

Subpart F Income Rules and Sections 956, 958, and 1248: Reporting Challenges of Controlled Foreign Corporations

THURSDAY, FEBRUARY 6, 2020, 1:00-2:50 pm Eastern

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Subpart F Income Rules and Sections 956, 958, and 1248

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Subpart F Income, GILTI, and Sections 956, 958 and 1248: Meeting the Reporting Challenges of Controlled Foreign Corporations

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TCJA Changes

- Substantial changes to existing US tax system after 1986 – biggest since I started practicing international tax
- Complex rules and calculations
- Transition to modified territorial system
- C Corporations seem to get favored treatment

Provisions – Pre TCJA

- Worldwide tax system
- *Special privilege given to US controlled foreign corporations to provide level playing field so that they could compete with MNCs from other countries.*
- Deferral of tax on income earned in foreign corporation until the profits are repatriated to U.S., say by dividend distribution
- This provision is however subject to anti abuse provisions
 - Subpart F (IRC 951 to 965)
 - Earnings invested in U.S. Property (IRC 956)
 - Passive Foreign Investment Companies (PFICs (IRC 1291 to 1298))

Provisions – Pre TCJA

Example:

- USS owns 100% of Ireland Corporation
- Net income of \$1,000,000 taxed in Ireland at 12.5% and distributed to USS -\$125,000
- USS includes this income on US tax return and pays tax at 35% corporate income tax rate - \$350,000
- *Total worldwide tax paid = \$350,000*

Participation exemption

- 100% DRD for a US Corporate shareholder for the “foreign source” portion of dividends received from specified 10% owned foreign corporation (IRC 245A)
- Caveats:
 - Holding period must be at least 1 year
 - Must be out of E&P excluding effectively connected income with US trade or business
 - Deduction available to only US C Corporations (Hybrid system)
 - No credit allowed for foreign tax or withholding taxes paid
- Effective for tax years of foreign corporations that begin after December 31, 2017 and for tax years of US shareholders in which such tax years of foreign corporations end. (in other words, distributions made after December 31, 2017)

Post TCJA

Example with same facts as before:

- USS owns 100% of Ireland Corporation
- Net income of \$1,000,000 taxed in Ireland at 12.5% and distributed to USS -\$125,000
- USS includes this income on US tax return and pays no tax due to DRD
- Total worldwide tax paid = \$125,000

Subpart F intermediate issues

- Subpart F framework
- Definition of Controlled Foreign Corporation “CFC”
- Direct, indirect and constructive ownership
- Who is U.S. shareholder?
- Taxation of U.S. shareholder
- S. 951 inclusion and who qualifies for inclusion
- Section 951A
- Subpart F income and Key exceptions
- Distributions of Previously Taxed Income
- Compliance Refresher

Objectives

- Describe categories of income subject to subpart F rules
- Determine a U.S. shareholder's pro rata share of subpart F income
- Identify the type of income that comprise subpart F income
- Identify the application of the deemed paid FTC to subpart F inclusions
- Describe the application of tested income and GILTI rules
- Describe how distributions of previously taxed income are taxed

Objectives (Cont.)

- Define E&P
- Identify the importance of foreign corporate E&P
- Explain the determination of foreign corporate E&P

Overview of Subpart F Provisions

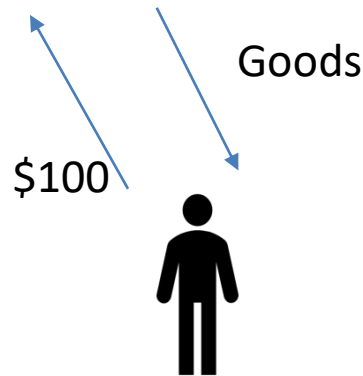
The Perceived Problem Prior to 1963

U.S. Companies with foreign subsidiaries

- Low tax outside of United States
- IRS could only tax “actual distributions”
- Strong incentive to defer U.S. taxation

Overview of Subpart F Provisions

The Perceived Problem Prior to 1963 (cont.)



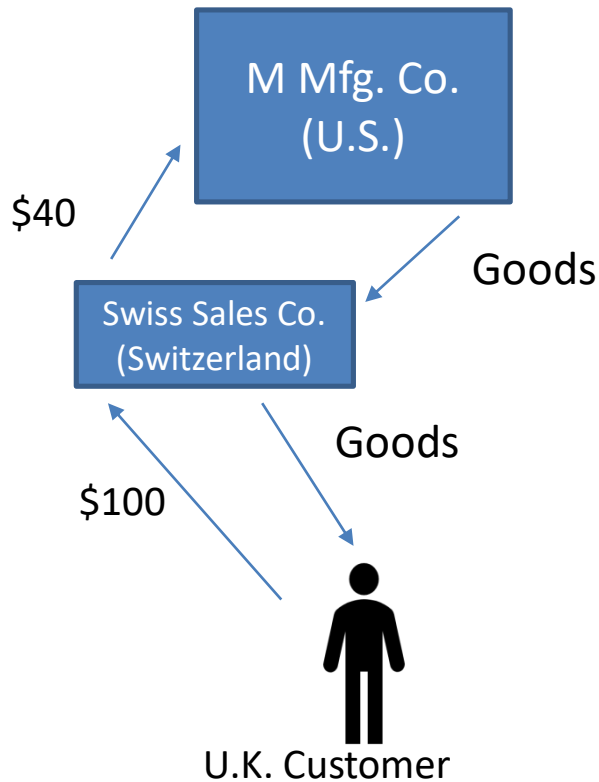
U.K. Customer

70% Tax
U.S. Co.

Sales	100
COGS	<u>(30)</u>
Profit	70
G&A	<u>(10)</u>
Income	60
Taxes	<u>(42)</u>
Cash Available	18

Overview of Subpart F Provisions

The Perceived Problem Prior to 1963 (cont.)



	70% Tax <u>U.S. Co.</u>	10% Tax <u>Swiss Co.</u>	Total <u>(With Elims)</u>
Sales	40	100	100
COGS	(30)	(40)	(30)
Profit	10	60	70
G&A	(10)	(10)	(20)
Income	-	50	50
Taxes	-	5	5
Cash Available	-	45	45

