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ABSTRACT: In a special report, Joseph M. Calianno of Grant Thornton and Martin J. Collins of McDermott, Will & Emery explain the planning possibilities offered by the new controlled foreign corporation look- through rule of IRC section 954(c)(6).

SUMMARY:

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Joseph M. Calianno is a partner and international technical tax practice leader with the National Tax Office of Grant Thornton, LLP in Washington, and Martin J. Collins is a partner with the law firm of McDermott Will & Emery, LLP in Washington. The authors would like to thank Michael DiFronzo, a partner with McDermott Will & Emery, LLP, for his insightful comments.

In this report, the authors discuss recently enacted section 954(c)(6), in which, they explain, Congress took a major step toward permitting deferral for most active earnings of controlled foreign corporations by providing look-through treatment for some payments made by CFCs to related CFCs.

The opinions expressed in this article are solely those of the authors and do not necessarily reflect the viewpoints of their respective firms.

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AUTHOR: Calianno, Joseph M.;
Collins, Martin J.
Grant Thornton;

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The CFC Look-Through Rule: Congress Changes Landscape of Subpart F

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In the recently enacted Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222), Congress took a major step toward permitting deferral for most active earnings of a controlled foreign corporation/1/ by adding section 954(c)(6) to the code. This new provision provides for look-through treatment for some payments made by CFCs to related CFCs (the CFC look-through rule). The CFC look-through rule scales back the subpart F rules so that a CFC's active income generally is not subject to U.S. tax until that income is repatriated to the United States -- a generally welcome change for U.S.-based multinationals in the increasingly competitive global economy.

The CFC look-through rule provides that dividends, interest, rents, and royalties received or accrued by a CFC from related CFCs attributable to non-subpart-F income of the payer-CFC will not be treated as subpart F income to the recipient-CFC under look-through rules similar to the rules of sections 904(d)(3)(C) and (D). This article examines the rules before enactment of the CFC look-through rule, the mechanics of the CFC look-through rule and some aspects of the rule that likely will require some clarification, and advantages that U.S.-based multinational corporations may be able to achieve as a result of the application of the new rule.

Prior Rules/2/

A U.S. shareholder of a CFC generally must include in gross income its pro rata share of a CFC's subpart F income, regardless of whether the CFC repatriates that income./3/ Section 952 defines subpart F income to include foreign base company income (FBCI),/4/ and FBCI includes the sum of several categories of income, including foreign personal holding company income (FPHCI). FPHCI is defined in section 954(c)/5/ to include the portion of a CFC's gross income that includes dividends, interest, rents, and royalties. Therefore, absent an exception, dividends, interest, rents, and royalties received by a CFC from a related CFC (as defined in section 954(d)(3)) result in FPHCI that, correspondingly, generally results in an income inclusion by the CFC's U.S. shareholders. There are, however, exceptions to that general rule under which the income received from a related CFC will not be considered FPHCI. Some of the exceptions (for example, the same- country exceptions, the high-tax exception, and the de minimis exception) that may apply are discussed below./6/

There are several same-country exceptions to FPHCI when a CFC receives payments from a related (as defined in section 954(d)(3)) CFC. For instance, section 954(c)(3)(A)(i) generally provides that dividends and interest received by a CFC from a related CFC will not be treated as FPHCI if the payer-CFC is created or organized under the laws of the same foreign country as the receiving CFC and the payer-CFC has a substantial part of its assets used in its trade or business located in the same foreign country. Under the exception for dividends, the dividends will be excluded only to the extent they are paid out of earnings and profits earned or accumulated during a period when the stock on which the dividends are paid was owned by the CFC directly or indirectly through a chain of one or more subsidiaries, each of which meets the requirements for the exclusion./7/ Additionally, in the case of interest, the exception will not apply to the extent that the interest payment reduces the payer-CFC's subpart F income or creates or increases a deficit that, under section 954(c), may reduce the subpart F income of the payer-CFC or another CFC./8/

Further, section 954(c)(3)(A)(ii) provides that rents and royalties received by a CFC from a related CFC will not be treated as FPHCI if the payments are for the use of, or the privilege of using, property in the country under whose laws the receiving CFC is created or organized. As with interest payments, this exception will not apply to the extent that the payment reduces the payer-CFC's subpart F income or creates or increases a deficit that, under section 954(c), may reduce the subpart F income of the payer-CFC or another CFC./9/ Although the code and regulations contain exceptions to FPHCI for rents and royalties derived by a CFC engaged in an active trade or business, those exceptions apply only if the rents and royalties are received from unrelated persons./10/ Thus, those exceptions will not be available for a CFC

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that receives rents and royalties from a related CFC.

The regulations further elaborate on and supplement each of the same-country exceptions discussed above./11/

Additionally, FBCI, which includes FPHCI, generally does not include any item of income received by a CFC if the taxpayer establishes to the IRS's satisfaction that the income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum corporate income tax rate specified in section 11 (currently 35 percent) and the taxpayer elects to apply the exception./12/

There is also a de minimis exception under section 954(b)(3)(A) providing that if the sum of gross FBCI and the gross insurance income for the CFC's tax year is less than the smaller of 5 percent of gross income or $ 1 million, then no part of the CFC's gross income for the year is treated as FBCI or insurance income./13/ This exception, however, often is difficult to satisfy.

