personal property:

1. If purchased from or sold to a related party, **(Test #1)** and
2. The property was manufactured or produced outside the country where the CFC is organized and the property is sold for ultimate use outside of country where CFC is organized. **(Test #2)**

Includes income from sales or purchase commissions.

**Exception:** Agricultural commodities not grown in the US in commercial quantities are exempt from FBSCI rules (discuss the coffee classification)

“Tax avoidance” purpose not relevant.
§954(d). **Two Part Test**

Income derived from the purchase and the sale of personal property:

1. If purchased from or sold to a related party,  **(Test #1)**
2. The property was manufactured or produced outside the country where the CFC is organized and the property is sold for ultimate use outside of country where CFC is organized.  **(Test #2)**
§954(d). **Two Part Test**

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§954(d). **Two Part Test**

Income derived from the purchase and the sale of personal property:

1. If purchased from or sold to a related party, *(Test #1)* and
2. The property was manufactured or produced or produced outside the country where the CFC is organized and the property is sold for ultimate use outside of country where CFC is organized. *(Test #2)*
Case #4: Brazilian Orange Juice

US Parent

Foreign Base Company

Sale

Sale

U.K. Subsidiary

Question: How do you remove All subpart F in this pattern?

Unrelated Brazilian Exporter

Sales

Foreign Base Company

Yes

Yes

UK Customer

No

§954(d). Two Part Test

Income derived from the purchase and the sale of personal property:

(1) If purchased from or sold to a related party, (Test #1) and

(2) The property was manufactured or produced outside the country
where the CFC is organized and the property is sold for ultimate
use outside of country where CFC is organized. (Test #2)
Exception from FBC sales income treatment where CFC conducts significant manufacturing of the product sold:

What is “manufacturing”? Must be “substantial transformation”; 20%+ “safe-harbor” possible for the CFC. Minor assembling is not sufficient to constitute “manufacturing”.

Fischbein case (later, Ch. 11, p. 825).
Possible application of a “branch rule” i.e., treating the branch as a separate corporation. §954(d)(2). Why?

Example: Swiss CFC engaged in manufacturing and using a Cayman Islands branch as the sales operation. Tax only in Switzerland on the manufacturing income (territorial approach). No tax in Cayman Islands on the sales activity (and income). CI branch is treated as a “subsidiary” for subpart F testing purposes.

**Case: Swiss Company Manufactures Swiss Watches**

- **US Parent**
- **Foreign Base Company**
- **Unrelated Supplier**
- **Cayman Sales Branch**
- **Customer (UK)**
- **Customer (UK)**
- **Sale Watches**
- **Manufacture in Switzerland**
- **Treat As Separate Sales Subsidiary**

- **Sale**
§954(e)(1). Services performed (1) for a related person and (2) performed outside the country where the CFC is organized. Both a “related person” and a “geographic” test need to be satisfied.

Consider foreign construction or drilling companies engaged in offshore activities. “Substantial assistance” to the affiliate subsidiary may cause this rule to apply.

**Case: Drilling Operations in Angola for Major E&P Company**
§954(g)(1). “Oil related” income realized by big producers outside the country of oil and gas production. E.g., refining, transportation and distribution income from oil and gas products. See §907(c) (2)&(3).

Applicable only to large producers (1,000+ barrels per day).

Exception for in country consumption.
§954(d)(3) specifies that a “related person” is one of the following:

1) More than 50% of the vote or value of a controlled corporation.

2) More than 50% of value of the beneficial interests in a partnership, trust or estate.
1) De minimis rule (lesser of 5% or 1 mil; e.g., for interest received on cash balances). §954(b)(3)(A).

2) Full inclusion (70%+) rule. §954(b)(3)(B).

3) Exception for a high-taxed income item. §954(b)(4). At least a 31.5% (effective, not nominal) tax rate. No PLR is available.

Blocked earnings exclusion. §964(b); but, note re swap and similar arrangements.
Consider Subpart F income realized by a partnership – attribution to the partners, including to a CFC (sub of a US parent)?

1. §702 provides for separate characterization. But see Brown Group cases. Congress shut-down the Brown Group technique by amending §954(d)(3) to treat partnerships as related parties for testing purposes.

