Calculating Foreign Sourced Dividends-Received Deduction After Tax Reform

TUESDAY, JANUARY 8, 2019, 1:00-2:50 pm Eastern

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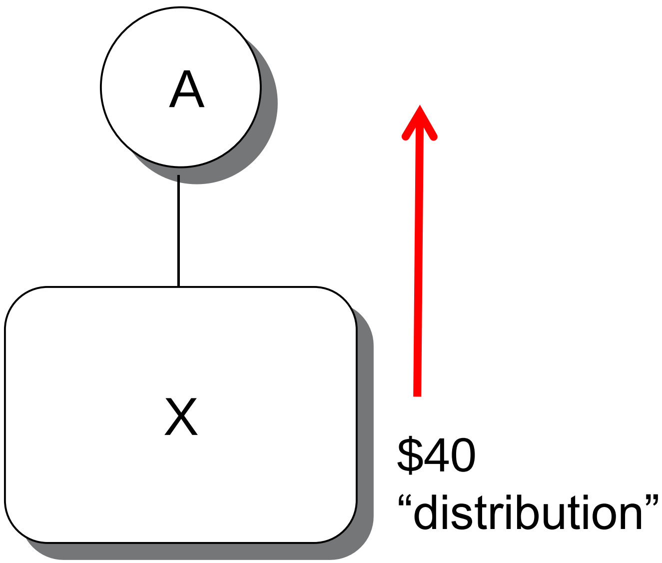
Strafford: Section 245A Foreign Sourced Dividends-Received Deduction

Corporate Distributions – Background

“Distribution” Defined



What is a distribution?

- Any payment by a corporation to its shareholders with respect to their stock.
- Unless otherwise classified as distributions under the common law “disguised or constructive dividend” principles, non-stock related payments to shareholders (*e.g.*, salary, interest, or rent) are not distributions (and hence cannot be dividends).

Constructive Distributions

— Excess compensation (especially if corporation closely held)

— Uneconomic sales, loans, or leases from corporation to shareholders

— “Interest” on (nominal) debt that is really equity

— Corporate payments (*e.g.*, of expenses or other shareholder obligations) on behalf of shareholders

— Bargain sale (or other non-arm’s length transfers) between brother-sister subsidiaries (or other commonly controlled corporations)

Amount of Distribution Received – Section 301(b)

- FMV of property on the day of the distribution, reduced by liabilities assumed by the recipient shareholder (or by the amount of liabilities to which distributed property is subject)
  - Generally, a recourse liability is assumed if the shareholder has agreed to, and is expected to satisfy the liability (or portion of the liability). A nonrecourse liability is assumed if the shareholder takes the property subject to the liability
  - Not below zero

Shareholder's Basis in Distributed Property

- Under section 301(d), a shareholder takes a FMV basis in distributed property.

Definition of “Dividend”

- Section 316(a) – A distribution by a corporation of “property” to a shareholder (with respect to its stock) out of either the corporation’s:
  - Current E&P; or
  - Accumulated E&P
- Unlike interest, dividends are not deductible by payor corporation. In this sense, the tax law favors debt over equity.
- Property is defined under section 317(a) as money, securities, and any other property (other than stock in the corporation making the distribution or rights to acquire such stock).

Treatment of “Ordinary” Nonliquidating Distributions – Section 301(c)

— Section 301(c)(1): Distribution treated as dividend (as defined in section 316) to extent of E&P.

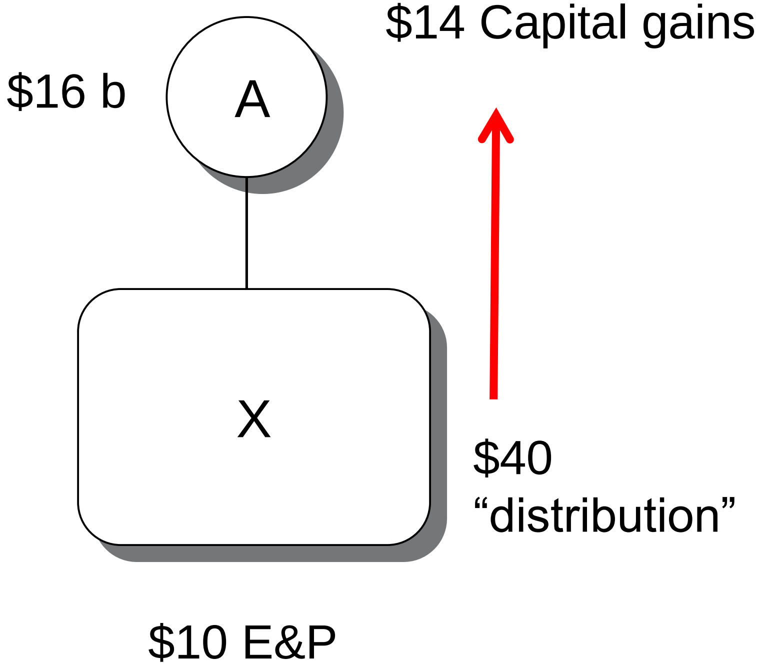
— Section 301(c)(2): Distribution treated as reduction in shareholder’s stock basis if no E&P (or E&P has been fully reduced pursuant to section 301(c)(1)).

— Section 301(c)(3): Distribution treated as capital gain to shareholder once basis has been fully absorbed pursuant to section 301(c)(2) (or shareholder had no basis prior to distribution).