Although those exceptions are relied on by taxpayers to avoid a subpart F inclusion, in many instances, they are not available for a variety of reasons. For example, many of the exceptions to FPHCI will not be available for a holding company CFC whose primary source of income consists of dividends, interest, rents, and royalty payments from several CFCs organized in several different countries. Therefore, the enactment of section 954(c)(6) adds a new exception that fills a gap when the other exceptions to FPHCI fall short.

The CFC Look-Through Rule

Section 954(c)(6) provides:

(A) In General. -- For purposes of this subsection, dividends, interest, rents and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraph (C) and (D) of Section 904(d)(3)) to income of the related person which is not subpart F income. For purposes of this subparagraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph.

(B) Application. -- Subparagraph (A) shall apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

This amendment to section 954(c) applies to tax years of foreign corporations beginning after December 31, 2005, and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end./14/

Some important observations regarding this provision are worth noting. First, the payments to the CFC must be received or accrued from a CFC. Clearly, this requirement is satisfied when one CFC pays dividends, interest, rents, or royalties directly to another CFC. Suppose the payments are made to a CFC by a partnership that has a CFC partner ("partnership expense" scenario) or, alternatively, payments are made to a partnership from a related CFC, in which a

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partner in the partnership is another related CFC ("partnership income" scenario). Is the "received or accrued from a CFC" requirement satisfied?

From a policy standpoint, it would appear that the requirement should be satisfied. For example, in the partnership expense scenario, to the extent that the payments made by a partnership can be viewed, under an aggregate view of partnerships, as being paid from one related CFC to another related CFC, it would seem reasonable to apply the CFC look-through rule. Similarly, in the case of a partnership receiving income from a related CFC (dividends, interest, rents, royalties -- the partnership income scenario), the income would be part of the distributable share of partnership income or loss. To the extent the income is allocable to a CFC partner, it would seem reasonable to accord similar treatment to the existing rules in this area, which generally take an aggregate approach to partnerships to determine whether a partnership's income is subpart F income to its CFC partners./15/ To resolve those questions, the IRS and Treasury will have to issue guidance regarding the application of the CFC look-through rule in the context of CFC-owned partnerships.

Second, the payer-CFC must be related to the CFC receiving the payments. It appears that section 954(c)(6) adopts the related-person definition of section 954(d)(3). In discussing the definition of a related person, the legislative history provides that:

> For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes./16/

Assuming that section 954(c)(6) can apply in the case of CFC- owned partnerships, it would seem logical that the current regulations' general aggregate approach to partnership taxation -- which focuses on the CFC rather than the partnership in making the related-party determination -- should apply./17/

Query: Is it sufficient that the payer-CFC be related to the recipient-CFC at the time of the payment? Suppose a CFC pays a dividend to another CFC when the payer-CFC is related to the recipient-CFC but the E&P (and the income comprising the E&P) sourcing the dividend were accumulated while the two corporations were unrelated. Can the recipient-CFC still rely on section 954(c)(6) to exclude some or all of the dividend from FPHCI? It appears that such a dividend may qualify under section 954(c)(6). The statute does not specifically contain a requirement that the E&P be earned or accumulated by the payer-CFC while it was related to the recipient- CFC./18/ This should be contrasted with the same-country exception for dividends discussed above. For that exception to apply, the statute (section 954(c)(3)(C)) and the regulations (reg. section 1.954-2(b)(4)(ii)) require some direct or indirect ownership by the recipient-CFC while the E&P were earned or accumulated to qualify for the same-country exception.

Third, the mere fact that the new look-through rule applies to a particular payment received by a CFC from a related CFC does not necessarily exclude the payment from being treated as FPHCI. An analysis must be performed on the payer-CFC's income to determine whether the recipient-CFC has FPHCI. An amount is excluded from FPHCI only to the extent that it is attributable or properly allocable to the payer-CFC's income that is not subpart F income. Rules similar to the rules of sections 904(d)(3)(C)/19/ and (D)/20/ are used to make that determination.

For dividend distributions between related CFCs within a section 958(a) chain of ownership, it would appear that, in most cases, any subpart F income would be treated as previously taxed E&P (PTI) of the payer-CFC under section 959, which could be distributed as PTI to the upper-tier CFC without a corresponding section 951 income inclusion by the U.S. shareholder (or certain successors in interest). Any dividend distribution from the remaining non-PTI of the CFC generally would appear to qualify for an exception to FPHCI under the CFC look-through rule.

