Corporate Tax - USA

IRS releases guidelines for examining CFC transactions

Contributed by **Caplin & Drysdale, Chartered**

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Introduction

On July 17 2015 the Internal Revenue Service (IRS) released three new practice units, each examining a particular type of transaction involving a controlled foreign corporation (CFC). The IRS develops practice units internally for use both as training materials and as job aids for examiners. Practice units are not formal legal authorities and may not comprehensively reflect the IRS's interpretation of current law. They can, however, provide insight into how IRS examiners will approach certain issues during an audit.

Taxpayers' calculations of Sub-part F income have rarely been a focus of IRS audit activity, but these practice units suggest that examiners will be encouraged to look more closely at multinational taxpayers' determinations of and accounting for Sub-part F income.

CFCs and Sub-part F income

A CFC is a foreign corporation in which US shareholders own, directly or indirectly, stock representing more than 50% of the corporation's aggregate voting power or aggregate stock value. Although the United States generally does not tax US persons on the earnings of a foreign corporation in which they hold stock until the earnings are remitted to them as, for example, dividends, a different rule applies when the corporation is a CFC. In that case any US shareholder that holds stock representing at least 10% of the corporation's total combined voting power must include in its US income – and pay US tax on – its *pro rata* share of certain of the CFC's earnings. These certain CFC earnings are known as 'Sub-part F income'.

The recently released practice units deal with two types of Sub-part F income: foreign personal holding company income (FPHCI) and foreign base company sales income. FPHCI consists of, essentially, passive income, specifically including dividends and interest. Foreign base company sales income consists of income from the sale of goods that is especially 'mobile', in that the activities giving rise to the income need not be performed where the goods are produced or where they are consumed. More formally, foreign base company sales income is income derived by a CFC in connection with the purchase or sale of goods from, to or on behalf of a related party, where:

- the goods were manufactured or otherwise produced outside the CFC's country of organisation, without any substantial contribution by the CFC; and
- the goods are sold for consumption, use or other disposition outside the CFC's country of organisation.

For the purposes of both FPHCI and foreign base company sales income, a party is related to a CFC if it controls (or is controlled by) the CFC, with 'control' defined as direct, indirect or constructive ownership of more than 50% of the CFC's (or related party's) stock, by vote or value.

Each practice unit first presents a fact pattern in which a CFC earns income and then explains how to determine whether that income is Sub-part F income.

CFC sale to related party with same-country unrelated party manufacturing

In the first practice unit US corporation USP has two wholly owned foreign subsidiaries, CFC1 and CFC2. Because they are wholly owned by a US person, these foreign subsidiaries qualify as CFCs; and because USP owns 100% of their stock, it is currently taxable on their Sub-part F income. CFC1 is incorporated in Country A and CFC2 is incorporated in Country B. Both CFC1 and CFC2 purchase goods from unrelated Country B manufacturers and sell the goods to USP without substantially

Authors

Peter A Barnes

J Clark Armitage

H David Rosenbloom

altering them. USP sells the goods to US consumers.

The practice unit walks an examiner through application of the three-part foreign base company sales income definition to the foregoing fact pattern. First, because they are wholly owned by USP, both CFC1 and CFC2 sell goods to a related party. Second, both CFC1 and CFC2 sell goods for consumption outside their countries of organisation. The CFCs are incorporated in, respectively, Country A and Country B, but the goods are consumed in the United States. Third, CFC1 sells goods that were manufactured in Country B, outside its country of organisation, and has not substantially contributed to their manufacture. Consequently, its income from sales to USP is Sub-part F income and USP will be currently taxable on it. CFC2, however, does not sell goods that were manufactured outside its country of organisation: it is incorporated in Country B and buys from a Country B manufacturer. Because the goods are manufactured in the same country in which CFC2 is organised, its income from sales to USP is not Sub-part F income.

CFC purchase from related party with same-country sales

In the second practice unit, complementary to the first, USP manufactures goods in the United States and sells them to its wholly owned Country A subsidiary, CFC1. Without substantially altering the goods, CFC1 sells them on to:

- unrelated third parties in Country A;
- CFC2, its wholly owned Country A subsidiary; and
- CFC3, its wholly owned Country B subsidiary.

The practice unit assumes that the goods are consumed in the locations into which CFC1 sells them, but advises examiners to confirm that the location of sale is in fact the ultimate destination.

In analysing whether CFC1's sales income is foreign base company sales income, the practice unit focuses first on relatedness. The unrelated third parties are by definition unrelated; but because CFC1 owns 100% of the stock of CFC2 and CFC3, both CFC buyers are related parties. Second, the goods CFC1 sells to CFC2 and CFC3 are manufactured outside CFC1's country of organisation. USP manufactures the goods in the United States, while CFC1 is incorporated in Country A. Third, because the practice unit assumes that the goods are used or consumed in the country into which they are sold, and because CFC1 is incorporated in Country A, CFC1's sales to the unrelated third parties and to CFC2 in Country A do not generate Sub-part F income.

The opposite result holds for its sales to CFC3. CFC3 is organised in Country B and the practice unit assumes that the goods sold to it are consumed there. Hence, the goods are consumed outside CFC1's country of incorporation and its income from those sales is Sub-part F income.