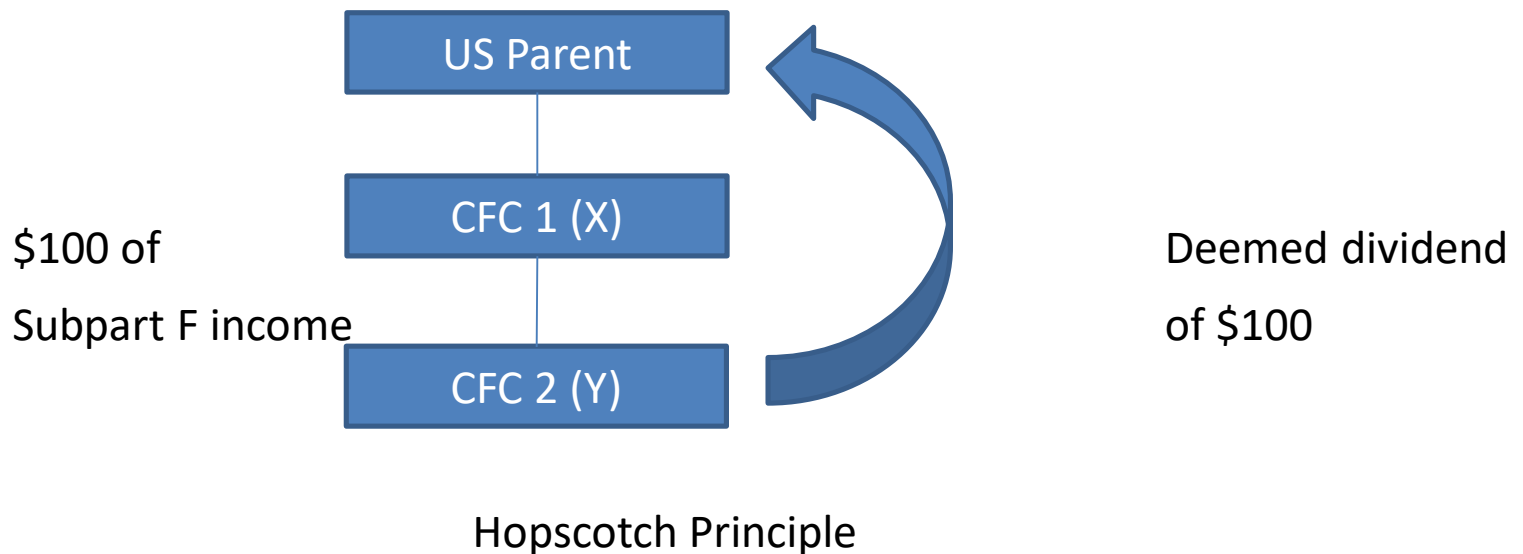
Overview of Subpart F Provisions

The Perceived Problem Prior to 1963 (cont.)

- Only “actual distributions” (now: S. 951 and 951A)
- Swiss Co. could “loan” cash to M (now: S. 956)
- Transfer Pricing was low risk (now: S. 482 and S. 6662)
- Sell Swiss shares for low tax capital gain (now: S. 1248)

Overview of Subpart F Provisions

- Created U.S. tax jurisdiction – “deemed” distributions
- “Tainted” income
- Applies to Controlled Foreign Corporations (CFC)



Who is subject to Subpart F?

- “U.S. shareholders” of a foreign corporation
- That is a “Controlled Foreign Corporation”;
and
- Such CFC earns “Subpart F income” or
increases its investment in “U.S. property”
- Post-2017, all CFC earnings are potentially
subject to GILTI for US shareholders

Is a Foreign Corporation a Controlled Foreign Corporation (CFC)?

- General Rule: five requirements – S. 957(a)
 - Any “foreign corporation”
 - Of which more than 50 percent of the total combined voting power or the total value of stock
 - Is owned (S958(a)) or considered as owned (S 958(b)) (Direct, Indirect or Constructive)
 - By “United States Shareholders” (S 951 (b), 957(c))
 - On **any day** during the taxable year of such foreign corporation
- If the five requirements are satisfied, any lower tier foreign subsidiary can be a CFC

Is the Entity a Foreign Corporation?

- Check-the-box rules simplify entity classification rules (Treas. Reg. S 301.7701-1 and the following)
- Classification turns on three determinations:
 - Does a separate business entity exist?
 - Is the entity a *per se* corporation?
 - What is its desired classification?

Greater than 50 percent Vote or Value Requirements

- S 957(a): **More than 50 percent** voting power or total value must be owned by U.S. shareholders
 - “Voting power” is power to elect, appoint, or replace directors
 - **Any** class of stock with these rights is counted
 - No definition of “total value” is provided
 - *Framatome Contractors USA Inc. v. Comm’r*, 108 Fed. Appx. 683 (2nd Cir. 2004)(The determination of whether more than 50 percent of the voting power of a foreign corporation is owned by U.S. shareholders depends on all facts and circumstances, including provisions of the corporate law of the country where the FC is incorporated)
- The value-of-stock test applies to determine if a corporation is a CFC

Indirect Ownership – S 958(a)(2)

- Indirect ownership **through foreign entities:**
- A U.S. person is deemed to own a pro rata amount of a foreign corporation's stock owned directly by a **foreign** corporation, **foreign** partnership, or **foreign** estate
- Proposed regs will extend this to **domestic** partnerships
- A U.S. person with a beneficial interest in a foreign trust that, in turn, owns stock of a foreign corporation is deemed also to own that foreign corporation's stock in proportion to the beneficial interest

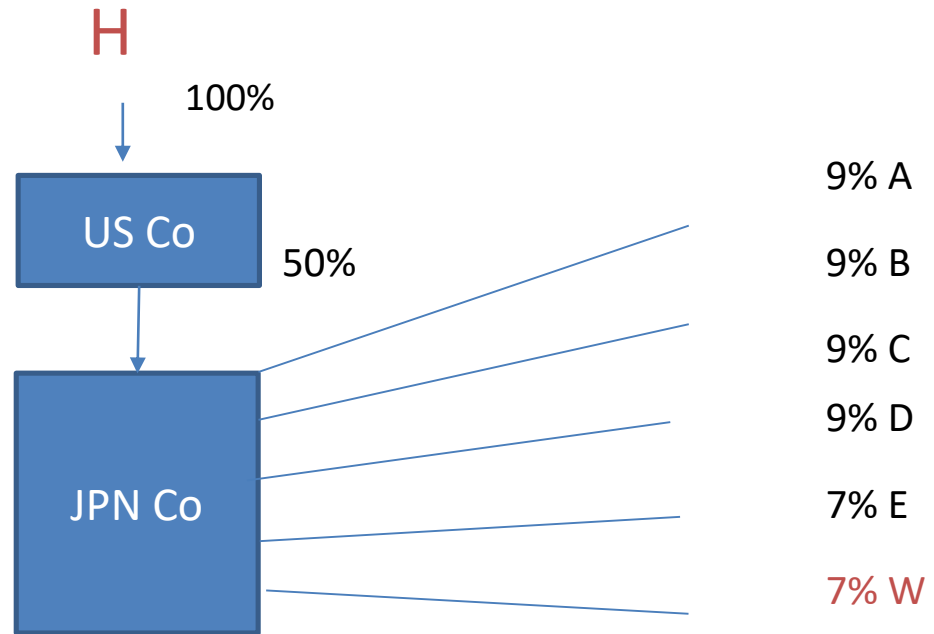
Indirect Ownership – S 958(a)(2) (Cont.)

- This rule creates a chain of ownership through attribution, which **stops with first U.S. person in the chain** (Treas. Reg. S.1.958-1(b)).
- The indirect ownership rules also are used to determine the subpart F inclusion received by the U.S. shareholders of the CFC

Constructive Ownership S 958(b)

- Constructive ownership rules apply
 - Section 318 attribution rules are modified
- Family attribution rules – S 958(b)(1)
 - Individuals are deemed to own the stock owned directly or indirectly by or for their spouse, children, grandchildren, and the parents. Stock owned by non resident individual (other than foreign trust or estate) shall not be considered as owned by a citizen or by a resident alien individual.
- Entity attribution rules – S 958(b)(2)
 - Stock owned directly or indirectly by or for a partnership, estate, or trust is considered to be owned proportionally by the partners or beneficiaries
- New Law amends constructive ownership rules (S 958(b)(4)) so that certain stock of foreign corporation owned by a foreign person is attributed to a related U.S. person for determining whether the related U.S. person is a U.S. shareholder of foreign corporation and therefore, whether the foreign corporation is a CFC – *Rev Proc 2019-40 provides certain safe harbors*

Attribution Rule Example



H&W are husband and wife. JPN Co is a CFC because W's 7% stock ownership is attributed to H under S. 958(b) and 318(a)(1)(A)(i). **Both H and W are US shareholders.**

U.S Shareholder/ U.S. Person

- U.S. shareholder defined in S 951(b):
 - A “United States person” who owns, or is considered as owning, 10 percent or more of the total value or the total voting power of all classes of stock entitled to vote in a foreign corporation
 - Direct, indirect, and constructive ownership rules of S 958 all apply
- U.S person defined in S 957(c) and S 7701(a)(30):
 - A citizen or resident of the United States
 - A domestic partnership
 - A domestic corporation
 - Any estate or trust other than a foreign estate or trust

Taxation of U.S. shareholders

- Year in which CFC has subpart F income
 - U.S. shareholder is taxed on pro rata share (S951)
 - U.S. corporate shareholder can claim foreign tax credit (S 960)
 - FTC basketing rule: same character as underlying subpart F income
- Actual dividend distributions in subsequent years (S 959)
 - Traced first to CFC's PTEP
 - Receipt of PTEP is tax free (except for possible FX gain)
 - U.S. shareholder cannot claim S 902 credit for taxes (including withholding taxes on dividend received) from 2018 tax year onwards as the code section is repealed by the new law. C-Corps receive DRD, individuals loose out.