Special rules for consolidated groups

Dividend

$10 Dividend
$16 Basis reduction
$14 Capital gains

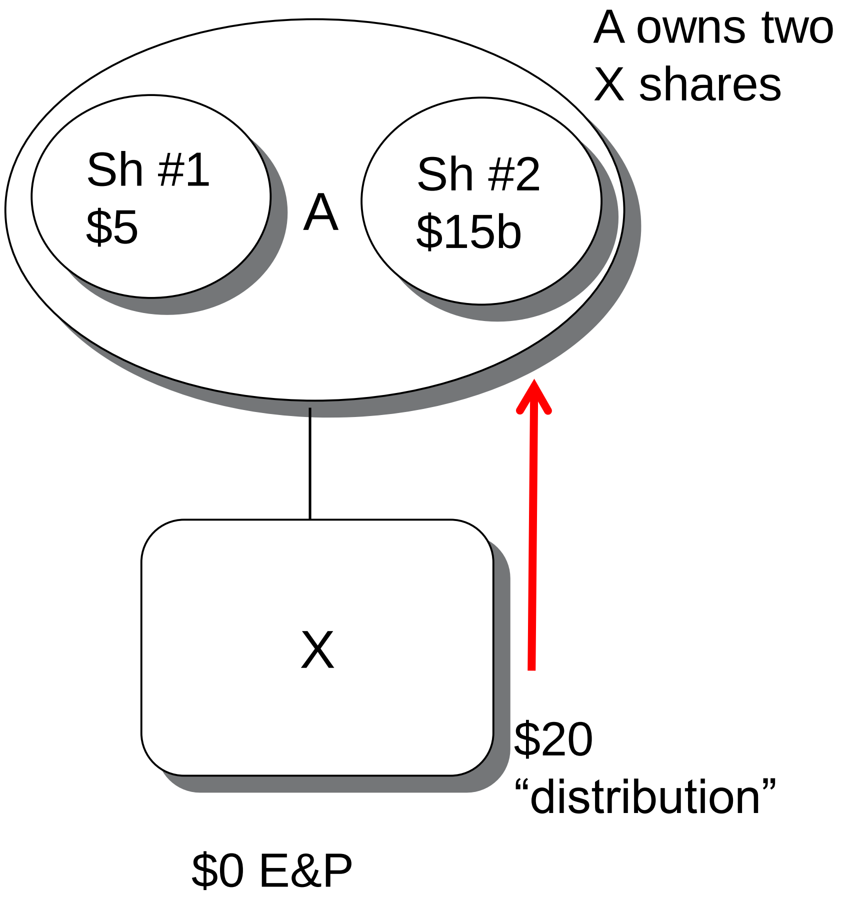


<u>301(c)(1)</u>:
Dividend to extent of E&P

<u>301(c)(2)</u>: Reduction in basis

<u>301(c)(3)</u>: Capital gain

Section 301(c)(2) pro rata basis access



<u>301(c)(2)</u>: Reduction in basis
Distribution pro rata to each share;
Johnson, (5th Cir. 1971)

$10 distribution on Share #1:
Reduce basis from $5 to $0
$5 capital gain

$10 distribution on Share #2
Reduce basis from $15 to $5

DRD Provisions, In General

Section 243, In General

- Generally allows domestic corporate shareholders a deduction for a portion of dividends received from domestic corporations. Section 243(a)
- Amount of deductible portion depends on the percentage of stock held by corporate shareholder
  - 50% DRD: Corporate shareholder owns less than 20% of the stock. Section 243(a)(1) (was 70% prior to Tax Reform)
  - 65% DRD: Corporate shareholder owns at least 20% (vote and value) of stock and no affiliation. Section 243(c) (was 80% prior to Tax Reform)
  - 100% DRD: Corporate shareholder and distributing corporation are part of the same affiliated group. Section 243(a)(3) and (b)
- If P and S file consolidated returns, section 243 does not apply and P excludes income pursuant to Reg. 1.1502-13(f)(1)(ii)

Section 246, In General

- Section 246 places several limitations on the DRD under sections 243, 245, and 245A
  - No DRD is available for dividends from tax-exempt corporations or for corporate shareholders receiving dividends from federal home loan banks. Section 246(a)
  - DRDs are limited to the percentage amount of the corporate shareholder's taxable income that matches the DRD (the "Aggregate DRD Limitation"). Section 246(b). For example, a corporate shareholder's 65% DRD under section 243(a)(1) is limited to 65% of the shareholder's taxable income.
    - The Aggregate DRD Limitation is determined without regard to NOL deductions, the section 199A deduction, capital loss carrybacks, basis reductions under section 1059, and the DRD itself.
    - The Aggregate DRD Limitation does not apply, however, if taking the DRD creates or increases an NOL. Section 246(b)(2).
    - If a corporate shareholder is taking both a 50% and a 65% DRD, the Aggregate DRD Limitation is computed first with regards to the 65% DRD.

Section 246 – Aggregate DRD Limitation Example 1

Facts

— Parent owns 25% of Sub.

— Parent has $100,000 of taxable income before applying the 65% DRD.

— Included in Parent's taxable income are $80,000 of dividends from Sub.

Analysis

— Parent's tentative DRD is $52,000 ($80,000 X 65%).

— Parent's Aggregate DRD Limitation is $65,000 ($100,000 X 65%).

— Parent should have taxable income of $48,000 after the DRD ($100,000 – $52,000).

Section 246 – Aggregate DRD Limitation Example 2

Facts

- Parent owns 25% of Sub.
- Parent has $65,000 of taxable income before applying the 65% DRD.
- Included in Parent's taxable income are $100,000 of dividends from Sub.

Analysis

- Parent's tentative DRD is $65,000 ($100,000 X 65%).
- Parent's Aggregate DRD Limitation is $42,250 ($65,000 X 65%).
  - Thus, Parent is limited to a DRD of $42,250.
- Parent should have taxable income of $22,750 after the DRD ($65,000 – $42,250).

Section 246 – Aggregate DRD Limitation Example 3

Facts

— Parent owns 25% of Sub.

— Parent has $64,000 of taxable income before applying the 65% DRD.

— Included in Parent's taxable income are $100,000 of dividends from Sub.

Analysis

— Parent's tentative DRD is $65,000 ($100,000 X 65%).

— Parent's Aggregate DRD Limitation is $41,600 ($64,000 X 65%).

— Because the DRD would create an NOL of $1000 ($64,000 – $65,000), the Aggregate DRD Limitation does not apply. Accordingly, Parent should have taxable income of ($1,000) after the DRD ($64,000 – $65,000).

— **Compare with Example 2** – because the rule of section 246(b)(2) creates a "cliff effect," Parent is incentivized to find additional deductions (or defer income) to reduce its taxable income below the level of the Aggregate DRD Limitation. In other words, Parent can take a DRD of $65,000 when taxable income is $64,999, but may only take a DRD of $41,600 when taxable income is $65,000.

Section 246(c)(1): Holding Periods

- No DRD is permitted on stock that is held for 45 days or less during the 91 day period beginning on the date which is 45 days before the date on which shares become ex-dividend (the date when the shareholder becomes legally entitled to the dividend). Section 246(c)(1)(A).
  - The declaration of an ex-dividend date is a procedure of a stock exchange that is used to prevent misunderstandings between parties selling shares as to who will be the recipient of dividends paid after the contract for sale is entered into. The ex-dividend date is normally set for stocks two business days before the record date. If you purchase a stock on its ex-dividend date or after, you will not receive the next dividend payment. Instead, the seller gets the dividend. If you purchase before the ex-dividend date, you get the dividend.
- Holding period tolled when risk of loss diminished (e.g., swap or hedge). Section 246(c)(4).