2. §701 anti-abuse regulations give further authority to treat a partnership as an “aggregate”.

3. Notice 96-39 states IRS won’t follow Brown Group 8th Cir. opinion. p. 568

4. Subsequent regulations issued in 2002 attempt to overturn the Brown Group analysis by mandating an aggregate approach.

5. §954(c)(4) added in 2004 applies aggregate approach to characterize the sale of a partnership interest as FPHCI or not depending on underlying partnership assets (a look-through approach).
Impact of the Subpart F rules on transactions conducted through websites and the internet.

Sourcing issues: Where is the place of performance or the place of use? Sales of goods? Royalties? Services? Manufacturing within the CFC, e.g., for software?

Relevance of “branch rules”? Or, “U.S. trade or business status”? 
Matterhorn (a CFC) acquires from parent and sublicenses patents for royalties to be received from independent licensees outside Matterhorn’s place of organization.

**Question**: Do these royalties create FPHCI?

**Answer**: Yes, these royalties included in definition of FPHCI unless: (i) same country-related person exception under §954(c)(3)(A)(ii) or (ii) the active business – unrelated person exception of §954(c)(2)(A). Neither apply absent additional facts.
Matterhorn patents are acquired from inventions developed by Matterhorn’s own technicians.

**Question:** Do these royalties create FPHCI?

**Answer:** No. FPHCI is not created since the royalties are “derived in the active conduct of a trade or business.” See §954(c)(2)(A); Reg. §1.954-2(d).
Matterhorn (Swiss Co.) receives 200,000 of dividends and 100,000 of interest from each of two wholly owned subsidiaries organized in (i) Belgium and (ii) Switzerland.

Dividend and interest income normally constitutes FPHCI under §954(c)(1). But, consider the same country related person exception (Swiss). §954(c)(3)(A)(i).

But, consider rule concerning payment is not permitted to reduce Subpart F income.
Problem 1d
Matterhorn

Sales of gold coins having numismatic value purchased for investment. Sale is made to an independent dealer in Switzerland.

**Question:** Does the sale of these coins create FPHCI?

**Answer:** Yes, this sale does create FPHCI to Matterhorn. The coins are investment in property which “does not give rise to any income”. Thus, the gain on this sale is FPHCI. §954(c)(1)(B)(iii). The gain would not be FPHCI if Matterhorn were a dealer (i.e., the coins were inventory in its hands).
Sale of all rights to a group of patents to a Swiss corporation.

**Question:** Does the sale of the Swiss patents create FPHCI?

**Answer:** Yes, the sale of these patents creates FPHCI under §954(c)(1)(B)(i). There is no exclusion for selling patents that were not used in the active trade or business income. This is an odd result given that the royalties would have not created Subpart F income due to the same country related party exception of §954(c)(3)(A)(ii).
Problem 1f
Matterhorn

Purchase of golf balls from USM and sold to an unrelated person outside Switzerland.

**Question:** Does this trading pattern create FBC sales income?

**Answer:** Yes, because a related person is involved in the purchase or sale transactions **(Test #1)** and the product originated outside Switzerland and is sold for use outside of Switzerland **(Test #2)**. Note that packaging is not manufacturing.
Sale of golf balls to independent distributors in Switzerland (assuming the property is for actual use in Switzerland).

**Question:** Does this trading pattern create FBC sales income?

**Answer:** No FBC sales income exists here since goods are sold within Switzerland, i.e., no third country is involved (assuming no subterfuge on destination of purchases!). Test #1 met **but not** Test #2.
Purchase of golf balls from independent US manufacturer and sold to an unrelated person outside Switzerland

**Question:** Does this trading pattern create FBC sales income?

**Answer:** No FBC sales income since no related person is involved in the purchase or sale transactions. **Test #2** is met, but **Test #1** is not met and so there is no FBC sales income.
Manufacture by Matterhorn of golf balls in Switzerland from components purchased from the U.S. parent corporation.

**Question:** Does this trading pattern create FBC sales income?

**Answer:** No if the Matterhorn activities constitute “manufacturing” that entitles it to the “manufacturing exception” of §954(d)(1), but minor assembly or repackaging is not sufficient to be manufacturing for this purpose. See the Fischbien case in later chapter.)
Manufacture by contract manufacturer in Switzerland from components purchased from USM.

