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Corporate Taxes

A little discussed provision of the tax reform bill changes the stock attribution rules for determining when a foreign corporation is treated as a controlled foreign corporation (CFC) for U.S. tax purposes. This expansion of the CFC definition creates an immediate reporting obligation with respect to those corporations, a requirement that could prove costly to multinationals if they fail to file information returns on time.

Changes to CFC Definition Expands Reach of Section 965 Transition Tax, Creates New Reporting Obligations

BY BRITT HAXTON AND SANDRA MCGILL

Introduction

When Republicans unveiled their tax reform proposal, they introduced the most sweeping overhaul of the Internal Revenue Code in more than 30 years. A few of the international corporate provisions in the bill have, thus far, received most of the attention of commentators: The transition tax, the base erosion rules, and the inclusion of "global intangible low-taxed income" will all have major U.S. tax consequences for multinational corporations.

But one provision that may have slipped under the radar for some taxpayers will likely be relevant for many multinational corporations, including non-U.S.-owned multinational corporations. Section 14213 of the bill amends tax code Section 958(b), which has the effect of changing the stock attribution rules for determining whether a foreign corporation is a CFC and whether a U.S. person is treated as a U.S. shareholder of the CFC for U.S. federal income tax purposes. The modification of the stock attribution rules is, by itself, an important change to which corporations and their tax managers should pay close attention. More surprising, perhaps, and of more immediate relevance is the retroactive effective date: Amendments to Section 958(b) apply to the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent taxable year of such foreign corporations. In other words, some foreign corporations that were not considered CFCs before this amendment will be treated as CFCs for certain purposes, effective in 2017.

Britt Haxton is a partner with McDermott Will & Emery in Washington, D.C., focusing on international tax matters. Sandra McGill is a partner with the firm in Chicago, focusing on international tax planning.

It is not yet clear whether the IRS will issue guidance providing a grace period for foreign corporations affected by this provision. Lacking that, some multinationals may face hefty penalties if they fail to timely file Forms 5471 for the affected subsidiaries.

Current Stock Attribution Rules Under Section 958(b)

A CFC is defined in Section 957 as a foreign corporation that is more than 50% owned (directly, indirectly, or constructively under Section 958(b)) by U.S. persons who are U.S. shareholders. A U.S. shareholder is defined in Section 951(b) as a U.S. person who owns (directly, indirectly or constructively under Section 958(b)) 10% of the voting stock of a CFC. The constructive ownership rules are all found in Section 958(b).

Section 958(b) of the tax code provides that the Section 318(a) constructive ownership rules apply (with certain exceptions) for purposes of determining whether a foreign corporation is a CFC under Section 957 or whether a U.S. person is a U.S. shareholder under Section 951(b). Specifically, Section 958(b)(4) modifies the application of Section 318(a) by providing

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that Sections 318(a)(3)(A), (B), and (C) do not apply for purposes of Section 958(b) to consider a U.S. person as owning stocked owned by a non-U.S. person. Sections 318(a)(3)(A), (B), and (C) are provisions that treat a U.S. corporation, partnership, or trust as owning stock which is owned by a foreign shareholder corporation, a foreign partner, or a foreign beneficiary of a trust or estate. As a result of Section 958(b)(4), stock owned by a foreign corporate shareholder, a foreign partner, or a foreign beneficiary of a trust or estate is never attributed to a U.S. person such as a domestic corporation, partnership, or trust, respectively, for purposes of defining a CFC or a U.S. shareholder. As discussed below, the amendments made by the tax reform bill change that, by allowing attribution of stock from a non-U.S. person to a U.S. person.

Modification of Subpart F Stock Attribution Rules in Section 958(b)

Section 14213 of the tax reform bill repeals current Section 958(b)(4) of the tax code. Section 14213 also strikes the phrase ''Paragraphs (1) and (4)'' in the last sentence of Section 958(b) and inserts ''Paragraph (1).'' Earlier versions of both the House and the Senate bills contained an identical provision. Section 14214 of the tax reform bill also expands the definition of a U.S. shareholder to mean any U.S. person who owns 10% of the stock of a CFC, both by vote or by value, effective for taxable years of foreign corporations beginning after Dec. 31, 2017.

It is believed that the repeal of Section 958(b)(4), together with the change to the definition of U.S. shareholder, is in response to CFCs decontrolling in an effort to avoid subpart F inclusions for U.S. shareholders. As a result of the repeal of Section 958(b)(4), a foreign subsidiary that is more than 50 percent owned (by vote and value) by a foreign parent corporation would be treated as a CFC if the foreign parent corporation also owns more than 50 percent of the value of the stock of a domestic subsidiary. That is, as a result of the Section 318(a)(3)(C) constructive ownership rules (post-repeal of Section 958(b)(4)), the domestic subsidiary of the foreign parent corporation would be treated as constructively owning more than 50 percent of the foreign subsidiary (through attribution from the foreign parent corporation).

As noted above, the repeal of Section 958(b)(4) which affects both the definition of a U.S. shareholder and the definition of a CFC shall apply to ''the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent taxable year of such foreign corporations,'' and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. In effect, the amendment to the definition of a CFC and a U.S. shareholder is retroactively effective to the first day of the last taxable year that begins before Jan. 1, 2018 (e.g., Jan. 1, 2017, for calendar-year taxpayers).