For example, assume USP, a domestic corporation, wholly owns CFC1 and CFC1 wholly owns CFC2. In the

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relevant tax year, assume CFC2 has $ 100 of subpart F income (FPHCI, FBCI, and so forth) and $ 70 of non-subpart-F income/E&P, and makes a $ 120 cash distribution to CFC1. Of the $ 120 distribution, $ 100 will be PTI under section 959(b);/21/ the remaining $ 20 should qualify for an exception to FPHCI under the new look-through rule./22/

Moreover, the statute does not seem to restrict the applicability of the exception to a CFC's E&P generated in a year the CFC look-through rule applies. Therefore, it would seem that to the extent that a dividend is paid out of pre-2006 E&P that relates to non-subpart-F income, the dividend could qualify for an exception to FPHCI even if the E&P were generated before the application date of the CFC look-through rule./23/

Fourth, it is not entirely clear how this new look-through rule interacts with other exceptions to FPHCI. For instance, how does section 954(c)(6) interact with the same-country and high-tax exceptions for dividends in determining whether the dividend results in FPHCI? The IRS and Treasury will have to provide guidance in this area.

Fifth, the provision applies to tax years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to tax years of U.S. shareholders with or within which those tax years of foreign corporations end (unless extended by Congress). The limited duration of the provision has several implications. As an initial matter, for some taxpayers -- for example, calendar-year taxpayers -- the provision is retroactive for their 2006 tax year. If a calendar-year CFC received a dividend from a related CFC (non-same-country) in January 2006, a U.S. corporation that owned the CFC receiving the dividend may have concluded that it would have an income inclusion under section 951(a)(1)(A) because the dividend constituted FPHCI, along with a corresponding deemed paid foreign tax credit under sections 902 and 960. However, because the CFC look-through rule would apply to the dividend paid during January of 2006, the tax consequences of the dividend may be altered. As a result of the application of section 954(c)(6), some or all of the dividend may not be treated as FPHCI. Consequently, the foreign tax credit implications of the dividend would be changed. The look- through rule precludes the ability of taxpayers to use the mechanics of subpart F to hopscotch FTCs into the United States and, hence, places a greater emphasis on section 956 planning to achieve a similar result (as discussed below).

Additionally, taxpayers seeking to avoid FPHCI via section 954(c)(6) may be required to restructure their foreign operations for U.S. federal tax purposes in the not-so-distant future to avoid having FPHCI, because of the new rule's limited duration.

Section 964(e), Section 304 & Similar Transactions

The new legislation also appears to apply to exclude some deemed dividends from FPHCI in instances in which a CFC is treated under some code sections as receiving a dividend from a related CFC.

For instance, a CFC may be treated under section 964(e) as receiving a dividend from a related CFC. Section 964(e)(1) generally provides that if a CFC sells or exchanges stock in any other foreign corporation, the gain recognized on the sale or exchange will be included in the gross income of the CFC as a dividend to the same extent that it would have been so included under section 1248(a) if the CFC were a U.S. person. Normally, this deemed dividend results in FPHCI under section 954(c)(1)(A). Section 964(e)(2) specifically provides that the same-country exception to FPHCI under section 954(c)(3)(A) that otherwise could apply to avoid FPHCI on such a deemed dividend does not apply, and other exceptions to FPHCI, such as the high-tax exception under section 954(b)(4), may not apply as a factual matter.

If the selling CFC is treated as receiving the deemed dividend from a related CFC, it would appear that a U.S. taxpayer would be able to rely on section 954(c)(6) to avoid treating the deemed dividend as FPHCI./24/ Importantly, in enacting section 954(c)(6), Congress did not make any corresponding amendment to section 964(e) to prevent section 954(c)(6) from applying to amounts recharacterized as dividends under section 964(e), as it did regarding the same-country exception for dividends under section 954(c)(3)(A). Therefore, this provision may be an alternative to the "check-and-sell" type of strategies that have been employed by taxpayers when an upper-tier CFC sells the stock of a lower-tier CFC to avoid FPHCI. Such a strategy was illustrated in Dover Corp. v. Commissioner./25/

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Additionally, the same logic and analysis that applies to amounts recharacterized under section 964(e) also would appear to apply when a CFC is treated as receiving a deemed dividend from a related CFC as a result of a section 304 transaction. For example, if a CFC (CFC Seller) sells stock of its wholly owned CFC (CFC Target) to a brother CFC (CFC Acquiror) in a section 304(a)(1) transaction and both CFC Seller and CFC Acquiror are wholly owned by the U.S. parent, a deemed dividend distribution from CFC Acquiror or CFC Target to CFC Seller under section 304(b)(2) that otherwise may constitute FPHCI would appear to be eligible for an exception under the CFC look-through rule. The fact that the dividend results from the application of section 304(a)(1) to the transaction (rather than a CFC paying an actual dividend) should not prevent the look-through rule from applying. Under some circumstances, this provision may permit U.S. shareholders to realign the CFCs in a more efficient manner without a corresponding income inclusion under section 951(a)(1)(A) that otherwise may result absent the application of the look-through rule.

It also would appear that other amounts that are treated or recharacterized as dividends, interest, rents, and royalties may qualify for look-through treatment under section 954(c)(6).

Comparison of CFC/FDE Structures

Often, taxpayers structure their foreign operations to avoid generating FPHCI by their CFCs. For instance, one common organizational structure employed by a U.S.-based multinational group is to have a CFC holding company that owns several foreign entities that are classified for U.S. tax purposes as foreign disregarded entities (FDEs). Frequently, the CFC will be a first-tier CFC of the U.S. parent corporation. Payments of dividends, interest, rents, and royalties frequently will be made between the CFC and its FDEs and between the FDEs. Those payments generally will facilitate the efficient movement of funds within the group, reduce foreign taxes, and, as discussed below, avoid being treated as FPHCI.