**Question:** Does this trading pattern create FBC sales income?

**Answer:** Probably does create FBC sales income. Matterhorn does not appear to have made a “substantial contribution” with respect to the manufacturing process through the activities of its employees. See Reg. §1.954-3(a)(4)(iv)(a) through (d) and especially Reg. § 1.954-3(a)(iv)(d), Ex. 1. Thus, the sale of the golf balls would constitute FBC sales income under §954(d).
Manufacture by contract manufacturer in Switzerland from components purchased from USM. Matterhorn employees provide product design, quality control, and oversaw manufacturing logistics.

**Question:** Does this trading pattern create FBC sales income?

**Answer:** Probably not FBC sales income because Matterhorn makes a “substantial contribution” with respect to the manufacturing process through the activities of its employees thus entitling it to the “manufacturing exception.” See Reg. § 1.954-3(a)(4)(iv)(a)-(d) and especially Reg. §1.954-3(a)(iv)(d), Ex. 2.
Problem 11
Matterhorn Definition of “Related”

Matterhorn (1) purchases from (a) USM 49 percent owned German corporation and (b) USM 51 percent owned Dutch corporation and (3) resells outside Switzerland.

Issue concerns what is a “related party” for Subpart F purposes – see §954(d)(3) concerning definition of a related party. More than 50% of the vote or value is required. German Co. not related; Dutch Co – yes related.
Matterhorn (Swiss Corp.) purchases from a 50 percent owned German corporation.

**Question:** Does the below trading pattern create FBC sales income?

**Answer:** The German corporation would be related (to Matterhorn) and the Matterhorn sales income would be foreign base company sales income. See §958(b) and §318(a)(3)(C) re “related party” attribution of all Matterhorn stock from USM to German corp.
Matterhorn acts as a sales agent, receiving commission for services, rather than buying and reselling.

**Question:** Does the below trading pattern create FBC sales income?

**Answer:** inclusion for commissions from Dutch Co since (in addition to purchase/resale arrangements) the FBC sales income definition contemplates sales commission income but not German Co since not a related party.
Services are rendered by Matterhorn to independent customers outside Switzerland:

**Question:** Does the below trading pattern create FBC services income?

**Answer:** No. Although services are performed outside of Switzerland where Matterhorn is organized, these services were not performed for a related party. See §954(e).
Services are rendered for a related party (brother-sister corp.). See §954(d)(3).

Question: Does the below trading pattern create FBC services income?

Answer: No FBC services income. Services are performed in the country (Switzerland) where Matterhorn is organized. Consequently, not FBC services income (the geographic element of the FBC services income test is not met). See §954(e).
Only 4% of the income is FC Services income and, therefore, all this income is within the protection of the “de minimis” rule (i.e. no FBC income taint).

**Question:** Does this fact pattern create a subpart F inclusion?

**Answer:** No. The de minimis rule applies. This is a gross income test. See §954(b)(3)(A). Planning: generate large amount of active operation gross income (20 million.) to protect a limited passive income amount (< $1 million.).
75 percent of the Matterhorn income is FBC services income. 

**Question:** Does this fact pattern create a subpart F inclusion?

**Answer:** Yes. All the Matterhorn income (including 25% non-tainted income) is treated as FBC services income under the §954(b)(3)(B) “full inclusion” (more than 70%) rule.
Services income is subject to an effective rate of Swiss and other foreign income taxes of 32 percent.

**Question:** Would there be a subpart F inclusion in this case?

**Answer:** No subpart F inclusion. Services income is excluded from FBC services income if the proper high-taxed income election is made. The effective tax rate in this problem is greater than 31.5% (90% of 35%).
Matterhorn as a 60% partner in a Belgium partnership and the partnership receives interest income that would be FPHCI if received directly by Matterhorn.

**Question:** Does USM have a subpart F inclusion?

**Answer:** Issue is whether to make a classification decision concerning the income as if the income is being received directly by the partner? Is an entity or aggregate analysis applicable? See Reg. §1.954-1(g)(1) & Brown case (Tax Court).
Sale by a U.S. seller to a Swiss sub of installment notes received by the U.S. seller. The price paid is less than the unpaid balance on the obligations. Swiss sub either (1) collects on the obligation or (2) sells it at a profit to an unrelated party.