Example

A U.S. person owns 80 percent of the value and 5 percent of the voting power of a foreign corporation. Is the U.S. person considered a “U.S. shareholder” of the foreign corporation for purposes of S 951?

A. Yes

B. No

Example - Solution

Answer:

B. Yes

- To be considered a U.S. shareholder, the U.S. person must own 10 percent or more of the voting power or value of foreign corporation

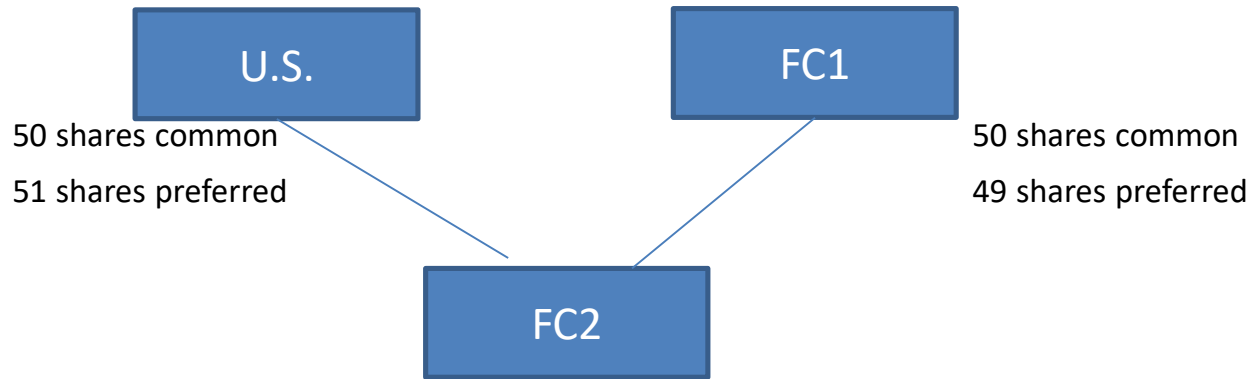
Who ‘Qualifies’ for S 951 Inclusion?

- Every U.S. shareholder who owns stock on the “last day” in the taxable year that the corporation is a CFC must include in income the shareholder’s pro rata share of the CFC’s subpart F income
- Only U.S. shareholders who own CFC stock under the S 958(a) direct and indirect ownership rules must take S 951 income into account
 - *S. 958(b) (constructive ownership) does not apply for this purpose*
- For S. 951(b) purposes (defining US Shareholder), stock ownership has always been computed, and continues to be computed using the “direct” and “indirect through foreign entities” of S 958(a) and the constructive attribution rules of S 958(b) (includes S 318 with significant modifications)
- Although constructive ownership rules are used to identify US shareholders and CFCs, income is included in proportion to each US shareholder’s direct and/or indirect ownership only. US shareholders are never subject to tax based on shares they own only constructively.
- Even for S 965 purposes, constructive ownership can cause S 965 to apply, however only the E&P of foreign corporations attributable to shares actually owned (directly or indirectly) are deemed repatriated.

U.S. shareholder Distinction

- Rule determining who is a U.S. shareholder is different from rule determining who must include subpart F income
 - CFC status test
 - Stock owned at any time during the tax year, and
 - Constructively owned stock relevant
 - Subpart F income test
 - Constructively owned stock irrelevant
- May still need to file Form 5471 even with no subpart F income

Is a Foreign Corporation a CFC?



Assumptions:

- Common stock and preferred stock have \$1 per share value
- Preferred stock is nonvoting stock
- US shareholder needs to own more than 50% of vote or value of FC2 for FC2 to be a CFC
- Total stock outstanding equals 200 shares which is equal to \$200 of value, total voting share is 100
- Total value owned by US is $101/200 = 50.5\%$

Result: FC2 is a CFC

What is the amount of S 951 inclusion?

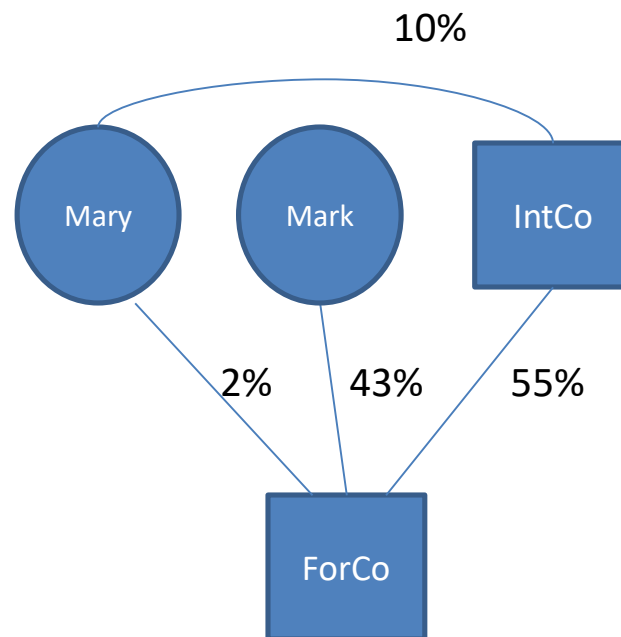
- Amount that would have been distributed with respect to stock the shareholder owns if CFC had distributed pro rata to its shareholders its subpart F income on the last day of the year
- Need to know the dividend entitlement of different classes of stock
- Special rules for:
 - Foreign corporations that are not CFCs for the entire year
 - U.S. shareholders that purchase stock on which a dividend was paid to previous shareholder in same year

Example

Pro Rata Share

What ownership rules apply when determining the percentage of foreign IntCo's subpart F income that Mary will include as a deemed dividend?

- A. Direct only (2%)
- B. Direct plus Indirect (7.5% = 2% + 5.5%)
- C. Direct plus constructive (12% = 2% + 10%)



% = Voting Power

Example Solution

Answer:

B. Direct plus indirect – 7.5%

- Mary owns 2% directly and 5.5% indirectly, resulting in a 7.5% share of any subpart F income
- Although the constructive ownership rules of S. 958(b) treat Mary as owning 12% of ForCo for purposes of determining whether Mary is a U.S. shareholder and ForCo a CFC, only the direct and indirect ownership triggers a subpart F inclusion under S 951.