Receipt of dividend or interest from related CFC

The third practice unit focuses on two exceptions to the general rule that interest and dividends are Sub-part F income: the same-country exception and the look-through rule. Under the same-country exception, a dividend or interest payment is not Sub-part F income if the payer is a related corporation that is incorporated in the same country as the payee and uses a substantial part of its assets in a trade or business in that same country, unless the payment reduces the payer's own Sub-part F income.

The much broader look-through rule exempts dividends and interest from Sub-part F income if:

- the payer is a related CFC; and
- the payment does not reduce the payer's Sub-part F income or income effectively connected with a US trade or business (ECI).

In this fact pattern, USP has three subsidiaries, none of which earns ECI:

- CFC1, wholly owned by USP and incorporated in Country A;
- CFC2, wholly owned by CFC1 and incorporated in Country B; and
- CFC3, wholly owned by USP and incorporated in Country A.

CFC2 earns income from operating an active business in Country B and pays a $100 dividend to CFC1. CFC3 earns $200 of interest income and pays $200 of interest to CFC1.

CFC2's dividend to CFC1 satisfies the look-through rule, but not the same-country exception. Because CFC2 is not incorporated in CFC1's country of organisation, Country A, and because CFC2 does not use a substantial part of its assets in a Country A business, the same-country exception does not apply. Nevertheless, because CFC1 owns 100% of CFC2's stock, they are related. Further, because CFC2 earns the income from which it paid the dividend by operating an active business in Country B, the underlying income is not Sub-part F income, so the dividend payment does not reduce CFC2's Sub-part F income. Hence, the look-through rule applies.

At first blush, CFC3's interest payment to CFC1 might appear to qualify for the same-country exception and for the look-through rule. CFC1 and CFC3 are both incorporated in Country A, and are related because USP owns 100% of their stock. However, CFC3's interest payment to CFC1 reduces its Sub-part F income. CFC3 earned $200 of interest income, which was Sub-part F income. Had it retained

those funds, the income would have been currently taxable to USP. When CFC3 paid $200 of interest to CFC1, however, it obtained a $200 interest deduction that reduced its Sub-part F income to zero. Consequently, the payment cannot satisfy either of the two exceptions and is Sub-part F income to CFC1, currently taxable to USP.

The practice unit offers three additional points of guidance to examiners concerning dividend payments:

In addition to actual dividends, deemed dividends – such as a distribution to a CFC in redemption of stock that is treated as a dividend under general corporate tax rules – can constitute Sub-part F income. The same-country exception and look-through rule apply to some, but not all deemed dividends.

If the funds used to pay a dividend are attributable to earnings accrued before the CFC acquired the payer's stock, then the dividend payment will not qualify as Sub-part F income.

An examiner should take into account previously promulgated anti-abuse rules that preclude the application of the look-through rule to:

- payments that reduce the US tax base;
- payments in avoidance of the rules governing the investment of unrepatriated CFC earnings in US assets;
- payments involving options and similar interests, where a principal purpose for using the option or similar interest is to qualify the payment for the look-through rule; and
- payments through a conduit entity that change the character of income in a manner designed to qualify the payments for the look-through rule.

The practice unit directs examiners not to apply these rules without first consulting with IRS counsel.

Comment

These practice units present a straightforward interpretation of certain Sub-part F definitions, the same-country exception and the look-through rule; but they also highlight the technical complexity of the Sub-part F rules and the disparate results that even small factual variations can produce. The instructions to examiners embedded in them reflect some common themes:

- All three practice units direct the examiner to determine early in the examination the amount of a taxpayer's unrepatriated offshore earnings. Noting that the taxpayer's Sub-part F inclusion is limited to this amount, the practice units characterise this determination as a 'decision point', suggesting that the larger the amount, the greater the likelihood that the audit will encompass CFC transactions. Taxpayers should thus pay keen attention to the accuracy of the accumulated earnings and profits data they report for each CFC on its respective Form 5471.
- Both practice units dealing with sales income emphasise that the Sub-part F rules and transfer pricing rules are not mutually exclusive and encourage an examiner reviewing Sub-part F issues to consult with the IRS's transfer pricing practice group. These instructions may reflect a more comprehensive approach to auditing taxpayers' foreign related-party transactions.
- Two of the practice units identify a taxpayer's foreign-country income tax, value-added tax and property tax returns as resources which the examiner may consult to determine the source and destination of goods sold by or to a CFC, as well as the location where and extent to which a CFC uses its assets in a trade or business. Taxpayers can expect to be asked to provide copies of their foreign tax filings during an IRS audit and should likely be prepared to supply customs or shipping documents.
- Each practice unit identifies Country A as 'low tax', signifying a tax rate which is lower than that of the United States. The practice units warn examiners that taxpayers may sell or otherwise channel payments through a low-taxed CFC to shift profits out of the United States or another relatively high-tax jurisdiction. These comments suggest that transactions involving CFCs in countries with tax rates below the US rate may receive heightened scrutiny.

For further information on this topic please contact Peter A Barnes, J Clark Armitage or H David Rosenbloom at Caplin & Drysdale by telephone (+1 202 862 5000) or email (pbarnes@capdale.com, carmitage@capdale.com or drosenbloom@capdale.com).

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