**Question:** Does this fact pattern create FPHCI?

**Answer:** Yes. The income (when) realized is related party factoring income and interest. §864(d)(1). And, therefore, FPHCI is received by Sub. See also slide 102 for §956 implications.
Matterhorn loans funds **directly** to unrelated foreign customers who use the funds to buy USM goods.

**Question:** Does this trading pattern create FPHCI?

**Answer:** The income on the loan would be interest income and would be FPHC income. §864(d)(6).
Eastlaw (U.S.) online legal research database. Foreign Base Co. (sub) purchases access to database and sells access to unrelated customers in other foreign countries.

**Question:** Does FBC S.A.’s income represent subpart F income? The issue to resolve is whether the database access a sale of a good so that the FBC sales rules apply or is it a service?

**Answer:** The income of FBC S.A. is likely subpart F regardless of analysis.
1) FBC Sales Income: Related party purchase and sale outside of Bermuda.
2) FBC Services Income: FBC services income if Eastlaw provided “substantial assistance” to FBC S.A.
Problem 5
In-Country Services (Sales)?

U.S. Corp. sells computers on Internet. Tax haven sub processes customer orders and arranges delivery into third countries. Tax haven sub receives a fees for its services.

**Question:** Does this trading pattern create FBC sales income?

**Answer:** Better view is that this is FBC sales income (commission income) for agent sale-side support. If tested under the FBC services income rules, then it would not be FBC services income because the services are rendered in the tax haven; if outside the tax haven, FBC services income. §954(e).
Concept of **deemed repatriation** of foreign earnings (any income type – not limited to “tax-haven” type income realized by CFC).

For determining this amount “invested in U.S. property” – i.e., the lesser of:

1) The current year investment, or  
2) The shareholder’s pro rata share of “applicable earnings”.

Limit of the required inclusion is the **adjusted tax basis** of property acquired (less debt).
Impacts of §956 Inclusion:
1) 2\textsuperscript{nd} inclusion is avoided if Subpart F inclusion has occurred per §959.
2) No foreign tax withholding at source on the deemed dividend.
3) §960(c) limits the FTC availability to the lesser of the tentative credit allowed by a straight application of §956 or the hypothetical credit that would have occurred if there had been an actual dividend through the chain.

§960(c) calculation:
   a. “Tentative FTC” is $50.
   b. Hypothetical Credit is $60 (100/280 * 170).
1) Tangible property located in the United States - §956(c)(1)(A).


3) Debt obligations of related U.S. persons. §956(c)(1)(C) (as of end of each Quarter).

4) Rights to use U.S. patents, know-how, copyrights or similar U.S. use property.
Exclusions from “United States Property” §956(c)(2)

Examples:
1) U.S. Treasury obligations and bank deposits – but consider *The Limited* 6th Cir. (p. 533) where CFC purchased CDs from related (credit card) internal related-party bank. Held: bank deposit exception applied. But, see §956(c)(2)(A) (2004), as revised, re a “real bank”.

2) Export Property (if customary in amount)

3) Stock issued by an unrelated corporation.

4) Transportation equipment outside U.S.

**Temporary Exceptions for Financial Crisis:**
1. Notice 2008-91: “60-180” obligation. Repay loan with 59 days and total loan days cannot exceed 180 days. Two year rule.
2. Notice 2009-10: extend to 3 years availability.

**Anti-abuse Rules:**
2. A series of short-term loans might be integrated for §956 purposes. See Rev. Rul. 89-73
3. Dropping cash into CFC sub to make loan and sub has no E&P.
Loans to Related Party
Merck v. U.S. (a.k.a. Schering Plough)

FACTS: Schering Plough entered into swap on notional $650 million where it paid LIBOR and received Fed Funds. Schering-Plough assigned its right to receive Fed Funds on $650 million to Scherico for $460 million.

Issue: Was Scherico’s payment of $460 million to Schering Plough sales proceeds for the sale & assignment of the contractual right to receive Fed Funds on notional amount of $650 million (to which Rev. Rul. 89-73 set forth treatment) or was this a $460 million “loan.”