30 day rule - repealed

- CFC status test is met
 - Stock owned at any time during the tax year, and
 - Constructively owned stock relevant
- Inclusion of Subpart F income for U.S. Shareholder (Below provisions repealed)
 - ~~Must be a CFC for at least 30 days during the year, and~~
 - ~~Constructively owned stock irrelevant~~

SUBPART F INCOME



SUBPART F INCOME OVERVIEW

Subpart F Income includes the sum of:

1. The foreign base company income (as determined under §954),
 - Foreign personal holding company income - §954(c)
 - Foreign base company sales income - §954(d)
 - Foreign base company services income - §954(e)
2. Insurance income (as defined under §953),
3. International boycott income (as determined under §952(a)(3) and §999),
4. Illegal bribes, kickbacks, or other payments (within the meaning of section 162(c)) paid by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government, and
5. Income derived from any foreign country during any period during which section 901(j) applies to such foreign country (for example, a country with which the US government has severed diplomatic relationships or identified as supporting terrorism, i.e., Iran, North Korea, Sudan, and Syria)
 - Cuba was removed from the Sec. 901(j) list in March 2016

SUBPART F – EXCLUSIONS & LIMITATIONS

US Source Income

- Subpart F income does not include any item of income from sources within the United States that is effectively connected with the conduct of a US trade or business unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to an income tax treaty (§ 954(b))
- The CFC will be taxed in the US on the effectively connected income in the period earned

De Minimis Rule

- If the sum of foreign base company income and the gross insurance income for the taxable year is less than the lesser of:
 - (i) 5 percent of gross income, or
 - (ii) \$1,000,000
- No part of the gross income for the taxable year shall be treated as foreign base company income or insurance income (§ 954(b)(3)(A))

SUBPART F – EXCLUSIONS & LIMITATIONS

Full Inclusion Rule

- If the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70% of gross income, the entire gross income for the taxable year shall be treated as subpart F income (§954(b)(3)(B))

High Tax Exception

- Foreign base company income (other than oil-related income) and insurance income do not include any item of income received by a CFC if the taxpayer establishes that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum **corporate** rate imposed by the US (i.e. 18.9% -- 90% of 21%)

Foreign Base Company Income (“FBCI”)

- The largest and most significant category of subpart F income is Foreign Base Company Income, which consists of:
 - Foreign personal holding company income - §954(c)
 - Foreign base company sales income - §954(d)
 - Foreign base company services income - §954(e)

SUBPART F – FOREIGN PERSONAL HOLDING COMPANY INCOME

Foreign Personal Holding Company Income (“FPHCI”)

- If a US parent employs a foreign corporation to isolate investment income in a low-tax jurisdiction, the income will be FPHCI
- FPHCI is that portion of gross income (generally passive income) which consists of:
 - Dividends, interest, royalties, rents, annuities [§954(c)(1)(A)]
 - Net gain from:
 - Certain commodity transactions
 - Certain foreign currency transactions
 - The sale or exchange of certain property which generates either passive income or no income, and
 - The sale or exchange of an interest in a trust, partnership, or real estate mortgage investment conduit
 - Any income equivalent to interest
 - Personal service contracts
 - Payments in lieu of dividends derived from securities lending transactions under §1058, and
 - Net income from notional principal contracts

SUBPART F – FOREIGN PERSONAL HOLDING COMPANY INCOME

Foreign Personal Holding Company Income (“FPHCI”)

- FPHCI *does not include*:
- Dividends and interest received from related parties incorporated in the same country as the CFC
- Rents and royalties which are derived from the active conduct of a trade or business and which are received from unrelated persons
- Rents and royalties received from related parties for the use of property in the CFC’s country of incorporation
- Reduced risk of tax avoidance where the property is located in the country of incorporation
- Export financing interest derived from the conduct of a banking business

Look-through Rule for Related CFCs

- Dividends, interest, rents, and royalties received from a related CFC are not treated as FPHCI to the extent attributable to income of the related CFC that is neither subpart F income nor ECI
- **Applicable to tax years of CFCs beginning after December 31, 2005 and before January 1, 2021**

SUBPART F – FOREIGN BASE COMPANY SALES INCOME

Foreign Base Company Sales Income (“FBSCI”)

- Income derived from the purchase and sale of property where the property purchased is manufactured, produced, grown or extracted outside the country of the CFC and sold for use, consumption and disposition outside such foreign country when:
 - Purchased from a related person, sold to any person
 - Sold to any person on behalf of related person
 - Purchased from any person, sold to related person
 - Purchased from any person on behalf of related person
- Essentially, sales to or from any person where a related person is involved

SUBPART F – FOREIGN BASE COMPANY SALES INCOME

Definition of a Related Person

- A person is a related person with respect to a CFC if:
- Such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the CFC; or
- Such person is a corporation, partnership, trust, or estate that is controlled by the same person or persons who control the CFC
- Control: More than 50% of the vote or value of stock of a corporation, or more than 50% of the value of the beneficial interest in a partnership, trust, or estate
- Ownership includes indirect ownership and ownership through attribution

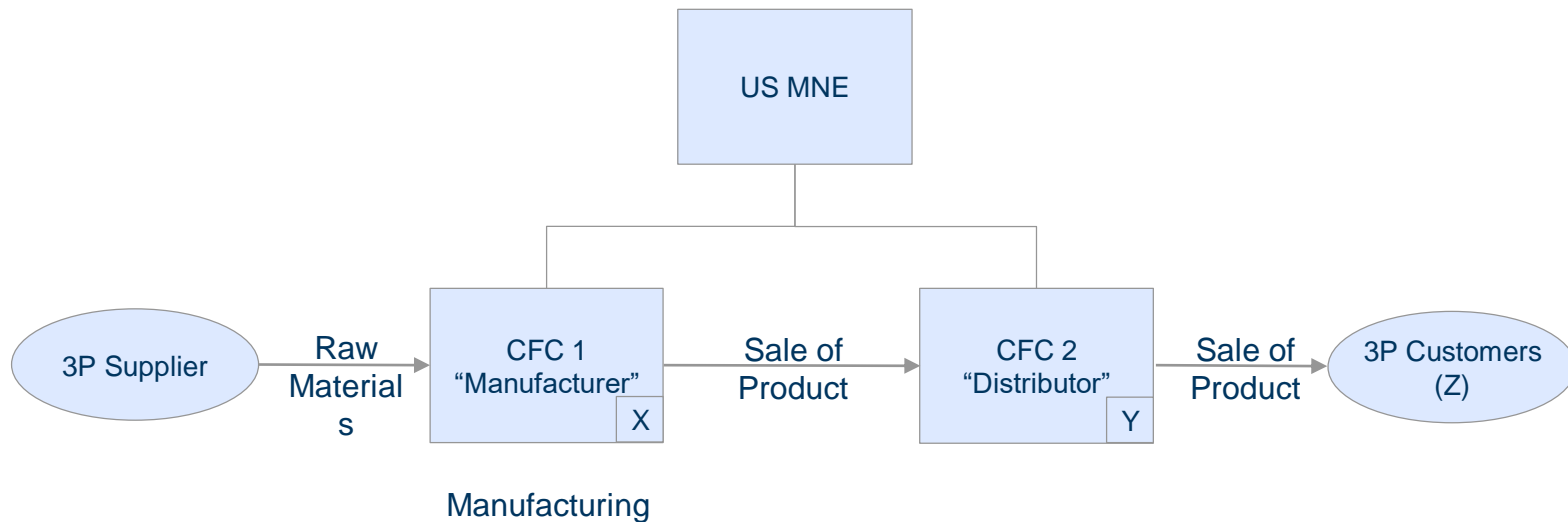
SUBPART F – FOREIGN BASE COMPANY SALES INCOME

Exceptions to FBCSI:

- Personal property sold for use, consumption or disposition within the CFC's country of incorporation (“same country exception”)
- Personal property manufactured by the CFC (“manufacturing” exception)
- Personal property manufactured in CFC's country of incorporation, where a related party is the manufacturer (“same country manufacturing” exception)

SUBPART F – FOREIGN BASE COMPANY SALES INCOME

Example of structure that may have exposure to subpart F Income



Note: FBCSI aims to prevent the manipulation of income between related entities (e.g. CFC1 & CFC2) whereby profits could be designated to a low tax jurisdiction

SUBPART F – FOREIGN BASE COMPANY SERVICES INCOME

Foreign Base Company Services Income (“FBCSvI”)

- If a US parent isolates services income in a low tax jurisdiction, they may be subject to FBCSvI
- Income derived from the performance of services for or on behalf of any related person, and outside the country of organization of the CFC
 - Such services may include technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services