Holding Periods – Example

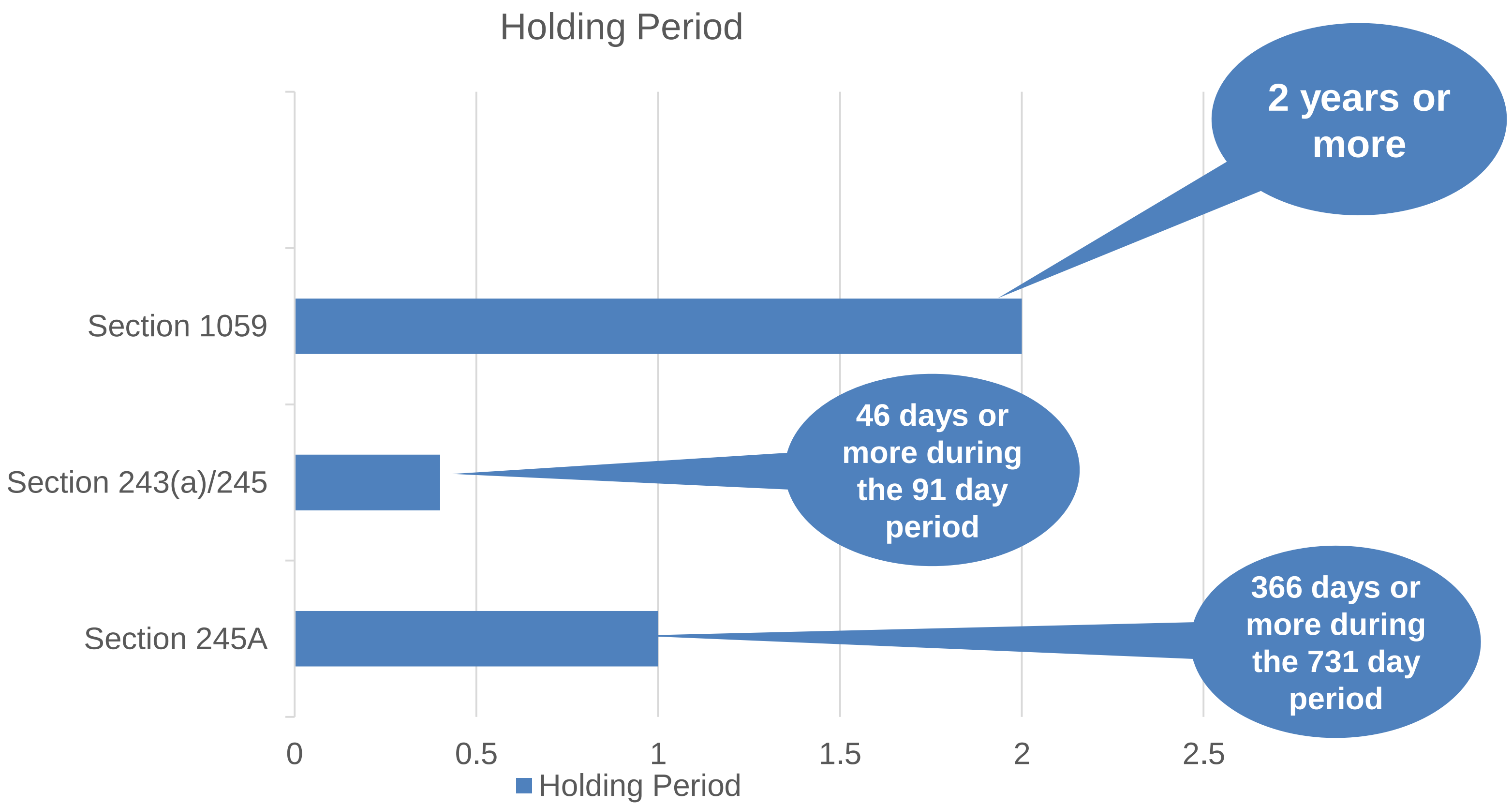
- On July 27, 2004, Company XYZ declares a dividend payable on September 10, 2004 to its shareholders. XYZ also announces that shareholders of record on the company's books on or before August 10, 2004 are entitled to the dividend. The stock would then go ex-dividend two business days before the record date.
  - Declaration Date: 7/27/2004
  - Ex-Dividend Date: 8/6/2004
  - Record Date: 8/10/2004
  - Payable Date: 9/10/2004
- Here, the record date falls on a Tuesday. Excluding weekends and holidays, the ex-dividend is set two business days before the record date or the opening of the market – in this case on the preceding Friday. This means anyone who bought the stock on Friday or after would not get the dividend. At the same time, those who purchase before the ex-dividend date receive the dividend.
- With a significant dividend, the price of a stock may move up by the dollar amount of the dividend as the ex-dividend date approaches and then fall by that amount after the ex-dividend date.

Section 246(c)(2) and (5): Holding Periods

- In the case of dividends received on stock with a preference to dividends, the holding period requirement is extended such that no DRD is allowed if the shareholder held the stock for 90 days or less during the 181 day period beginning on the date which is 90 days before the date on which shares become ex-dividend. Section 246(c)(2)
- For purposes of section 245A (discussed in more detail below), no DRD is allowed if the shareholder held the stock for 365 days or less during the 731 day period beginning on the date which is 365 days before the date on which shares become ex-dividend. Section 246(c)(5)
- **Note** – section 1059, discussed in more detail below, imposes a 2 year holding period on the shareholder

Holding Periods

- **What are the holding periods?**



- To determine holding period, count the disposition day but not the acquisition day.

Section 243(e), In General

- Section 243(e) generally provides for a DRD for a domestic corporation with respect to dividends received from a foreign corporation that is a successor to a domestic corporation and which has U.S.-sourced E&P
- The limitations imposed by section 246, discussed above, apply to section 243(e)

Section 245, In General

- Section 245 provides two sets of rules whereby a domestic corporation may take a DRD for the U.S.-sourced portion of dividends received from foreign corporations.
- First, a domestic corporate shareholder that owns 10 or more (by vote and value) of a foreign corporation is allowed a DRD for the U.S.-source portion dividends paid by the foreign corporation. Section 245(a)
  - The deduction is available only for corporate shareholders. Domestic corporations that own through domestic partnerships appear to be entitled to the deduction. See Treas. Reg. 1.702-1(a)(5).
  - It applies only to dividends paid by "qualified 10-percent owned foreign corporations" ("QFC") – **note:** not restricted to CFCs.
  - It does not apply to dividends from a PFIC or amounts treated as dividends under section 1248.
  - It applies only to the U.S. source portion of the dividends. Special sourcing rules apply. See section 245(a)(3) and the following slide.
  - The section 246(c)(1) holding period rules apply.
  - No foreign tax credit is available under section 901. The dividend is treated as U.S. source for purposes of section 904.

Section 245, In General (continued)