Holding: Third Circuit said that the substance of the transaction was a loan and refused to respect the separate assignment leg as a separate and distinct transaction that was a sale of a contractual right.
See §956(d) concerning deemed repatriations re pledges and guarantees.

Possible alternative situations:

1) CFC guarantees the financial obligation of the U.S. corp.

2) U.S. corporation pledges the stock of the CFC to secure financing.
FACTS: Stock of CFC (Oceanic, a Panamanian corporation) pledged by Ludwig as collateral for a loan to enable Union Oil stock acquisition by Ludwig.

Holding: CFC (Oceanic) was not a guarantor of Ludwig’s obligation. No undertakings by CFC. Remedy is a sale of the pledged stock (not Oceanic liquidation).
Reg. §1.956-2(c)(2) concerning indirect pledges:

If the assets of a controlled foreign corporation serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation’s discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business.

Why a 66 2/3% requirement (and negative covenants)?

What authority for IRS to promulgate this §956 regulation?

What if two loans with pledges of 35% and 65% of stock of the CFC to two lenders?
Indirect Ownership of U.S. Property (Through Partnership)

Rev. Rul. 90-112  p. 601

CFC is a minority partner in foreign partnership owning real property in U.S. The partnership is foreign country based and invests in US land.

Code §956(c)(1) includes this U.S real property (indirectly owned) within the concept of U.S. property.

Use of an “aggregate” partnership approach deemed appropriate.
What About Pledge of a U.S. LLC Interest?

Assume (1) U.S. parent corp. pledges its interest in a U.S. LLC and (2) U.S. LLC itself owns stock in a CFC (and an interest in a U.S. business).

Should the LLC be treated as disregarded for applicability of §956? Probably.
Further §956 Questions Re Pledges

1) What if pledge of asset worth less than amount of loan? Inclusion to amount of loan or lesser value of asset?

2) Guarantee by CFC, but value of CFC is less than the loan?

3) Pledge of partnership interest when partnership holds CFC stock?

4) Loan by CFC to foreign partnership owner where U.S. partner holds majority/minority interest in the partnership?
Dutch corporation owned by U.S. corp.; Dutch corp. engaged in manufacturing. Assume no FBC income. Dutch corp.’s surplus earnings are:

1. Loaned to U.S parent corporation (over Quarter end). Loan to a related person is treated as an investment in U.S. property under §951(a)(1)(B) and §956.

2. Used to purchase stock of unrelated NYSE listed company. Not an investment in US property.

3. Used to purchase U.S. patent for license to unrelated US person is an investment in US property.
Problem 2  
Sale or Loan to CFC

1) Sale by USM to Matterhorn of installment notes. The price paid is less than the unpaid balance on the obligations. Amounts paid by Matterhorn from its earnings to USM is an investment in U.S. property to the extent of the U.S. obligations. §956(c)(3) and §864(d).

2) Loan to unrelated foreign customers of USM is not an investment in U.S. property since not acquiring a trade or business receivable from a related U.S. person. §956(c)(3)(A).
Three levels of possible income recognition:

1) Subpart F

2) §956 – investment in U.S. property

3) Actual dividend distribution
   See §959(c) re order of distributions
   (§956 income first, then Subpart F income)

If previously taxed, nontaxable distributions not carrying out foreign tax credits.
Consider an upstream dividend from a 2nd tier subsidiary (CFC) to a first tier subsidiary (CFC). Subpart F (FPHC) income to first tier subsidiary?

Treatment of Stock Sale
Gain as Ordinary Income

General Rule of §1248: Gain realized on the disposition of the CFC stock investment is (recast) as dividend income.

1. §1248 Result: Transforms capital gain into a “deemed” dividend distribution to the extent of 10% shareholder’s allocable E&P, limited to amount of stock gain.

2. Implication: Is §1248 treatment preferred? Yes, for a corporate shareholder, since the deemed paid FTC is available. Reg. §1.1248-1(d).

3. Foreign Tax Advantage: Generally there is no foreign withholding tax on a stock sale (rather than if an actual dividend distribution).