For income to be considered FBCSvI two tests must be met

- Related Party Test: Services performed for, or on behalf, of a related person
 - Services which are performed for, or on behalf of, a related person includes services performed by a CFC where “substantial assistance” contributing to the performance of such services has been furnished by a related US person or persons (Notice 2007-13, effective January 1, 2007)
 - The Notice limits the scope of the regulations, which by their terms apply to substantial assistance from any related person
- Geographical Test: Services must be performed outside the CFC’s country of incorporation for it to be FBCSvI

SUBPART F – FOREIGN BASE COMPANY SERVICES INCOME

Geographical Test

- In order for the geographical test to be met, the services generating the income must be performed outside the country under whose laws the CFC was created or organized
- Services are generally considered performed where the services are physically performed that result in the CFC's services income

The following items are specifically exempted from FBCSvI Income:

- Services related to the sale or exchange by a CFC of personal property manufactured, produced, grown or extracted by the CFC if the services were performed where the property was sold or exchanged, or
- The services directly relate to the sale or exchange of personal property which was manufactured, produced, grown or extracted by the CFC

Exclude ECI

- Any US source ECI is not included in the subpart F determination, unless it is exempt from U.S. tax under a treaty or is subject to a reduced rate (S 952(b)).
- This applies to all categories of subpart F income

SECTION 951A – GILTI



SECTION 951A – GILTI

- All CFC earnings are now potentially subject to tax in the hands of US shareholders under S 951A.
- CFC “tested income” includes all income other than
 - US ECI
 - Subpart F income
 - High-taxed income
 - Dividends from related persons
 - Foreign oil and gas extraction income
- Tested income is reduced by allocable deductions and by “net deemed tangible income return”
- The US shareholder’s pro rata share of net tested income or loss of all CFCs is aggregated and reduced by the shareholder’s aggregate “net deemed tangible income return” of CFCs to determine the shareholder’s Global Intangible Low Taxed Income amount
- Net deemed tangible income return is equal to 10% of qualified business asset investment minus interest expense, except interest paid to a related CFC owned by the US shareholder

SECTION 951A – GILTI

- US **corporate** shareholder is entitled to deduct 50% of its GILTI inclusion (S 250)
- US **corporate** shareholder is also entitled to an indirect foreign tax credit with respect to the taxes paid by CFCs on tested income

SECTION 956 – EARNINGS INVESTED IN US PROPERTY



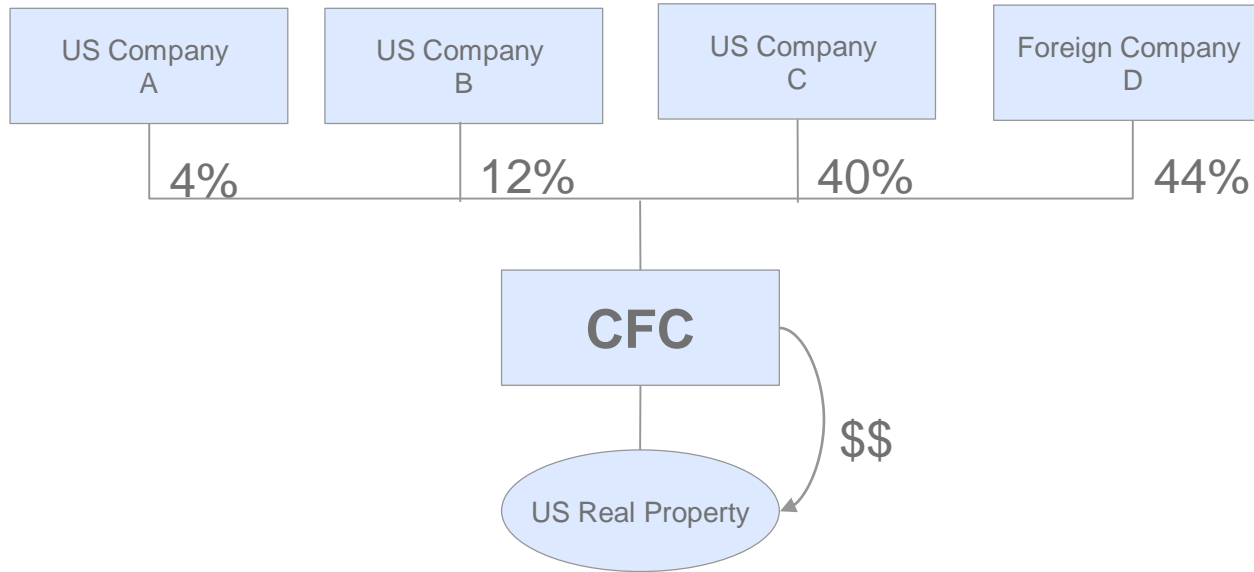
INVESTMENTS IN US PROPERTY (SECTION 956)

- Enacted to treat certain indirect repatriations similar to direct repatriations (dividends)
- US shareholders are taxed when a CFC invests previously untaxed earnings in “US property,” such as:
 - Stock or debt of a US shareholder or related US corporation (25% relatedness test)
 - Tangible assets used in the US
 - Intangible assets licensed for US use
- Unlike other subpart F provisions, the character and timing of the underlying earnings is not relevant (i.e. current v. accumulated)
 - Quarterly averaging of “investment” is applied to determine taxable amount
- If a CFC guarantees or pledges property as security for a loan to a related US party it is considered investment in US property as if the CFC made the loan (See section 956(d))
 - A pledge of 2/3 or more of a CFC’s shares is treated the same as a guarantee by the CFC
- US shareholders can exclude an obligation held by the CFC that would constitute a section 956 investment provided the obligation is collected within 60 days from the time it is incurred
 - This exclusion is not available if the CFC holds obligations for 180 or more days during its taxable year that, without regard to the 60 day rule, would constitute an investment in United States property

INVESTMENTS IN US PROPERTY (SECTION 956)

- Section 956 amounts are first attributed to previously taxed E&P (PTEP) of the CFC.
- A corporate US shareholder is not required to include section 956 amounts in income to the extent that a dividend of that amount from the CFC would have been eligible for the new “participation exemption” deduction in S 245A

INVESTMENTS IN US PROPERTY (SECTION 956)



Example: CFC holds no US property at the end of Year 1, but acquired \$10M of US real estate to be used by the US branch of CFC in year 2. The accumulated earnings and profits of CFC are \$100M at the close of Year 1 and remain \$100M at the close of Year 2 (CFC's operations break even during Year 2). The amount of the CFC's increase in earnings invested in US property for Year 2 (i.e., the amount that determines its US shareholders' section 956 income for the year) is \$10M. US Company B will recognize \$1.2M (.12 x \$10M) in current gross income and US Company C will recognize \$4M (.40 x \$10M) in current gross income.