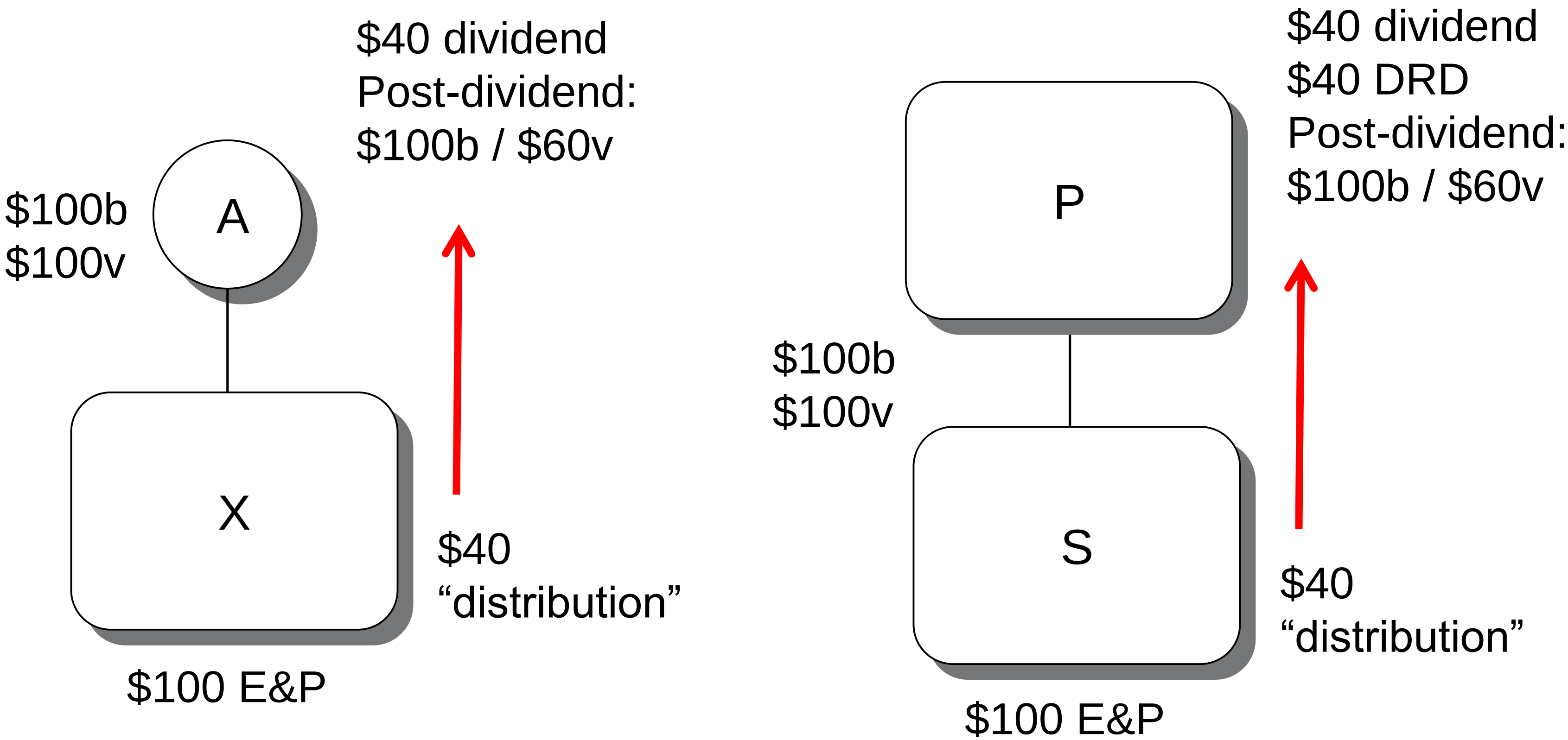
- Section 245(a) sourcing rules:
  - Under Section 245(a)(3), the "U.S.-source portion" of any dividend from the QFC is calculated based on the ratio of:
    - the "post-1986 undistributed U.S. earnings" of QFC to
    - the total "post-1986 undistributed earnings" of QFC
  - "Undistributed earnings" are calculated according to sections 964(a) and 986 and exclude previously taxed subpart F earnings ("PTI").
  - If the QFC's first year as a QFC is after 1986, this text only looks to earnings during years in or after which it was first a QFC.
  - "Post-1986 undistributed U.S. earnings" are that portion of the post-1986 undistributed earnings attributable to:
    - Income of QFC "effectively connected with the conduct of a trade or business within the U.S." subject to tax under Chapter 1 of the Code
    - Any dividend received, directly or indirectly, from any domestic corporation (other than a RIC or REIT) that is at least 80% owned (vote and value) by QFC

Section 245, In General (continued)

- Second, a domestic corporate shareholder that wholly-owns of a foreign corporation is allowed am 100% DRD for the U.S.-source portion dividends paid by the foreign corporation. Section 245(b)
  - Ownership of the foreign corporation may be direct or indirect, but the domestic corporation must own the stock of the foreign corporation during the taxable year in which the dividends are received
  - The foreign distributing corporation's gross income from all sources must be effectively connected with the conduct of a U.S. trade or business. Section 245(b)(2)

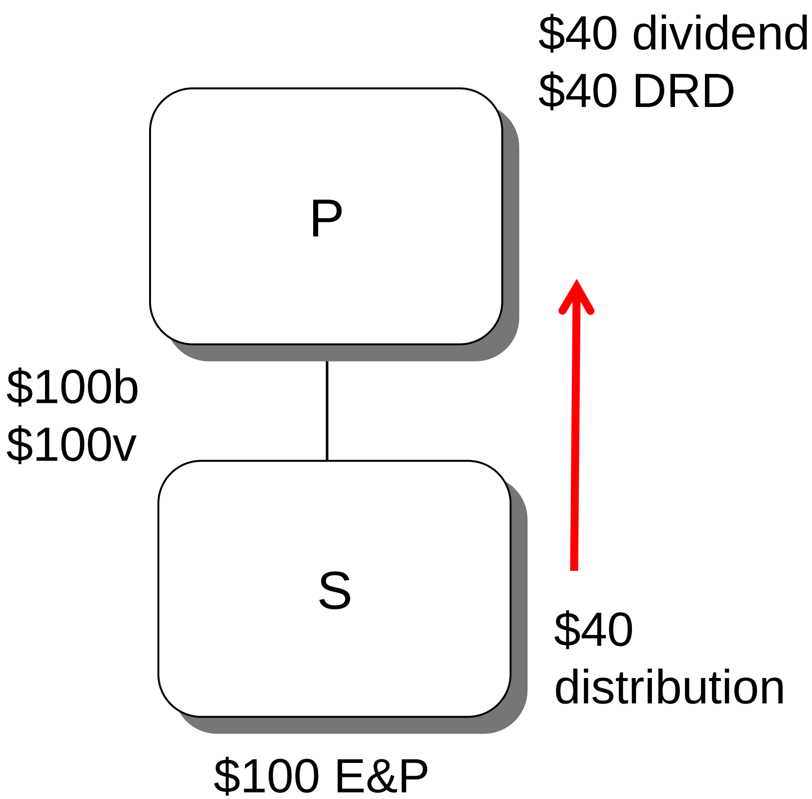
Section 1059

Basis in stock receiving dividend



P could sell X stock at a loss
Section 1059 addresses this result

Section 1059 Policy



Without section 1059
(outside of consolidation)

P received $40 dividend
subject to a $40 DRD

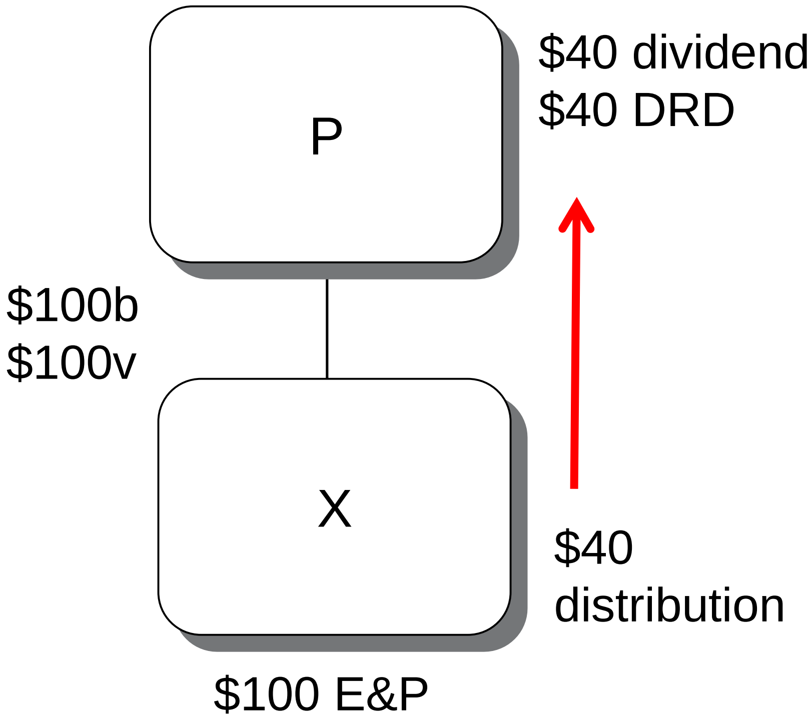
X declined in value from $100
to $40
BUT – basis remains $100