4. Individuals: Can avoid §1248 by holding CFC stock until death.
Treatment of Stock Sale
Gain as Deemed Dividend

§1248(b) limits the tax attributable to the deemed dividend. Deemed dividend under §1248 does not reduce the CFC’s E&P.

§959(e) treats §1248 deemed dividend as previously taxed E&P and, therefore, not subject to tax on a later distribution.

E&P reduced when a subsequent nontaxable distribution is actually made. §959(e).
Consider (1) a sale of CFC stock and (2) CFC income previously included as Subpart F income in seller’s income or includible under §956.

Inclusion in gross income again? No, §959(a).
§964(e) recasts gain as dividend to the extent of CFC #2 earnings and profits. The dividend carries §902 credits.

Section 964(e) applies policy of §1248 to the CFC level.
Problem - §1248
Corp. Partial Stock Sale

Mary sells all 20% and Heavy Metals sells 20% of its interest in Foreign Base Co

Heavy Metals Consequences:
1. The sale of 20% interest in FC for $300,000 (cost basis is $14,000 + $36,000 basis increase from prior Subpart F inclusion) provides $250,000 gain of which only $70,000 is reported as long-term capital gain ($250,000 - $180,000).
2. Ordinary Dividend is $180,000 (20% of $900,000) per §1248.
3. §78 Gross-Up of $20,000 (20% of $100,000).
4. So, total income inclusion is $270,000 ($70,000 + $180,000 + $20,000).
5. §902 Deemed Paid Credits: $20,000

Mary
1. The sale of 20% interest in FC for $300,000 (cost basis is $14,000 + $36,000 from prior Subpart F inclusion) provides $250,000 gain of which only $70,000 is reported as long-term capital gain.
2. Mary could elect to apply §962 to obtain §78 Gross-Up and Deemed Paid Credits.
§1249 transforms capital gain into ordinary income when a patent is sold to a foreign corporation by a U.S. transferor which owns more than 50% of the voting power of the purchaser foreign corporation.

To preclude capital gains sales to CFC which then sublicenses (receiving ordinary, deferred income; but FPHC income?).

Cf., §367(d) re contribution of intangibles to foreign corporation.

Note: §174 re prior R&D deduction.
PFIC provisions - §§1291-1298

Applicable to **all** U.S. **persons**.

Choices of taxation for U.S. shareholders:

1) **Election for current inclusion (QEF)** -- §1293. Exception: Can elect to defer US tax on amounts not currently distributed, but the cost of this election is an interest charge on the deferred tax -- §1294.

2) **Mark to market election (current income)** -- §1296

3) **Not QEF** – tax on (i) distribution from the QEF (plus interest charge) or (ii) sale of shares (plus interest) -- §1291(a).
**PFIC Test:**

(i) 75% of Corp.’s gross income is passive income (an income test, i.e., income that would be foreign personal holding company income) or

(ii) 50% of assets are held for the production of passive income (the asset test, based on value, subject to election – except for public company – to use tax basis; plus mandatory requirement for non-public CFCs to use tax basis). §1297(a). Year-by-year test.
PFIC Test:
Leased properties treated as assets held by PFIC – as part of the active business assets. §1298(d). p. 613

Active banking business exception. §1297(b)(2)(A)  p. 613

Interest, dividend, rent and royalty from a related person exception (sourced from business income). §1297(b)(2)(C). p.613
PFIC Test:
Look through rule for 25 percent or more owned subsidiaries - §1297(c).

Purpose: To prevent foreign corps having active subs from being treated as PFICs.

Dividends and interest received from this subsidiary are eliminated from income for purposes of the income test.

Stock of this subsidiary is eliminated for purposes of the asset test. §1297(c).
**PFIC Test:**
Special rules apply for:

1) The start-up year for an active business operation, §1298(b)(2), and

2) Corporations changing active businesses. Corporation not treated as a PFIC. §1298(b)(3).
**PFIC / Subart F Overlap:**

If both PFIC and Subpart F would apply, then the Subpart F rules take priority. §1297(d).

This enables deferral without an interest charge accruing (for non-Subpart F income).