B and C may qualify for the participation exemption in S 245A. If so, they are not required to include any amount in income under S 956

SECTION 959 – PREVIOUSLY TAXED INCOME



PREVIOUSLY TAXED INCOME (SECTION 959)

- Earnings and profits that have been subject to tax under subpart F (either as subpart F income, as GILTI, or as investments in US property) are not taxed again when distributed to US shareholders or to higher-tier CFCs
- Basis in CFC shares is adjusted upward for subpart F inclusions, and downward for PTEP distributions
- If a PTEP distribution exceeds the adjusted basis of the CFC shares for any reason, a gain is recognized
- Distributions are considered to be made out of PTEP to the extent available
- Section 956 amounts are also attributed to available PTEP from subpart F income inclusions
- Lower-tier PTEP distributed through the chain to US shareholders is excluded by each distributee and becomes PTEP in higher-tier CFCs

SECTION 1248 – SALE OF CFC STOCK



TREATMENT OF GAIN ON CFC STOCK (SECTION 1248)

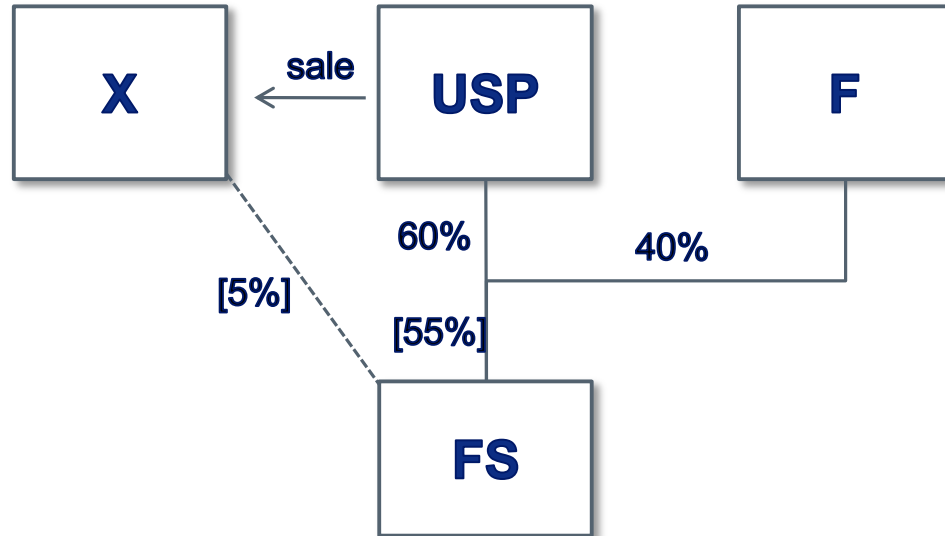
- Combined with subpart F, section 1248 is intended to ensure that income derived through a CFC is eventually treated as ordinary income
- Section 1248 treats gain recognized on sale or other disposition of stock of a foreign corporation as ordinary, dividend income to the extent of the foreign corporation's earnings and profits that are
 - Attributable to the stock sold;
 - Accumulated while the selling shareholder held the stock, while the foreign corporation was a CFC, and while the seller was a 10% shareholder; and
 - Not previously taxed by the United States, either directly or through subpart F
- A S 1248 dividend is generally eligible for the participation exemption deduction in S 245A

SECTION 1248 EXAMPLE

Facts:

- USP bought 60% of FS from foreign corp. F on 12/31/2010.
- USP sells 5% of FS to X on 1/1/2012, recognizing gain of \$15.
- FS has the following E&P for the indicated years:

Through 2010	\$1,000
2011	\$200
2012	-0-



SECTION 1248 EXAMPLE

- **FS is a CFC while USP owns > 50%**
- **E&P of \$200 accumulated**
 - While FS was a CFC
 - While USP held FS stock
- **Portion attributable to the stock sold is 5% of \$200 = \$10**
- **Gain recognized = \$15**
- **Amount treated as a dividend (lesser of \$10 or \$15) = \$10**
- **Amount treated as a capital gain = \$5**

FORM 5471



FORM 5471

Overview

- ▲ Filed by certain US shareholders, officers and directors of certain foreign corporations with their U.S. income tax return (or, if applicable, partnership or exempt organization return)
- ▲ Used by the IRS to identify activities and income of the foreign corporation that give rise to taxable inclusions of U.S. shareholders (e.g., both actual distributions and deemed inclusions under Subpart F of the Code)
 - Identify Subpart F, 956, PTEP
 - Track Earnings & Profits
- ▲ Also used by the IRS to identify related party transactions for transfer pricing review

Form 5471 - Summary

Pre-TCJA

Post-TCJA

Filing Requirements for Categories of Filers

Required Information*	Category of Filer				
	1	2	3	4	5
The identifying information on page 1 of Form 5471 above Schedule A, see Specific Instructions		✓	✓	✓	✓
Schedule A			✓	✓	
Schedule B			✓	✓	
Schedules C, E, and F			✓	✓	
Schedule G		✓	✓	✓	✓
Schedule H				✓	✓
Schedule I				✓	✓
Separate Schedule J				✓	✓
Separate Schedule M				✓	
Separate Schedule O, Part I		✓			
Separate Schedule O, Part II			✓		

Filing Requirements for Categories of Filers

Required Information*	Category of Filer				
	1	2	3	4	5
The identifying information on page 1 of Form 5471 above Schedule A, see Specific Instructions	✓	✓	✓	✓	✓
Schedule A			✓	✓	
Schedule B, Part I			✓	✓	
Schedule B, Part II	✓		✓	✓	✓
Schedules C and F			✓	✓	
Separate Schedule E (including Schedule E-1)	✓			✓	✓
Schedule G			✓	✓	✓
Separate Schedule H				✓	✓
Schedule I and Separate Schedule I-1				✓	✓
Separate Schedule J	✓			✓	✓
Separate Schedule M				✓	
Separate Schedule O, Part I		✓			
Separate Schedule O, Part II			✓		
Separate Schedule P	✓			✓	✓

Form 5471 - Summary

- Identifying information on CFC – use any number as identifying number – software generates
- CFC's issued and outstanding stock (Schedule A)
- Information on US shareholder (Schedule B)
- Income Statement (Schedule C)
 - Both functional currency and US\$
 - Income Statement converted to average exchange rate
 - Look for potential subpart F (interest, rent, royalties)
- Taxes (Schedule E)
 - Creditable v. Non-creditable taxes
 - Convert taxes to US\$ at spot rate at the time taxes were paid to foreign country

Form 5471 - Summary

- Balance Sheet (Schedule F)
 - Convert most accounts to US\$ at the year-end rate except for fixed assets and R/E which are converted at the historical rates
 - Subpart F and other income inclusions
- E&P adjustments (Schedule H), Common adjustments:
 - Statutory Reserves (Bad Debt reserves, vacation/bonus accruals, inventory reserves and Sec 263A
 - Taxes
 - Unrealized exchange gains and losses

Form 5471 - Summary

- Subpart F Income and other income inclusions (Schedule I)
- Accumulated E&P (Schedule J)
 - Functional currency
 - Previously taxed E&P – subpart F and Sec 956
- Transactions with related parties (Schedule M)
 - Interco transactions: sale or purchases to/from controlled group; interco debt; rent, royalties, interest paid or received – cross check with 1042-S and FATCA requirements
- Additional stock acquisitions by US shareholders and changes in CFC's stock holdings (Schedule O)
 - Organization or reorganization – Link to Form 926

Form 5471 - Summary

New or Revised Schedules	Purpose
Schedule B Part II	Requests information on “direct” SH
Schedule E	Now it is 3 pages
Schedule E-1	New
Schedule G	Grew from 1/3 page to little over 1 page; Single question has 22 sub-questions
Schedule I-1	New
Schedule J	Now has additional columns
Schedule P	New

Form 5471 - Summary

- New Forms
 - Form 965, 965-A, 965-B
 - Form 8992 – U.S. Shareholder GILTI Calculation
 - Form 8993 – FDII and GILTI

FORM 5471

Form 5471 – General Concepts

- **Definition of Terms**

- ▲ **US Person:** Includes a citizen or resident of the US, a domestic partnership, a domestic corporation, and an estate or trust that is not a foreign estate or trust
- ▲ **US Shareholder:** A **US Person** who owns 10% or more (directly, indirectly, or constructively) of the total combined voting power of all classes of stock entitled to vote in a foreign corporation, or of the total value of the stock
- ▲ **Controlled Foreign Corporation (“CFC”):** Any foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock, is owned directly, indirectly, or constructively by **US Shareholders** on any day during the taxable year

FORM 5471

Form 5471 – General Concepts

- **Definition of Terms**

- ▲ **Control:** A US Person has control of a FC if, at any time during the person's tax year, it owns stock possessing:

- More than 50% of total value of all classes of stock, or
- More than 50% of the combined voting power of all stock entitled to vote
- **Example:** Company X has 100 shares of Class A voting stock and 50 Shares of Class B non-voting stock outstanding
 - **The fair value of Class A and Class B are \$1 and \$2, respectively**
 - Shareholder Y owns 51 shares of Class A stock
 - Shareholder Z owns the remaining 49 shares of Class A and all 50 shares of Class B
 - **Both Shareholders have control over Company X**
 - **Shareholder Y controls more than 50% of the voting power and Shareholder Z controls more than 50% of the value**

FORM 5471

Form 5471 – Who Must File?