However, in many instances, if the FDEs were treated as separate CFCs, the payments would result in FPHCI being generated by the CFCs with a corresponding income inclusion at the U.S. shareholder level. Depending on the particular facts, the movement of the funds within the group of CFCs could result in a high U.S. tax cost, even factoring in the possible deemed paid FTC under sections 902 and 960. Therefore, taxpayers often ensure that the foreign entities are FDEs and, in many instances, are required to make check-the-box elections to classify the foreign entities as FDEs. The payments then will be treated for U.S. tax purposes as being made between divisions of a single corporation rather than between separate CFCs. Thus, the payments do not result in FPHCI (even though the payments may have exchange gain or loss consequences under section 987).

This structure also has FTC implications for the U.S.-based multinational group. Because the foreign entities owned by the CFC are FDEs, the income, gain, losses, deductions, and taxes of the entities generally flow up to the CFC and are combined. Consequently, the E&P and foreign taxes of the CFC and its FDEs are blended at the CFC level./26/ This often results in the blending of high- and low-taxed E&P. So a dividend distribution from the CFC to its U.S. parent generally will result in a deemed paid foreign tax credit under section 902 based on the combined E&P and taxes of all the foreign entities. From an FTC planning perspective, this may not be the most ideal structure.

Additionally, if not carefully monitored, this type of structure can run afoul of the rules relating to foreign base company sales (FBC sales) income/27/ and foreignbase company services (FBC services) income./28/

Consider the following example in the context of FBC services income. USP, a domestic corporation, wholly owns CFC, a foreign corporation organized in Country X, which in turn wholly owns FDE, organized in Country Y. USP pays FDE to perform technical services that USP is obligated to perform in Country Y (that is, FDE performs the services on behalf of USP). This type of arrangement generally will result in FBC services income because CFC (the regarded entity for U.S. tax purposes) is considered to be performing services on behalf of USP outside its country of organization, Country X.

Depending on the facts, the new CFC look-through rule may provide some of the same benefits via a CFC/CFC

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structure that the CFC/FDE structure currently provides and, under some circumstances, some additional benefits. For instance, if the look-through rule applies, taxpayers may be able to avoid FPHCI on dividends, interest, rent, and royalty payments if the related payer-CFC has active income. It also may provide a greater opportunity to separate high- and low-taxed E&P at the CFC level and permit taxpayers to better manage their use of FTCs./29/ This should be contrasted with the blending of E&P and taxes that occurs under the CFC/FDE structures. Taxpayers should evaluate each structure and possibly consider using a combination of those two structures to best manage their FTCs.

Moreover, in some situations, the CFC/CFC structure may provide additional benefits under the FBC services rules. For instance, in the example above dealing with FBC services income, if FDE were a separate CFC organized in Country Y, FDE's income from the transaction generally would be excluded from FBC services income because the services are performed on behalf of USP in its country of organization.

By no means are these the only considerations when comparing the two types of structures; however, the foregoing discussion does illustrate some of the issues that should be considered when contrasting a regarded versus a disregarded entity structure. Despite the benefits, taxpayers should consider the temporary applicability of the new CFC look-through rule before implementing any potential changes to their foreign tax structure.

Taxpayers in a CFC/FDE structure seeking a CFC/CFC structure may wish to convert specific FDEs to CFCs. Presumably, this conversion would be treated as a foreign-to-foreign section 351 transaction./30/ In such a case, in addition to the normal subchapter C provisions that would need to be considered (for example, sections 357, 358, 362, and so forth), taxpayers should consider international provisions that may apply to the transaction. For instance, a foreign-to-foreign section 351 transaction would be covered by section 367(b) and the regulations but generally should not result in an income inclusion under section 367(b)./31/ Additionally, the effect of any branch terminations under section 987 must be considered./32/ E&P earned and foreign taxes paid by the FDEs following incorporation would be attributes of the newly incorporated CFCs. However, attributes of the CFC-transferor (for example, E&P and foreign tax pools) before the incorporation of the FDEs would remain at the CFC-transferor level and would not be transferred to the FDEs on their incorporation./33/

Limited Applicability; Subsequent Restructuring

The benefits of look-through treatment under section 954(c)(6) have a limited duration unless Congress decides to extend the provision the way it extended for two years the exception to subpart F for active financing and insurance income under sections 953(e)(10) and 954(h)(9). Taxpayers who have an organizational structure that has several CFCs making dividend, interest, rent, and royalty payments to one another and who rely on the CFC look-through rule to avoid FPHCI will need to evaluate whether they can rely on any of the other exceptions to FPHCI going forward. If other exceptions do not apply or have limited applicability, the taxpayers should evaluate the tax cost of their current structure and consider possible restructuring of the group and the associated costs and implications of the restructuring.

For instance, one type of restructuring to avoid FPHCI may involve a CFC/FDE-type structure, which may mean converting some CFCs wholly owned by other CFCs into FDEs. That may require making a CTB election to treat the lower-tier entity as an FDE of the upper-tier CFC. However, the taxpayer should consider the possible application of the 60-month rule relating to CTB elections/34/ and possible alternatives to making a CTB election to achieve its desired result.