Non “U.S. shareholders” (e.g., less than 10% ownership) are subject to the PFIC rules.
If not a QEF, an interest charge is imposed on the value of the tax deferral at the time:

1) Of the disposition of PFIC stock at a gain, or

2) The receipt of an “excess distribution” from the PFIC (i.e., above 125% of prior dividend distribution level).

§1291(a)(1) & (2).

PFIC distribution to U.S. corp. enables deemed paid FTC. See §1291(g).
Qualified Electing Fund (QEF)

Election by each shareholder
- not by the PFIC.

Information to come from the corporation. Current inclusion in gross income of the shareholder’s prorata share of the PFIC’s earnings and profits. §1293.

Can divide into the prorata shares of fund’s:

(i) Net capital gains, and
(ii) Ordinary income. §1293(a)(1).
§1294 does permit the PFIC – QEF election shareholder to elect to defer the tax amount if no actual distribution has occurred.

No deferral if §951 applies.

Deferral is subject to an interest charge.

Loan to a shareholder is treated as a distribution. §1294(f).
Available for “marketable stock” of PFIC.

§1296 – U.S. shareholder includes in (ordinary) income the excess of fair market value of the PFIC stock at close of year over basis (as previously adjusted).

Treated as ordinary income.

What if loss? Permitted to the extent of the “unreversed inclusions”. Treated as ordinary loss. §1296(a)(2).
PFIC provisions apply even if no CFC status. Apply even to less than 10 percent ownership by U.S. shareholder in PFIC.

CFC provisions of Subpart F apply to more income types. PFIC only applies to passive income.

PFIC ends benefits of deferral for all income of the PFIC, not limited to specified types of gross income. PFIC has a more complete termination of deferral of income recognition.
Tax Avoidance is a CFC under §957(a): Two “United States shareholders” holding more than 50%:

U.S. parent owns 40 shares and Sam (U.S. citizen) owns 12 shares; no attribution to Sam from NRA sister - §958(b)(1).
Tax Avoidance is a PFIC under §1297(a):

Meets the 50% passive assets test (based on tax basis ratios).

§1297(a)(2) & §1297(f)(2)(A).
1. U.S. shareholders are U.S. Parent (40%) and Sam (20%).
2. US Parent and Sam have constructive dividends for pro rata shares of Tax Avoidance’s $6.5 million Subpart F income: (i) $5.5 million dividends and capital gains (§954(c)(A) & (B)) and (ii) $1 million FBC sales income (§954(d)).
1. PFIC provisions apply without regard to the amount of ownership. But, not treated as a PFIC for those persons treated as U.S. shareholders of a CFC. §1297(e). This is applicable to U.S. Parent & Sam.

2. Alexandra (indirect ownership), (ii) USA, Inc., and (iii) John are subject to the PFIC rules. Options for them: interest charge or QEF. No “mark-to-market” option.
1. Stock would constitute “marketable stock” within the meaning of §1296(e).
2. Those shareholders subject to the PFIC rules could make the “mark to market” election under §1296.
Information returns (IRS Form 5471):

§6046 – information of formation of the foreign corporation.

§6038 – annual information by every person who is in control of a foreign corporation.
Options for Foreign Income Taxation:

1) Current Full Inclusion

2) Subpart F Structure

3) Foreign corporation dividend exemption.

See:
House Ways & Means draft of Tax Reform Act of 2014 (February 26, 2014)
Senate Finance Committee Discussion Draft of Provisions to Reform International Business Taxation (Nov. 19, 2013)
JCT 2005 Options Paper
Bush 2005 Tax Panel Recommendations
2000 U.S. Treasury Study
**Problem – U.S. Cleanliness and Camclean Foreign Sub.**

**Issues:**

A) **Right of the U.S. to tax under international law?**

B) **What basis for the exercise of tax jurisdiction by the IRS?**

C) **Taxability in the United States?**

D) **If taxability, then how:** on (i) a gross withholding basis or (ii) a net income basis?

**Camclean earns:**

1. **US Interest** (portfolio interest?)
2. **US Royalties**
3. **US Dividends**
4. **Capital Gains on US stock**
5. **Gains from sale of US IP**
6. **Service Income in Compania**
7. **Dividends from US subsidiary**
8. **Service Income from US branch**