- **Category 1 Filers:**

- ▲ US shareholders of “specified foreign corporations” , including CFCs and any other foreign corporation with a 10% corporate US shareholder

- **Category 2 Filers:**

- ▲ US citizen or resident who is an officer or director of a foreign corporation in which a US Person has acquired:
 - 10% of a FC’s stock (by vote or value), or
 - An additional 10% of the outstanding stock of FC (by vote or value)
- ▲ Triggers the filing of Schedule O
- ▲ The filings related to this category are often missed

FORM 5471

Form 5471 – Who Must File?

- **Category 2 Filers:**

- ▲ Facts

- Year 1: A, a US person, owned no stock in foreign corporation FC
 - Year 2: A bought 5%
 - Year 3: A bought another 5%, bringing his ownership to 10%
 - Year 4: A bought another 6%, bringing his ownership to 16%
 - Year 5: A bought another 4%, bringing his ownership to 20%
 - Year 6: A bought another 10%, bringing his ownership to 30%
- ▲ In what year(s) are US officers and directors of FC Category 2 filers with respect to FC?

FORM 5471

Form 5471 – Who Must File?

- **Category 3 Filers:**

- ▲ US Person who acquires stock in FC which, when added to the stock already owned, meets the 10% stock ownership requirement
- ▲ US Person who acquires stock which, without regard to stock already owned, meets the 10% stock ownership requirement
- ▲ A person who becomes a US Person while meeting the 10% stock ownership requirement
- ▲ US Person who disposes of sufficient stock in the FC to reduce the ownership to less than 10%
- ▲ A person who is treated as a US Shareholder under IRC Section 953(c) (related to Captive Insurance Companies)
 - ❖ Often applies to formations, acquisitions, mergers, restructuring or dispositions
 - ❖ Triggers the filing of Schedule O
 - ❖ Category 3 Filers need to attach a statement that includes amount and type of indebtedness the FC has with:
 - Any US Person owning 5% or more in value of its stock, or
 - Any other FC owning 5% or more in value of the outstanding stock of the FC, provided that the shareholder filing the return owns 5% or more in value of the outstanding stock of such other FC
 - ❖ Provide information of each shareholder or entity

FORM 5471

Form 5471 – Who Must File?

- **Category 4 Filers:**

- ▲ This includes a *US Person* who had **control** of a foreign corporation for an uninterrupted period of *at least 30 days* during the annual accounting period of the foreign corporation
 - Definition of US Person under Category 4 also includes nonresident aliens for whom an election is in effect under section 6013(g) to be treated as a resident of the US for the purpose of filing a joint return, and
 - An individual for whom an election is in effect relating to nonresident aliens who become residents of the US during the tax year and are married at the close of the tax year to a citizen or resident of the US

- **Category 5 Filers:**

- ▲ A US Shareholder (10% owner) who owns stock in a FC that is a CFC for an uninterrupted period of 30 days or more during any tax year of the FC, and who owned that stock on the last day of the CFC's year

FORM 5471

Form 5471 – Exceptions for Filing

- **Multiple filers of same information**

- ▲ Form 5471 allows the filer of the form to file on behalf of another person with similar filing requirements
- ▲ For Category 3 filers, the required information may only be filed by another person having an equal or greater interest (by vote or value)
- ▲ Page 1, item E must be completed to provide the necessary information about the person on whose behalf they are filing
 - If Form 5471 has been filed on the taxpayer's behalf, a statement must be attached to such taxpayer's federal tax return providing information of the person filing Form 5471
- ▲ A separate Schedule I and M must be submitted for each person who is being filed on behalf of
 - Schedule I indicates amount of Subpart F includible for that shareholder, among other "by shareholder" items
 - Schedule M indicates the intercompany transactions between that specific shareholder and related parties.

FORM 5471

Form 5471 – Constructive Ownership

- **Constructive Ownership:**

- ▲ For Category 2 & 3 filers:

- Stock owned directly or indirectly by or for a foreign corporation or foreign partnership is treated as being owned proportionately by its shareholders or partners
- An individual is treated as owning stock owned directly or indirectly by or for his brothers and sisters (whether by whole or half blood), his spouse, his ancestors and his lineal descendants; but stock owned constructively under this rule is not re-attributed to others

- ▲ For Category 4 Filers:

- A person in control of a corporation that, in turn, controls another corporation, is treated as controlling such other corporation

Example: Corporation A owns 51% of Corporation B voting stock. Corporation B owns 51% of Corporation C voting stock. Corporation C owns 51% of Corporation D voting stock. Corporation A is treated as controlling Corporation D.

- These rules generally adopt the constructive ownership rules of IRC §318(a), with certain modifications.

FORM 5471

Form 5471 – Constructive Ownership

- **Constructive Ownership:**

- ▲ For Category 5:

- Generally incorporates the constructive ownership rules of IRC §318(a)
- However, in applying §318(a)(1)(A), stock owned by a nonresident alien shall not be considered as owned by a U.S. citizen or resident alien;
- In applying §318(a)(2)(A), (B) and (C), if a partnership, estate, trust or corporation owns, directly or indirectly, more than 50% of the total combined voting power of a corporation's stock, it shall be considered as owning all of the voting power;
- In applying §318(a)(2)(C), the phrase “10 percent” is substituted for the phrase “50 percent”.

FORM 5471

Form 5471 – Additional Information

● When and Where to File

- ▲ Form 5471 is due when the US filer's federal income tax return is due, including extensions
- ▲ Form 5471 needs to be filed with the US filer's income tax return (electronically or in paper form)

● Penalties for Failure to File Forms 5471, Schedule M

- ▲ A \$10,000 penalty for each annual accounting period that a FC fails to provide the required information within the time prescribed
 - Additional \$10,000 in penalties can be assessed for failure to respond to IRS notices within the time provided (90 days), up to \$50,000 for each failure
 - Automatic assessment of penalties began in January 2009
 - Abatement requests may be filed but likely will be difficult to obtain
- ▲ Reduction of up to 10% of the creditable foreign taxes under Sections 901, 902, and 960
 - Additional reductions for failure to respond to IRS notices in the prescribed period of time may be imposed (5% reduction for each 3-month period)
- ▲ Any persons required to file Forms 5471 and Schedules J, M, or O, who agree to have another person file the form on their behalf are subject to the same penalties

FORM 5471

Form 5471 – Page 1

- **Important Points**

- ▲ The tax year at the top is the FC's year, not the filer's year (e.g. U.S. Person)
- ▲ If the shareholder is a member of consolidated group, the name of the filer should be the common parent
- ▲ Name Change: Show the previous name in parenthesis if the name of the person filing the return, or the corporation whose activities are being reported changed within the last 3 years
- ▲ Item C: The % of stock owned in the foreign corporation at the end of the corporation's annual accounting period.
- ▲ Item E: If two persons are required to furnish the same information, one may file on behalf of the other. The following information must be included in the person's tax return on whose behalf the information is submitted:
 - A statement that each person's filing requirement have been or will be satisfied
 - The name, address, and identifying number of the return with which the information was or will be filed
 - The IRS Service center where the return was or will be filed (If electronic, enter "e-file")
- ▲ Item 2a: If a company has a US registered agent, it may be required to file Form 1120-F