P could recognize $40 BIL
at no tax cost

Section 1059 - Generally

- Shareholder required to reduce basis in stock to the extent of the "non-taxed" portion of an "extraordinary dividend" unless stock held for more than two years before the dividend announcement date
  - Non-taxed portion: DRD
  - Extraordinary dividend: Dividend equaling or exceeding a threshold percentage (5% for pfd and 10% for other stock) of the stock basis
  - If basis goes below zero, shareholder recognizes gain to excess
- Holding period requirement –
  - non-pro rata redemptions and section 304 – 1059 applies regardless of period
  - Stock held for life of issuer – 1059 generally does not apply
- Does not apply if parties file consolidated returns
  - Instead: Investment basis adjustment rules; Reg. 1.1502-32

Section 1059



IF:
P and X not filing consolidated returns

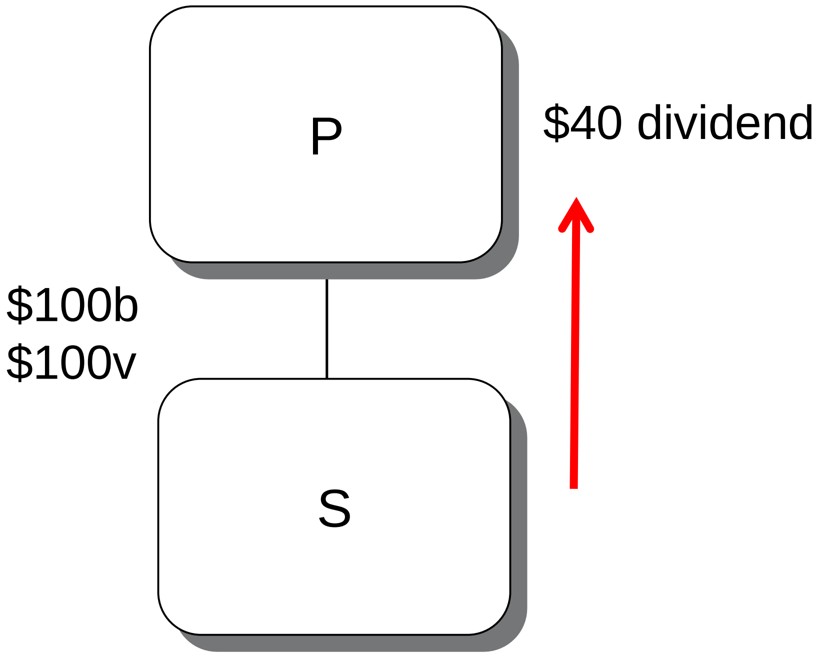
P acquired X stock within two years of distribution

P gets DRD for receipt of dividend

Dividend is “extraordinary”

THEN:
P reduces basis in S stock by amount of the DRD (to $60) and recognizes the excess, if any, as capital gain

If P and X File Consolidated Returns . . .



P does not take receipt of $40 into income
Reg. 1.1502-13(f)(2)(ii)

P reduces basis by amount of dividend:
$100b - $40b = $60b
Reg. 1.1502-32(b)(2)(iv)

If distribution exceeds P's basis, P creates an Excess Loss Account (negative basis) to the amount of the excess
Reg. 1.1502-19

Section 245A

Section 245A, In General

- **General Rule:** A U.S. corporation is permitted a deduction equal to the foreign source portion of any dividend received from a specified 10-percent owned foreign corporation if the U.S. corporation is a U.S. shareholder ("USSH") with respect to such foreign corporation. Section 245A(a).

Section 245A, In General (continued)

- **Specified 10-percent owned foreign corporation:** A foreign corporation with respect to which any U.S. corporation is a USSH. Section 245A(b).
  - USSH has the same meaning as for the controlled foreign corporation ("CFC") rules – a U.S. person within the meaning of section 957(c) (in this case a U.S. corporation) that owns 10 percent or more of the total vote or value of the stock of a foreign corporation. Section 951(b).
  - The term "foreign corporation" means any foreign corporation but does not include a passive foreign investment company ("PFIC") unless the PFIC is also a CFC. Section 245A(b)(2).

Section 245A, In General (continued)

— **Foreign-sourced portion:** the portion of undistributed earnings of the foreign corporation that are not attributable to ECI or to dividends received, directly or indirectly, from an 80-percent owned domestic corporation (determined without regard to whether the 80-percent owned domestic corporation is a RIC or a REIT). Section 245A(c); section 245(a)(5) and (12).

Section 245A, In General (continued)

- **Dividends Received:** Includes:
  - Actual dividends paid by a 10-percent owned foreign corporation
    - Includes the USSH corporation’s distributive share of dividends received by a partnership that owns the stock of the 10-percent owned foreign corporation
  - Deemed dividends under section 1248
    - Generally, gain recognized by a USSH on the sale or exchange of stock in a CFC is recharacterized as dividend income to the extent of the CFC’s E&P accumulated while it was a CFC and attributable to the shares sold (including the earnings of lower-tier CFCs).

Section 245A, In General (continued)

- **Dividends Received:** Includes (continued):
  - Deemed dividends under section 964(e)
    - Generally, gain recognized by a CFC on the sale of stock in another CFC is treated as if the selling CFC were a U.S. person, such that section 1248(a) would apply
    - Special rule under section 964(e)(4) reclassifies the foreign-sourced portion of the dividend as subpart F income to the selling CFC (no exceptions apply)
    - USSHs of the selling CFC are allowed a section 245A(a) deduction for their inclusion under section 951 as if they had received a dividend from the selling CFC equal to their inclusion.
  - Ostensibly, the all E&P amount within the meaning of Reg. 1.367(b)-2(e)

Section 245A, In General (continued)

- **Dividends Received:** What is a dividend received?
  - Section 245A(a) speaks only to dividends received by a domestic corporation from a 10-percent owned foreign corporation.
    - Does not apply to income earned by the domestic corporation through a foreign DRE/branch or income earned by individuals (U.S. or foreign)
  - Subpart F and GILTI inclusions under sections 951 and 951A, respectively, do not qualify even if dividends are actually distributed during the same year because the subpart F and GILTI inclusions are not dividends.
  - Thus, in practice, the section 245A DRD is limited to returns on investments in tangible assets for CFCs with low-tax earnings, as passive returns are expected to be covered under subpart F (unless an exception applies, e.g., high-tax) or included as income under the GILTI rules.
  - Uncertain how the participation exemption applies in consolidation. Regs. 1.1502-11(a)(7), -12(n), -26 provide that DRDs are determined on a consolidated basis, but they do not include a reference to section 245A.