Moreover, the tax implications of any conversion from a CFC to an FDE should be considered. Generally, in the case of a solvent corporation, this type of conversion will be treated as a section 332/337 liquidation of the lower-tier CFC into the upper-tier CFC. The taxpayer should consider the potential application of subchapter C as well as some international provisions. For instance, section 367(e) and the regulations generally apply to foreign-to-foreign liquidations. Subject to some exceptions, section 367(e) and the regulations generally provide that no gain or loss is recognized on the liquidation./35/ Additionally, the IRS and Treasury have proposed regulations under section 367(b) dealing with the carryover of attributes in foreign-to-foreign section 332 liquidations that should be considered,

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including rules relating to hovering deficits and the use of FTCs./36/

Interaction With Other Subpart F Rules

When the qualified deficit rule of section 952(c)(1)(B) applies, a U.S. shareholder will not have subpart F income, yet the income (that is, E&P) retains its character as subpart F income. A question then arises whether a look-through payment between related CFCs in a subsequent year could be attributed or properly allocable to this tainted income. Under section 952(c)(1)(B), the amount of a CFC's subpart F income includable in a U.S. shareholder's income is reduced by his pro rata share of any "qualified deficit" attributable to any "qualified activity."/37/ Section 952(c)(1)(B)(i) applies on a shareholder-by-shareholder basis. The relevant CFC's subpart F income is not reduced, but instead the particular U.S. shareholders' inclusion under section 951(a)(1)(A) is reduced./38/

Thus, a situation could arise in which a look-through payment may be attributable or properly allocable (traced) to a subpart F amount and fail to qualify for the CFC look-through rule./39/ The possible inability to apply the look-through rule to avoid FPHCI in this instance appears to lack any good policy reason; in effect, the interaction of the two rules would appear to undo USP's benefit realized in an earlier tax year by virtue of the "qualified deficit" rule under section 952(c)(1)(B).

[Image Omitted]

Section 956 Gains Favor

As discussed earlier, a U.S. shareholder of lower-tier CFCs with subpart F income generally is treated as constructively receiving that income directly from those CFCs under the "hop-scotch principle."/40/ For a domestic C corporation that is the U.S. shareholder, this constructive distribution also applies for purposes of determining its indirect FTC under sections 902 and 960. So the deemed paid foreign taxes are treated as flowing directly from the lower-tier CFC to the U.S. shareholder./41/ Consider the following example, illustrated in the figure below: USP, a domestic corporation, wholly owns CFC1 and CFC1 wholly owns CFC2. USP would be treated as receiving directly a constructive distribution of any subpart F income of CFC1.

In tax years before the application of the CFC look-through rule, taxpayers often would use the mechanics of subpart F to complete targeted repatriations of high-taxed E&P from lower-tier CFCs. In the above example, CFC2 would pay a dividend to CFC1, and USP would not elect the high-taxed exception under section 954(c)(4) for that dividend. CFC2's dividend received by CFC1 would be treated as being constructively received by USP under section 951(a)(1) and hence taxed to USP. For the tax years in which section 954(c)(6) applies, the CFC look-through rule will place more emphasis on completing these targeted repatriations of high-taxed earnings vis- a-vis section 956 (for example, a loan by CFC2 to USP or a guarantee by CFC2 of USP's debt obligations)./42/ Because of the CFC look-through rule, dividends from CFC2 to CFC1 generally will not give rise to a constructive distribution from CFC2 to USP under the mechanics of subpart F.

Antiabuse Rule

The discussion above regarding the treatment of issues and transactions under the CFC look-through rule is subject to a general antiabuse rule. The new legislation gives the IRS and Treasury authority to prescribe regulations preventing the "abuse of the purposes" of the new rule (section 954(c)(6)(A)). As this article illustrates, the CFC look-through rule provides greater flexibility to U.S.-based multinationals in reducing current U.S. taxation on active CFC earnings. Arguably, that change is consistent with the beginnings of subpart F when there was more concern with a shifting of income from the United States, as opposed to a shifting of active earnings from one foreign jurisdiction to another foreign jurisdiction./43/ A situation in which the antiabuse rule may apply is not readily apparent. Congress likely inserted the antiabuse rule as a matter of general tax policy, although arguably such a rule is unnecessary under current law./44/ Given the provision's limited duration, it is hoped that if the IRS and Treasury do view specific transactions as

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abusive, they will act quickly in alerting taxpayers to what transactions are covered by the rule.

Conclusion

Is the CFC look-through rule this year's version of the temporary dividends received deduction?/45/ Not quite. For starters, the new rule provides for non-U.S. taxability of active earnings within CFCs. Through planning, however, it may be possible to optimize cash in CFCs with favorable attributes, such as high effective tax-rate pools, which may yield reduced U.S. tax on an ultimate repatriation to the states. So why did the CFC look-through rule become law? Some observers believe that Congress saw the new rule as part of the extension of the active financing exception.