Importantly, the change in the attribution rules does not necessarily subject a U.S. shareholder to U.S. tax on the CFC's foreign earnings as a result of the change in the constructive ownership rules. This is because Section 951(a)(2) provides that only a U.S. shareholder that directly or indirectly owns stock in a CFC is required to include in gross income its share of the CFC's Subpart F income. So, only if the domestic shareholder directly or indirectly owns stock in the foreign subsidiary, such as in the case of a decontrolled CFC, could the repeal of Section 958(b)(4) result in Subpart F income inclusion with respect to a U.S. person that is not otherwise a U.S. shareholder. The change in the attribution rules will have other adverse consequences, as discussed below.

Consequences of Modification of Subpart F Stock Attribution Rules

Section 965 Transition Tax

Section 965 results in a mandatory deemed Subpart F inclusion of post-1986 accumulated foreign earnings attributed to a U.S. shareholder's ''specified foreign corporations'' in the last taxable year which begins before Jan. 1, 2018. Therefore, one question that arises is whether the amendments to Section 958(b) may cause additional foreign corporations to be considered ''specified foreign corporations'' for purposes of the transition tax. Section 965(e)(1) defines a specified foreign corporation as (a) a CFC, or (b) any foreign corporation in which a domestic corporation is a U.S. shareholder. As stated above, Section 958(b) applies the Section 318 constructive ownership rules to the extent the effect is to treat a U.S. person as a U.S. shareholder and to treat a foreign corporation as a CFC. Because the effective date of the Section 958(b)(4) repeal is retroactive, a specified foreign corporation appears to be determined without regard to that provision. Thus, more corporations would be treated as ''specified foreign corporations'' for purposes of the transition tax but, as discussed below, there is still a question as to whether any additional amount should be included in a U.S. shareholder's income as a result.

As noted above, the Section 958(b) constructive ownership rules do not apply to require a U.S. shareholder to include Subpart F income under Section 951(a)(1) because Section 951(a)(1) only applies to a U.S. shareholder who owns stock in a CFC ''within the meaning of Section 958(a)'' (i.e., directly or indirectly). The amount of post-1986 accumulated foreign earnings taken into account under Section 965 is defined to include only income that would be included in a U.S. shareholder's gross income under Section 951(a)(1). The repeal of Section 958(b)(4) could nonetheless result in mandatory inclusion under Section 965 to the extent that a domestic corporation has some direct or indirect ownership.

For example, consider the typical corporate structure after a decontrol transaction: A foreign parent owns 95 percent of a foreign subsidiary and 100 percent of a domestic subsidiary; the domestic subsidiary owns the remaining 5 percent of the foreign subsidiary. The repeal of Section 958(b)(4) causes the foreign subsidiary to be treated as a CFC and a ''specified foreign corporation.'' Moreover, the repeal of Section 958(b)(4) causes the domestic subsidiary to be treated as a U.S. shareholder. The domestic subsidiary would include the post-1986 deferred foreign income in its gross income under Sections 951(a)(1)(A) and 965 to the extent of its direct or indirect ownership of the specified foreign corporation (5 percent).

Therefore, the repeal of Section 958(b)(4) expands the number of entities that may qualify as specified for-

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eign corporations, and, in the certain cases, may also result in the inclusion of a portion of the post-1986 accumulated foreign earnings of such corporations in the gross income of the U.S. shareholder under Section 951(a)(1).

Information Reporting for Controlled Foreign Corporations

Under Section 6038(a)(1) and the related regulations, every U.S. person who ''controls'' a foreign business entity for an uninterrupted period of 30 days or more during an annual accounting period is required to file an annual information return with the taxpayer's U.S. federal income tax return on Form 5471. In the case of a foreign corporation that is a CFC, Section 6038(a)(4) provides:

> If any foreign corporation is treated as a controlled foreign corporation for any purpose under subpart F of part III of subchapter N of chapter 1, the Secretary may require any United States person treated as a United States shareholder of such corporation for any purpose under subpart F to furnish the information required under paragraph (1).

Although Treasury has not issued regulations under Section 6038(a)(4), Form 5471 (which is used by U.S. persons to satisfy the reporting requirement under Section 6038) states that a U.S. shareholder who owns stock in a foreign corporation that is a CFC for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned that stock on the last day of that year, is considered a ''Category 5 Filer'' that must file Form 5471. The IRS-issued instructions to Form 5471 provide that, for purposes of Category 5, a CFC is a foreign corporation that has U.S. shareholders that own (directly, indirectly, or constructively, within the meaning of Sections 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50% of (a) the total combined voting power of all classes of its voting stock, or (b) the total value of the stock of the corporation.

Based on the above, the repeal of Section 958(b)(4) will likely have an impact on CFC information reporting as Section 958(b) constructive ownership by U.S. shareholders is taken into account for purposes of CFC information reporting. Accordingly, the broadening of the definition of a CFC and a U.S. shareholder for the purposes of Form 5471 will result in more foreign corporations being subject to compliance requirements that, if left unsatisfied, could result in significant fines to their U.S. shareholders. Specifically, if a taxpayer fails to timely file a Form 5471, the IRS may assess a $10,000 penalty for each failure to file for each applicable accounting period. Moreover, Section 6501(c)(8)(A) provides that a taxpayer that is required to file Form 5471 under Section 6038 will have tax assessed with respect to ''any tax return, event, or period to which such information relates'' for a period up to three years *after* the date that the taxpayer reports the information to the IRS. In other words, if a taxpayer fails to furnish information on Form 5471, there is an extended statute of limitations. For some multinational corporations with multiple foreign subsidiaries, this oversight could prove to be a costly error.