Section 245A, In General (continued)

- **Dividends Received:** Does 245A apply to foreign-to-foreign dividends?
  - Section 245A(a) speaks only to dividends received by a domestic corporation.
  - However, legislative history provides:
    - "[i]ncluding a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. Treas. Reg. 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income." Conference Report, footnote 1486 (emphasis added).
  - Additionally, Reg. 1.952-2(b)(1) provides that the taxable income for a foreign corporation for any taxable year is determined by treating the foreign corporation as a domestic corporation taxable under section 11 and by applying the principles under section 63.
  - Consider whether the anti-hybrid rules, discussed below, also support the application of the Section 245A DRD to foreign-to-foreign dividends.

Section 245A, In General (continued)

— **Extraordinary Dividends Under Section 1059:**

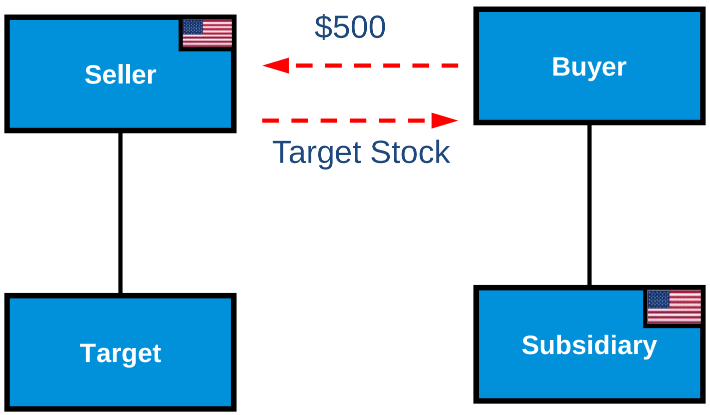
- Under section 1059, a corporation that receives (and is allowed to deduct any part of) an "extraordinary dividend" is required to: (i) reduce stock basis by the amount of the DRD, and (ii) recognize gain to the extent the DRD exceeds its stock basis.
- Section 1059(a) applies with respect to the non-taxed portion of a dividend (*i.e.*, the DRD under sections 243, 245, and 245A).
- Generally, an extraordinary dividend:
  - is paid on stock held by a corporation for less than 2 years (exception for stock held the entire existence of dividend-paying corporation, unless E&P inherited from another corporation), and
  - equals or exceeds:
    - 5% of the taxpayer's basis in preferred stock, or
    - 10% of the taxpayer's basis in any non-preferred stock
    - **note**: dividends paid within one year can be aggregated for this determination.
- Section 1059(e) creates a *per se* list of extraordinary dividends (*i.e.*, extraordinary without regard to holding period or amount), including dividends arising from:
  - Non-pro rata redemptions (including non-pro rata section 356(a)(2) "boot" dividends)
  - Dividend-equivalent section 304 transactions.

Special Rules for “Hybrid Dividends”

- The deduction under section 245A is not available if the dividend is a hybrid dividend.
  - A hybrid dividend is an amount received from a CFC for which a deduction would be allowed under section 245A, and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by a foreign country or possession of the U.S.
  - The denial of foreign tax credits (and deductions for foreign taxes) still applies.
- If the hybrid dividend is received by a CFC from a lower-tier CFC, the dividend is treated as Subpart F income and must be included in the income of the U.S. shareholder under the rules of section 951.
  - As noted above, it is uncertain whether section 245A applies to dividends received by CFCs.

Section 245A Examples

Target Stock Sale



Steps

— Buyer acquires 100% of Target from Seller for $500.

Considerations

— Seller will recognize gain of $200 on the sale of the stock (purchase price of $500 less tax basis of $300).

— Under section 1248(a), gain on a US taxpayer's sale or exchange of a CFC's stock is treated as dividend income to the extent of the untaxed E&P attributable to such stock accumulated in taxable years of the CFC beginning after December 31, 1962, and during the period the stock sold or exchanged was held by Seller while Target was a CFC.

— Section 1248 causes $25 of Seller's gain to be treated as a deemed dividend (i.e., to the extent of Target's untaxed E&P).

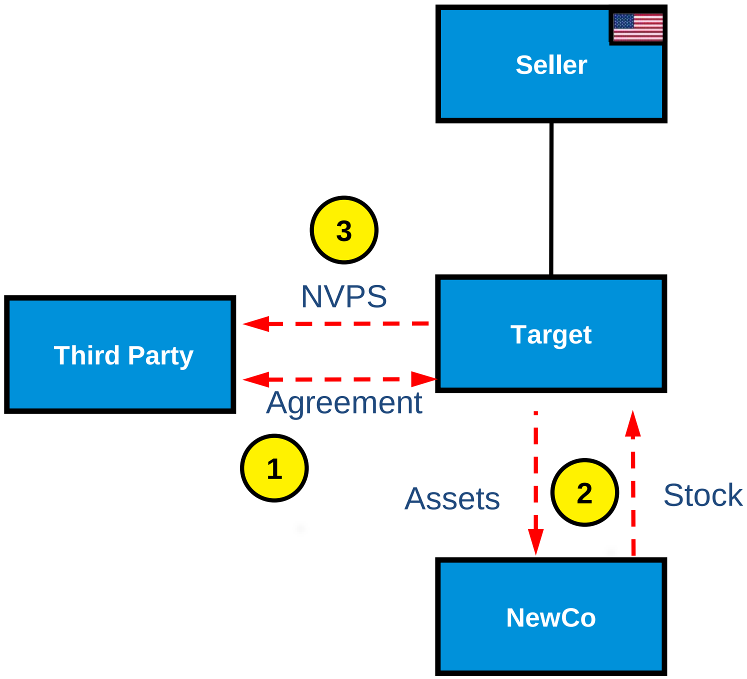
— Any gain treated as dividend as a result of section 1248 will also be treated as dividend to the extent a US taxpayer is eligible for the section 245A participation exemption.

— 100% deduction is allowed on the $25 of gain treated as a deemed dividend to Seller. The remaining $175 remains long-term capital gain and will be subject to 21% corporate tax rate

NOTE:

1. In the event that a US buyer, rather than a foreign buyer, acquires Target's stock on 12/30, the US buyer might be required to include GILTI and subpart F income in its gross income; however, section 951(a)(2)(B) could reduce the potential inclusion.