The new rule is welcome relief for U.S. multinational corporations as they continue to compete with non-U.S. multinational corporations in an ever-increasing competitive global economy. Obviously, the tax cost on corporate capital is one of many factors influencing the increased competition. One is left to consider, however, whether a more straightforward approach (for example, a reduced corporate tax rate) would not have been a more appropriate response to some of the temporary, one-time, and other export incentive legislation that we have seen in recent years./46/

FOOTNOTES

/1/ For the definition of a CFC, see section 957.

/2/ The rules discussed immediately below continue to apply. The authors thought it was necessary to provide some general background of those rules to address some distinctions with the new CFC look-through rule discussed later in this article.

/3/ For the definition of a U.S. shareholder, see section 951(b). For when a U.S. shareholder of a CFC must include in income its share of subpart F income and other special rules, see generally sections 951-964.

/4/ See section 954.

/5/ FPHCI is determined under section 954(c) and reduced by properly allocable deductions as provided in section 954(b)(5).

/6/ For other possible exceptions to and limitations on FPHCI, see, e.g., section 952(c)(1)(A) (providing for a current E&P limitation on subpart F inclusion subject to a recapture provision under section 952(c)(2)), section 954(c)(2) (exceptions for rents and royalties derived in an active business, some export financing interest, and dealers), and section 952(b) (exception relating to U.S.-source income effectively connected with a U.S. trade or business). Even if the requirements for an exception to FPHCI are satisfied, other provisions of the code and regulations may affect the applicability of the exception. See, e.g., section 954(b)(3) (the full-inclusion rule requiring all of the gross income of the CFC to be treated as FBCI or insurance income if some conditions are satisfied) and reg. section 1.367(b)-3(b)(3)(i) (providing that the same-country exception for dividends under section 954(c)(3)(A)(i) is inapplicable).

/7/ See section 954(c)(3)(C) and reg. section 1.954-2(b)(4). This rule is explained in the legislative history (from the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66)):

> The bill's limitation applies, and thus the same-country exception does not apply, even in cases where the controlled foreign corporation receiving the distribution did not exist at the time the distributed earnings and profits were accumulated, but the stock of the distributing corporation was held by the shareholders of the receiving corporation at such time. H. Rep. No. 1337, 83rd Cong., 2nd Sess. 41 (1993).

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/8/ See section 954(c)(3)(B).

/9/ Id.

/10/ See generally section 954(c)(2)(A) and reg. sections 1.954-2(b)(6), (c), and (d).

/11/ Reg. sections 1.954-2(b)(4) and (5).

/12/ For further details on the application of the high- tax exception, see section 954(b)(4) and reg. section 1.954-1(d)(1).

/13/ The term "gross insurance income" for this purpose means any item of gross income taken into account in determining insurance income under section 953. For further details on the de minimis exception, see reg. section 1.954-1(b). Additionally, there is a corollary rule, referred to as the full- inclusion rule, under section 954(b)(3)(B) providing that if the sum of the gross FBCI and the gross insurance income for the tax year exceeds 70 percent of gross income, the entire gross income for the tax year is, subject to sections 954(b)(4) and (5), treated as FBCI or insurance income (whichever is applicable).

/14/ The application of subsection 954(c)(6) is temporary, as is discussed later in the article.

/15/ See, e.g., section 954(c)(3)(A) and reg. sections 1.952-1(g), 1.954-1(g), 1.954-2(b)(4)(i)(B) and (5)(i)(B), and 1.702-1(a)(8)(ii). These rules generally address income received or earned by a partnership (the partnership income scenario); thus, a stronger position exists to apply the CFC look-through rule for payments received by a partnership that is included in the distributable share of income/loss allocated to the CFC partner (as compared with the partnership expense scenario). For a further discussion of the application of the subpart F rules as they apply to CFC-owned partnerships, see Lowell D. Yoder, 927 T.M., "CFCs- Foreign Personal Holding Company Income."

/16/ See House and Conference reports relating to section 103 of TIPRA.

/17/ See, e.g., reg. section 1.954-1(g)(1).

/18/ When Congress intends that a bifurcation take place, it generally has in the past enacted specific rules to provide for a bifurcation; for example, pre-2003 and post-2002 look-through for 10/50 companies made by the Taxpayer Relief Act of 1997 and changes made to the 10/50 company rules by subsequent legislation, and pre- 1987 and post-1986 tax and E&P pools from the Tax Reform Act of 1986.

/19/ Section 904(d)(3)(C) provides that any interest, rent, or royalty that is received or accrued from a CFC in which the taxpayer is a U.S. shareholder is treated as income in a separate category to the extent it is properly allocable (under regulations) to income of the CFC in that category. Reg. sections 1.904- 5(c)(2) and -5T provide very detailed rules for allocating related-party interest. The rules for allocating rents and royalties are contained in reg. section 1.904-5(c)(3), which provides:

> Any rents and royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent they are allocable to income of the controlled foreign corporation in that category under the principles of [sections] 1.861-8 through 1.861-14T.