- **Schedule A – Stock of the FC**

- ▲ **Categories 3 and 4**

- ▲ List each class of stock and the amount outstanding at the beginning and end of the year
 - Changes in stock may indicate the need for a Category 2 or 3 filing

FORM 5471

Form 5471 – Page 2

- **Schedule B – US Shareholders of FC**

- ▲ Categories 3 & 4
- ▲ List all US Shareholders who hold directly or indirectly 10% or more (by vote or value) of the corporation's outstanding stock
- ▲ List each shareholder's allocable percentage of the FC's Subpart F income

- **Schedule C – Income Statement**

- ▲ Categories 3 & 4
- ▲ The left column shows the FC's income statement in its functional currency and the right shows it in US dollars; information reported should be in accordance with US GAAP
 - Translation is done using the average rate for the FC's tax year, in accordance with to US GAAP rules
 - Special rules for hyperinflationary currencies (DASTM)
- ▲ Line 20 Taxes: Includes income taxes only and should equal taxes paid or accrued on Schedule E
- ▲ Lines 4, 5, & 6: Potential Subpart F income

FORM 5471

Form 5471 – Page 3

- **Schedule E – Income, War Profits, and Excess Profits Taxes Paid or Accrued**

- ▲ Categories 3 & 4
- ▲ Separately list each country in which taxes were paid by the FC in column (a)
- ▲ In general, the exchange rate in column (c) is the average exchange rate for the year
 - Report the exchange rate using the “divide-by convention”
- ▲ Remember to consider only taxes paid or accrued, NOT deferred taxes

- **Schedule F – Balance Sheet**

- ▲ Categories 3 & 4
 - Shows the FC’s balance sheet in US dollars translated at the year-end spot rate
- ▲ Balance sheet must be prepared and translated in accordance with US GAAP principles
- ▲ If the company is required to use DASTM, the balance sheet will be the tax balance sheet translated into US dollars in accordance with the Treas. Reg. under §985 rather than US GAAP

FORM 5471

Form 5471 – Page 4

- **Schedule G – Other Information**

- ▲ Identify if the FCs owned during the tax year:

- Any interest greater than 10% in a partnership; if yes, attach identifying information of the partnership
- Any interest in a trust
- Any foreign disregarded entities (tax owner); if yes, need to attach Form 8858 to Form 5471 for Category 4 & 5 filers; if not a Category 4 or 5 filer, attach a statement

- **Schedule H – Current E&P**

- ▲ Categories 4 & 5

- ▲ On Line 1, enter current year net income or loss from Schedule C Line 21 in functional currency

- ▲ Make E&P adjustments to conform to US tax principles in functional currency (US GAAP to US tax adjustments)

- Example E&P adjustments:
 - Adjust book depreciation
 - Adjust bad debt expense to conform to US tax principles
 - Adjust book gain to tax gain

- Translate to US dollars on Line 5d and include the exchange rate used (average rate for the year)

FORM 5471

Form 5471 – Additional Schedules

- **Schedule I – Summary of Shareholder’s Income From Foreign Corporation**

- ▲ Categories 4 & 5
- ▲ The total income on Line 6 is included in the US Shareholder’s tax return (Form 1120, Schedule C; Form 1040 Schedule B)
- ▲ Include Dividends Received (not PTEP) as dividend income.
- ▲ Include the exchange gain or loss on distribution of previously taxed income as “other income” in Form 1120 Line 10

- **Schedule J – Accumulated E&P**

- ▲ Categories 4 & 5
- ▲ All amounts are entered in functional currency
- ▲ Shows foreign company’s E&P from inception through the end of the year
- ▲ Reports the running balance of previously taxed income (Subpart F income and Section 956)

FORM 5471

Form 5471 – Additional Schedules

- **Schedule M – Related Party Transaction**

- ▲ Category 4 only
- ▲ Every US Person must file a separate Schedule M (or multiple “persons treated as one taxpayer, e.g., in consolidation)
- ▲ If the shareholder is a member of a consolidated group, the name of the filer should be the common parent
 - Determine with whom the CFC had transactions and place the totals in the appropriate column
- ▲ If the FC uses the accrual method of accounting, FC must report payment/receipts under such method
- ▲ Note that dividends paid or received do not include amounts previously taxed under Subpart F
- ▲ Amounts borrowed and loaned (Lines 19 and 20) should be shown as the highest amount during the year, not beginning or ending balances
 - Be sure not to report accounts payable as loans (unless non-ordinary course exceeding 30/60/90 days)
- ▲ Schedule M should include all transactions between disregarded entities that are owned by the CFC and other entities in the controlled group in addition to the activities of the CFC itself
 - Information that is included on Form 8858 also needs to be included on Schedule M unless there are branch-to-branch transactions where the branches are owned by the same CFC
- ▲ Do not leave Schedule M blank; if there is no activity for the year, zeros (NONEs) should be indicated (at least in Lines 25/26)

FORM 5471

Form 5471 – Additional Schedules

● Schedule O: Organization or Reorganization of FC and Acquisition and Disposition of Its Stock

- ▲ Category 2 files Part I
- ▲ Category 3 files Part II
 - This applies to both organizations and reorganizations, acquisitions, or dispositions of stock
- ▲ Certain **tax-free transactions** require Schedule O reporting even though there is no immediate potential tax impact
 - F & E reorganizations
- ▲ If an entity has an increase in US ownership that requires a Schedule O to be filed, the US officers and directors of that entity have a Category 2 filing requirement
- ▲ Section F additional information:
 - A chart must be attached showing chains of ownership, if any
 - A statement is necessary if the CFC or a predecessor US corporation filed a US tax return (for last 3 years)
 - Date of any reorganization within the last 4 years while the filer held 10% or more of the corporation's stock
- ▲ Practical rule of thumb:
 - If the transaction is taxable, report it in Sections B, C, and D
 - If the transaction is tax-free, report it in Section E

FORM 5471

Example – Schedule O Part II to Report Acquisition of CFC

Section C — Acquisition of Stock						
(a) Name of shareholder(s) filing this schedule	(b) Class of stock acquired	(c) Date of acquisition	(d) Method of acquisition	(e) Number of shares acquired		
				(1) Directly	(2) Indirectly	(3) Constructively
CYPRUS LIMITED	COMMON	01/01/2005	PURCHASE	1,000.		

For Paperwork Reduction Act Notice, see the Instructions for Form 5471.

Schedule O (Form 5471) (12-2005)

Schedule O (Form 5471) (Re

2

(f) Amount paid or value given	(g) Name and address of person from whom shares were acquired
2,064.	John Johnson, 123 Riverview Drive, Anytown, FL 33333

Form 5471- Important Reminders

- The form, filed for each CFC, cannot be filed on a consolidated basis
- It is often a challenge to obtain a separate company data

Form 5471 Schedule I: Summary of Shareholder's Income From Foreign Corporation

- You must compute Subpart F income before preparing the schedule
- Many categories of Subpart F income don't tie neatly to general ledger accounts. Therefore, you must allow adequate time to collect necessary data and perform calculations

Form 5471 Schedule J: Accumulated E&P of CFC

- The schedule is used to accumulate PTEP and thus derive basis adjustments
- Failure to maintain this information accurately can result in double taxation on later dividends or sales
- If you are in public practice and have a new client with old CFCs, make sure that you have a reliable starting point
- Information should tie to Schedule H (Current E&P) and Schedule I

Thank you!

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