Busted Section 351 Transaction



Steps

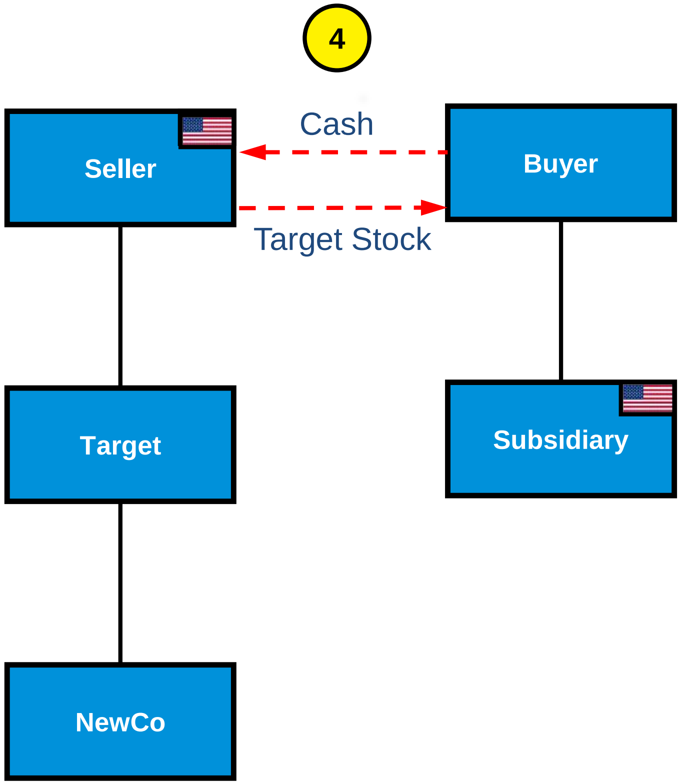
1. Target forms NewCo and enters into a pre-arranged binding commitment pursuant to which Target will sell NewCo's nonvoting preferred stock ("NVPS") to an unrelated third party buyer ("Third Party") immediately following a transfer of assets by Target to NewCo.
2. Target transfers all of its business assets with a FMV of $500 and a tax basis of $300 to NewCo solely in exchange for 100% of NewCo common stock and 100% of NewCo's NVPS, which may be a relatively small amount.
3. Seller sells NVPS to Third Party.

Considerations

— The sale of NewCo's NVPS to a Third Party pursuant to a binding commitment in place prior to the transfer of Target business assets to NewCo should cause such transfer to fail to qualify for nonrecognition treatment under section 351(a).

— Target will recognize $200 in gain (i.e., FMV of assets on the date of transfer less the tax basis). The gain will increase Target's previously untaxed E&P to $225 (i.e., $25 prior untaxed E&P plus $200).

Busted Section 351 Transaction (continued)



Steps

4. Buyer acquires 100% of Target stock for $500.

Considerations

— Seller will recognize $200 of gain on the sale of the stock (purchase price of $500 less tax basis of $300).

— Under section 1248(a), gain on a US person's sale or exchange of a CFC's stock is treated as dividend income to the extent of the untaxed E&P attributable to such stock accumulated in taxable years of the CFC beginning after December 31, 1962, and during the period the stock sold or exchanged was held by Seller while Target was a CFC.

— Section 1248 causes $200 of Seller's gain to be treated as a deemed dividend.

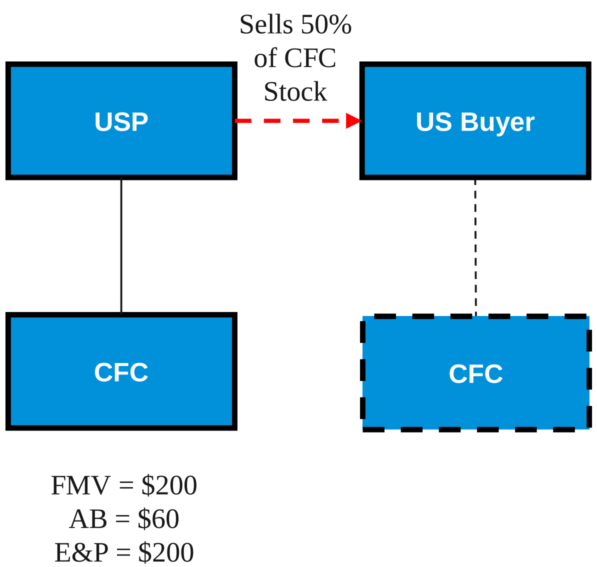
— Any gain treated as dividend as a result of section 1248 will also be treated as dividend to the extent a US taxpayer is eligible for the section 245A participation exemption.

— 100% DRD is allowed to Seller for the $200 deemed dividend.

NOTE:

1. In the event that a US buyer, rather than a foreign buyer, acquires Target's stock on 12/30, the US buyer might be required to include GILTI and subpart F income in its gross income; however, section 951(a)(2)(B) could reduce the potential inclusion.

Interaction of sections 245A, 1059, and 1248



Facts and Consequences

— USP has owned all the outstanding stock of CFC since the first day of the first tax year that CFC has E&P. After December 31, 2017, USP sells 50% of its interest in CFC to US Buyer for $100, recognizing $70 of gain.

Considerations

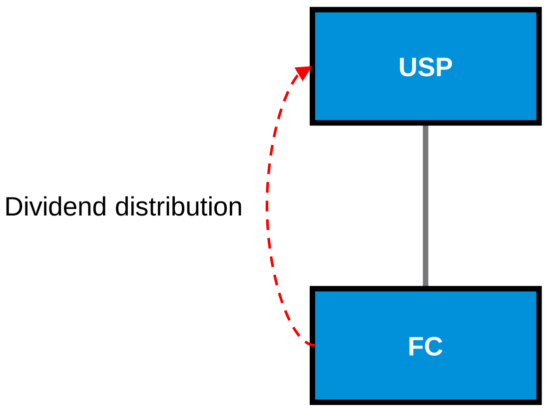
— Section 1248
  - All of the $70 of gain is recharacterized as a dividend under section 1248 (portion of the E&P attributable to the sold shares)

— Section 1059
  - If the $70 is an extraordinary dividend under section 1059, then USP reduces its basis in CFC immediately before the sale by the non-taxed portion (i.e., $70) of the dividend amount ($30 AB less $70 non-taxed portion of the dividend) to $0 (not below zero), resulting in total gain of $100 ($100 purchase price less $0 basis) and $40 of capital gain under section 1059(a)(2).
  - The $30 of additional gain under section 1059(a)(2) is recharacterized under section 1248 as dividend income eligible for a 100% DRD under section 245A

— Thus, $170 gain with $100 DRD on dividend portion resulting in a net gain of $70. Reduction of E&P at CFC is $0.

— The net effect of sections 245A, 1059, and 1248 is to revoke the benefit of section 245A and application of section 1248.