/20/ Section 904(d)(3)(D) provides that any dividend paid out of the E&P of any CFC in which the taxpayer is a U.S. shareholder is treated as income in a separate category in proportion to the ratio of (i) the portion of E&P attributable to income in that category to (ii) the total amount of E&P. For further details, see generally reg. sections

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1.904-5(c)(4) and -5T and Notice 88-71, 1988- 2 C.B. 374. This provision generally applies a pooling approach to dividend distributions for foreign tax credit purposes. This should be contrasted with the layering approach to dividend distributions provided in section 316, reg. section 1.316-2(a), and LTR 199907022, Doc 1999-6622, 1999 TNT 34-26 (the IRS concludes in applying the same-country exception for dividend distributions that a distribution is treated as first coming out of the CFC's most recently accumulated E&P).

/21/ To the extent a payer-CFC has subpart F income that is included in a U.S. shareholder's income under section 951, the amount of E&P representing that income inclusion will be characterized as previously taxed E&P (PTI) under section 959. The code and regulations provide ordering rules when there is a distribution by a CFC that has PTI. The ordering rules generally provide that PTI of a CFC is distributed before non-PTI on a distribution through a section 958(a) chain of CFCs. See section 959(c). Further, section 959(b) operates to shield the U.S. shareholder (and some successors in interest) from having a section 951 inclusion on the distribution of the PTI through the section 958(a) chain, with the PTI retaining its character as PTI at the upper-tier CFC level. See also reg. sections 1.959-2(b) and 3(b). Those rules essentially preserve a U.S. shareholder from being taxed on the same E&P twice. After depleting the PTI that reflects the payer-CFC's subpart F income, it would seem that the payer-CFC's remaining E&P generally would be non-subpart-F E&P, thus qualifying for an exception to FPHCI under the CFC look-through rule. For minority ownership and distributions of PTI through the chain, see Rev. Rul. 82-16, 1982-1 C.B. 106. For the effect of foreign taxes on the PTI accounts, see reg. section 1.959-3(d). The facts of each dividend distribution must be analyzed to determine its treatment under the CFC look-through rule.

/22/ It would be an odd result if the CFC look-through rule would consider the E&P/income related to the prior subpart F inclusions represented by the PTI in determining whether the remaining portion of the distribution (the remaining $ 20) is attributable or properly allocable to subpart F income. If that PTI were considered in the analysis and a portion of the dividend were considered attributable to subpart F income, the policy of section 959 would appear to be circumvented.

/23/ For a general look-through approach that applies for distributions of preacquisition E&P of a 10/50 company and the E&P and taxes accumulated in a non-look-through period, see T.D. 9260 and reg. section 1.904-7T. Query: Assuming that the E&P do not have to be generated when there is a related-party relationship as long as the CFCs are related at the time of the distribution, if the payer-CFC generated E&P while it was foreign-owned (not a CFC) and the E&P related to passive-type income that would have been subpart F income had it been a CFC but is not because there was no U.S. shareholder/CFC relationship, are the E&P attributable or properly allocable to non-subpart-F income for purposes of the CFC look- through rule?

/24/ Interestingly, in a somewhat related context, the IRS recently applied look-through treatment in the context of determining whether a foreign corporation is a passive foreign investment company. Specifically, in LTR 200604020, Doc 2006- 1630, 2006 TNT 19-37, the IRS concluded that, for purposes of determining whether a foreign corporation's gain from the sale of stock of a 25 percent owned subsidiary is passive income under section 1297(b)(1), the sale of the stock should be treated as a sale of the foreign corporation's proportionate share of the assets of the 25 percent owned subsidiary (and lower-tier 25 percent owned subsidiaries) that are treated as held by the foreign corporation under section 1297(c). For a further discussion of this ruling, see Calianno, "IRS Concludes That PFIC Look-Through Rule Applies to Gain on Sale of Subsidiary Stock," Journal of International Tax (May 2006).

/25/ 122 T.C. 324, Doc 2004-9660, 2004 TNT 88- 15 (2004).

/26/ For the authors' general commentary on this aspect of the law change, see Calianno, RIA's Complete Analysis of the Tax Increase Prevention and Reconciliation Act, para. 602, "Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Income Rules Subject to Look-Through Treatment for Tax Years Beginning Before 2009," and Yoder and Collins, CCH's Practical Analysis of Look-Through Treatment for Related Controlled Foreign Corporation Payments, Tax Increase Prevention and Reconciliation Act of 2005: Law and Explanation at para. 540.

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/27/ See section 954(d)(2) and reg. section 1.954- 3(b). The branch rule provides that if a CFC conducts sales activities through a branch or similar establishment located outside the CFC's country of incorporation and the use of the branch "has substantially the same tax effect" as if the branch were a separate wholly owned CFC, the branch will be treated as a separate CFC for purposes of determining whether the CFC earned FBC sales income. The branch rule was intended to prevent U.S. persons from segregating the sales income of a CFC (which can be conducted through a tax haven) from the operational income of a CFC (which typically must be earned in a more industrialized country with a higher tax rate). Essentially, this rule is designed to prevent a CFC from circumventing the FBC sales rules by using a branch rather than a separate CFC and, generally, puts both structures on equal footing from an FBC sales perspective. However, under some circumstances, it may be possible that a CFC/CFC structure may yield a better result from an FBC sales perspective than a CFC/FDE structure.

