Retroactive Tax Planning Re: U.S. Shareholders of Foreign Corporations

Saturday, June 14, 2014

Converting Subpart F Income into Qualified Dividends

U.S. shareholders of foreign corporations are generally not subject to tax on the earnings of such corporations until the earnings are repatriated to the shareholders in the form of a dividend. Moreover, when a foreign corporation is resident in a jurisdiction with which the United States has a comprehensive income tax treaty, the dividends distributed to its individual U.S. shareholders are eligible for reduced qualified dividend tax rates (currently taxed at a maximum federal income tax rate of 20 percent).

Where a foreign corporation is classified as a “controlled foreign corporation” (“CFC”) for an uninterrupted period of 30 days or more during any taxable year, however, its U.S. shareholders must include in income their pro rata share of the Subpart F income of the CFC for that taxable year, whether or not such earnings are distributed. A CFC is a foreign corporation, more than 50 percent of which is owned (by vote or value), directly or indirectly, by “U.S. shareholders.” A U.S. shareholder, for the purpose of the CFC rules, is a U.S. person who owns, directly, indirectly or constructively, at least ten percent of the combined voting power with respect to the foreign corporation.

In addition to the inability to defer taxation on its share of a CFC’s subpart F income, one of the pitfalls of a U.S. shareholder owning stock in a CFC is that subpart F income is treated as ordinary income to the U.S. shareholder (currently taxed at a maximum federal income tax rate of 39.6 percent), regardless of whether the CFC is resident in a jurisdiction that has an income tax treaty with the United States. Therefore, the U.S. shareholder would not be able to repatriate its profits at qualified dividend rates.

Among other things, subpart F income generally includes passive investment income (e.g., interest, dividends, rents and royalties) and net gain from the sale of property that gives rise to passive investment income. Gain on the sale of stock in a foreign corporation, for example, falls within this category. Consequently, when a CFC sells stock of a lower-tier corporation, the U.S. shareholders of the CFC will have to include their share of the gain from the sale as subpart F income, which will be taxed immediately at ordinary income rates.

Check-the-Box Elections

Pursuant to the “check-the-box” entity classification rules, a business entity that is not treated as a per se corporation is an “eligible entity” that may elect its classification for federal income tax purposes. An eligible entity with two or more members may elect to be classified as either a corporation or a partnership. An eligible entity with only one member may elect to be classified as either a corporation or a disregarded entity.
Generally, the effective date of a check-the-box election cannot be more than 75 days prior to the date on which the election is filed. However, Rev. Proc. 2009-41 provides that if certain requirements are met, an eligible entity may file a late classification election within 3 years and 75 days of the requested effective date of the election. These requirements may be met if:

1. The entity failed to obtain its requested classification solely because the election was not timely filed
2. The entity has not yet filed a tax return for the first year in which the election was intended
3. The entity has reasonable cause for failure to make a timely election

The conversion from a corporation into a partnership or disregarded entity pursuant to a check-the-box election results in a deemed liquidation of the corporation on the day immediately preceding the effective date of the election. Distributions of property in liquidation of the corporation generally are treated as taxable events, as if the shareholders sold their stock back to the corporation in exchange for the corporation’s assets. As a result, the corporation shareholders would recognize gain on the liquidating distributions to the extent the fair market value of the corporation’s assets exceeds the basis of the shareholders’ shares. In addition, subject to limited exceptions, the corporation generally would recognize gain on the liquidating distribution of any appreciated property.

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A CFC that elects to convert from a corporation into a partnership or disregarded entity generally would recognize Subpart F income on the deemed liquidation, to the extent it holds property that gives rise to passive investment income (such as stock in subsidiary corporations). The subpart F income inclusion rules only apply, however, when the foreign corporation has been a CFC for a period of 30 uninterrupted days in the given taxable year. Where the election is made effective as of January 2, the liquidation of the foreign corporation would be deemed to occur on January 1 of that year. Because the foreign corporation would be deemed to have been liquidated on January 1, it would not have been a CFC for 30 days during the year of liquidation. As a result, subpart F income would not be triggered on the deemed liquidation of the foreign corporation.

In addition, as a result of the check-the-box election, a U.S. shareholder of the foreign corporation would recognize gain on the deemed liquidation as if the shareholder sold its stock back to the corporation in exchange for the corporation’s assets. Section 1248(a) provides, however, that when a U.S. person sells or exchanges its shares in a foreign corporation that was a CFC during the 5-year period prior to disposition, the gain from the sale is recharacterized as a dividend to the extent of the allocable share of the earnings and profits of the foreign corporation. To the extent the foreign corporation is resident in a country with which the U.S. has an income tax treaty, its individual U.S. shareholders would be eligible for the reduced qualified dividend income tax rate on such dividend.

This may be illustrated by the following example:

A, a U.S. individual, is the sole shareholder of X, a foreign corporation resident in a country with which the United States has a comprehensive income tax treaty. X owns 40 percent of the shares of Y, another foreign corporation. In October 2013, X sells all of its shares of Y. X is a CFC and the net gain from the sale of the Y shares constitutes subpart F income. As a result, the gain would have to be included in A’s gross income as ordinary income. Instead, X files a retroactive check-the-box election pursuant to Rev. Proc. 2009-41 to be treated as a disregarded entity as of January 2, 2013. The election results in a deemed liquidation of X on January 1, 2013. Because X has not been a CFC for a period of 30 uninterrupted days in 2013, however, subpart F income is not triggered on the deemed liquidation of X. In addition, the gain recognized by A on the deemed liquidation of X is recharacterized as a dividend and subject to tax at the reduced rates applicable to qualified dividend income.

As a result, the combination of Section 1248(a) and the retroactive check-the-box rules allows individual U.S. shareholders of a CFC to convert gain that would be realized upon the sale of the CFC’s assets from subpart F income (taxed as ordinary income at rates up to 39.6 percent) to qualified dividend income (currently taxed at 20 percent). Following the deemed liquidation of the foreign corporation, because all of the assets would be deemed to have been distributed to the shareholders in complete liquidation of the corporation, and the shareholders would recognize gain on the receipt of the assets, the basis of the assets would be stepped up to fair market value, reducing or eliminating gain recognized upon the subsequent sale of the assets of the former CFC.

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