Section 245A(e) – Example 1



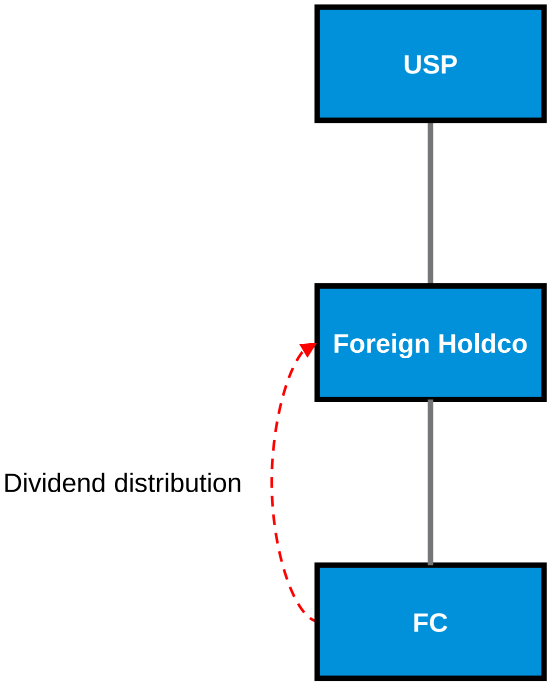
Facts

- USP directly owns 100% of FC. FC gets a deduction in its jurisdiction for dividends paid to USP. Assume FC has no PTI.
- FC makes a dividend distribution to USP:

Consequences

- Section 245A(e) applies because FC is allowed a tax benefit (i.e., the deduction) in its jurisdiction for the dividend paid.
- USP must include in income the full dividend, including the deducted amount that is deemed distributed or actually distributed.
- USP is also unable to take section 901 credits for any WHT or other taxes imposed by FC's jurisdiction on the dividend distribution.

Section 245A(e) – Example 2



Facts

— USP owns 100% of Foreign Holdco, Foreign Holdco owns 100% of FC. FC gets a deduction in its jurisdiction for dividends paid to Foreign Holdco. Foreign Holdco is allowed a participation exemption in its jurisdiction for dividends received from FC. Foreign Holdco's only source of income are dividends from FC. Assume FC has no PTI.

— FC makes a dividend distribution to Foreign Holdco.

Consequences

— Dividends paid by FC to Foreign Holdco are hybrid dividends under section 245A(e).

— Dividends received by Foreign Holdco are treated as Subpart F income to USP – no exceptions to Subpart F income are expected to apply. Section 245A(e)(2).

— USP cannot take FTCs with respect to hybrid dividend received by Foreign Holdco.

Section 245A(e) – Example 3

Brazil – INE Basics

— Under the INE rules, a Brazilian company can remunerate shareholders by creating an interest payable owed to their shareholders under a government-approved interest rate (an "INE Payable").

— INE for a given year is generally equal to the company's equity, multiplied by the central bank's long-term interest rate (such rate, the "TLJP").

— The INE Payable is deductible for Brazilian corporate income tax purposes at an effective rate of 34%; however, the INE payment to the shareholder is subject to a WHT of 15% or 25%.

— Thus, the potential net tax benefit in Brazil is a deduction of 19% or 9%, depending on the WHT rate.

— Because Brazil provides a deduction with respect to the INE payment, section 245A(e) is expected to apply to dividends received by a U.S. holder of CPECs.

Brazil – INE Basics (continued)

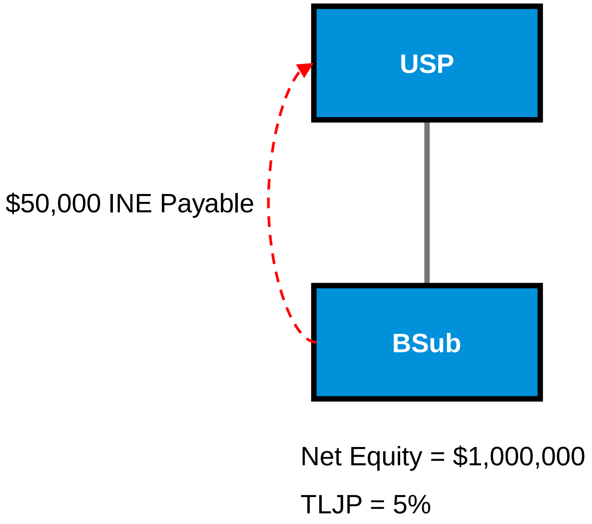
— Three ways to treat/use INE prior to Tax Reform

- Leave INE outstanding– Brazilian company gets deduction in Brazil but must pay 15% WHT, U.S. shareholder gets dividend (provided INE Payable is made unqualifiedly available on demand) with section 901/902 credits.
- Cash dividend – same results as above: Brazilian company gets deduction in Brazil but must pay 15% WHT, U.S. shareholder gets dividend with section 901/902 credits
- Capitalize INE – Brazilian company gets deduction and must pay 15% WHT; U.S. shareholder ignores distribution under circular cash-flow analysis to extent INE Payment is immediately contributed to Brazilian company pursuant to a pre-arranged plan.

— U.S. shareholder may credit/deduct a portion of WHT.

— Brazilian company has increased net equity, increasing potential INE Payable for subsequent year.

Section 245A(e) – Example 3 (continued)



Facts

— USP owns all of BSub, a Brazilian entity that may elect to create an INE payable.

— For the relevant taxable year, BSub has total net equity for INE calculation purposes of $1,000,000.

— The TJLP for the relevant taxable year is 5%.

— BSub can create an INE Payable of $50,000 (i.e., $1,000,000 total net equity multiplied by the 5% TJLP).

— Brazil would impose a 15% WHT on the $50,000, resulting in Brazilian tax of $7,500 and amount effectively remitted of $42,500.

— For Brazilian tax purposes, deducting the INE Payable would reduce taxes by $17,000 (i.e., $50,000 multiplied by 34%), resulting in estimated Brazilian tax savings of $9,500 (i.e., $17,000 of taxes at the corporate tax rate of 34%, reduced by the $7,500 of the 15% withholding tax).

Section 245A(e) – Example 3 (continued)

Impact prior to Tax Reform when INE is not created

— BSub makes distribution of $50,000 to USP.

— USP would have owed $17,500 of tax on the distribution ($50,000 multiplied by 35%), but would have been able to take the $17,000 of section 902 credits for taxes paid by BSub in Brazil ($50,000 multiplied times 34%) against its U.S. tax liability.

— Total tax paid would have been $17,500.

Impact prior to Tax Reform when INE is created

— USP would have owed $17,500 of tax on the distribution ($50,000 multiplied by 35%), but would have been able to take the $7,500 WHT as a credit against its U.S. tax liability.

— Total tax paid would have been $17,500.

Section 245A(e) – Example 3 (continued)

Impact of section 245A when INE is not created

- BSub would have to pay $17,000 of tax (i.e., $50,000 multiplied by 34%).
- When BSub distributes the $50,000 to USP, there is no residual tax due to the U.S. because section 245A(a) would apply.
- Accordingly, total tax paid on the $50,000 would be $17,000.

Impact of section 245A when INE is created

- BSub makes distribution of $50,000 to USP.
- Brazilian WHT due is $7,500.
- Under section 245A(e), because BSub gets a deduction for the INE Payable, the deemed dividend of $50,000 is a hybrid dividend and the participation exemption will not apply.
- **Note** that the amount of the INE Payable is $50,000 and not $42,500 (i.e., $50,000 less $7,500 WHT), because section 245A(e) would prevent USP from deducting (as well as crediting) the $7,500 WHT imposed by Brazil.
- USP would owe $10,500 of additional tax on the INE Payable ($50,000 multiplied by 21%).
- Total tax when the INE Payable is created is $18,000 (i.e., $10,500 U.S. tax plus $7,500 Brazilian tax).