/28/ See sections 954(a)(3) and 954(e) and reg. section 1.954-4.

/29/ See generally section 902.

/30/ See generally section 351 for the requirements that must be satisfied. The IRS generally requires a business purpose for a section 351 transaction. See, e.g., FSA 200233016, Doc 2002-19076, 2002 TNT 160-17, and Caruth v. U.S., 688 F. Supp. 1129 (D.C. Tex. 1988), aff'd on other grounds, 865 F.2d 644 (5th Cir. 1989). Whether a business purpose is required to implement tax planning, vis-a-vis a check-the-box election, to take advantage of a newly enacted statute would have to be considered.

/31/ See generally reg. sections 1.367(b)-1 and - 4.

/32/ See generally prop. reg. sections 1.987-2(f) and 1.987-3.

/33/ See generally section 381.

/34/ Reg. section 301.7701-3(c)(1)(iv).

/35/ See generally section 367(e) and reg. section 1.367(e)-2(c).

/36/ See generally prop. reg. section 1.367(b)-7. Other international provisions also may apply and should be considered as a result of the liquidation, depending on the specific facts.

/37/ For rules relating to the deficit rule, see generally section 952(c)(1)(B). Section 952(c)(1)(B)(iii) defines five separate types of qualified activity (for example, foreign base company oil-related income, FBC sales income, and FBC services income). A qualified deficit is any deficit in the CFC's E&P for any prior tax year that began after December 31, 1986, and for which the CFC was a CFC, but only to the extent the deficit is attributable to the same qualified activity as the activity giving rise to the income being offset and has not previously been taken into account. For further details on a qualified deficit, see section 952(c)(1)(B)(ii).

/38/ The rules of section 952(c)(1)(B) should be contrasted with the rules in sections 954(b)(4) and 954(b)(5) in which subpart F income "shall not include" or is "reduced," as opposed to the qualified deficit rule that permits subpart F income to linger.

/39/ Consider the following example: USP, a domestic corporation, wholly owns CFC1 and CFC2. In year 1, CFC1 has a $ 100 qualified deficit relating to its business that, if profitable, would have generated FBC sales income. As part of that deficit, it pays $ 5 of rent to CFC2 for the use of property that is used in that business. In year 2, CFC1 has $ 40 of income related to FBC sales income and once again pays $ 5 of rent to CFC2. USP generally will be able to rely on section 952(c)(1)(B) to reduce its inclusion under section 951(a)(1)(A) relating to CFC1's FBC sales income in year 2. Query: Does CFC2 have FPHCI under the CFC look-through rule because the rental payment relates to FBC sales income even though the deficit rule allows USP to shelter that income in the case of CFC1?

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/40/ "Every person who is a United States shareholder . . . of [a CFC] and who [directly or indirectly] owns stock in such corporation . . . shall include in his gross income" his pro rata share of the subpart F amounts of the CFC. Thus, the deemed distribution is not treated as passing through the chain of intervening CFCs. Section 951(a)(1) and reg. section 1.951-1(b)(2), Ex. 4. See also reg. section 1.1248-1(d)(1)(ii). See Conf. Rep. No. 99-841, 99th Cong., 2d Sess.II-623 (Sept. 18, 1986) (describing the "hop-scotch principle").

/41/ Section 960. See reg. section 1.960-1(c)(4), Ex. 3. Indirect credits are permitted from a sixth-tier CFC if specified requirements are satisfied, but not from a seventh-tier CFC or beyond. See section 902(b)(2).

/42/ See section 902(a). See also reg. section 1.902-1(f), Ex. 4 (suggesting that section 956 may be used to avoid locking in lower-tier deemed-paid credits at the upper-tier CFC level as a result of a deficit in E&P). For a detailed discussion of other planning ideas, see Yoder and McGill, "Treatment of CFC Loans to U.S. Affiliates: The Sword and Sickle of Subpart F," 26 Tax Mgmt. Int'l J. 454 (Sept. 12, 1997). The IRS generally concedes that section 956 may be used affirmatively (see Rev. Rul. 90-112, 1990-2 C.B. 186), but it may attempt to apply substance- over-form principles to deny the desired results under some circumstances (see CCA 200137005, Doc 2001-23705, 2001 TNT 180-68).

/43/ Emphasis on the word "more" in this sentence is necessary. Certainly, the branch rule of section 954(d)(2) seeks to tax purchasing and selling activity that may have been shifted from a high-tax jurisdiction (the place of manufacturing) to a lower- tax jurisdiction.

/44/ For example, section 269 or the "business purpose" or the "economic substance" doctrines would seem like more appropriate avenues for the IRS to attack potentially abusive situations (if there are any) given the lack of any readily identifiable potential abuse regarding the new CFC look-through rule.

/45/ Section 965, enacted as part of the American Jobs Creation Act of 2004.

/46/ See Martin A. Sullivan, "Economic Analysis: On Corporate Tax Reform, Europe Surpasses the U.S.," Tax Notes, May 29, 2006, p. 992, Doc 2006-10099, 2006 TNT 103-5.

END OF FOOTNOTES

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