A Note From the Editor-in-Chief

Living Without Code Sec. 954(c)(6)

Dividends, interest, rents and royalties received or accrued by a CFC generally constitute subpart F, foreign personal holding company income (FPHCI). Code Sec. 954(c)(6), however, provides an exception for such amounts received or accrued from a related CFC, except to the extent the payment reduces subpart F income of the payor.¹

Code Sec. 954(c)(6) expires for tax years beginning after December 31, 2011. Thus, U.S. multinationals should review their global structures, assess the subpart F consequences of the exception expiring (whether now or in the future) and determine if restructuring would be warranted.

In the absence of Code Sec. 954(c)(6), a disregarded entity (“DE”) structure may be used to avoid FPHCI. Dividends, interest, rents or royalties are ignored if paid by a DE to its owner (or vice versa), or paid by one DE to another DE with the same owner. For example, a foreign holding company may own a German company and an Irish company that are disregarded for U.S. purposes.² Interest paid by the German DE to the Irish DE is ignored when applying subpart F. Dividends paid by the German DE to the holding company also are ignored.

One must consider all U.S. tax consequences of electing DE status for a CFC. Disregarding operating companies under a holding company would result in averaging high and low tax pools of earnings reducing the ability to repatriate high taxed earnings. In addition, electing DE status for an entity deriving sales or services income can result in the loss of same country exceptions under the foreign base company sales and services income rules of subpart F. For example, income derived by a DE that performs services in its country of organization on behalf of a related person would become foreign base company services income. Furthermore, disregarding an entity can trigger application of the subpart F branch rules. For example, a CFC parent may purchase products from unrelated persons and sell products to unrelated persons, and hire a CFC subsidiary to engage in substantial contribution manufacturing activities. Electing to treat the subsidiary as a DE can cause the sales income to become subpart F income under the branch rules.³ Finally, Code Sec. 987 results in gain or loss with respect to payments made by a DE with a functional currency different from that of its owner. Accordingly, careful analysis must be undertaken before deciding to elect disregarded entity status, and the approach should be selective.

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Without Code Sec. 954(c)(6), FPHCI payments between CFCs may qualify for the narrower same country, related person exception. Dividends and interest qualify if received from a related person organized under the laws of the same foreign country as the CFC and that has more than 50 percent of its assets used in a trade or business in such country. Rents and royalties are not FPHCI if received from a related person for the use of, or privilege of using, property in the country where the CFC is organized. These exceptions are inapplicable, however, to the extent a payment reduces the payor’s subpart F income.

The same country exception often would not be available for dividends and interest payments received from a holding company or a finance company due to the business assets requirement. On the other hand, the CFC receiving the payments is not required to satisfy the business assets test. For example, a UK partnership classified as a corporation may loan funds to a related UK operating company and the interest generally should qualify for the same country exception.

Dividends, interest, rents and royalties received by a CFC also may qualify for the high tax exception. Such amounts qualify if subject to a tax rate that is greater than 90 percent of the corporate tax rate, i.e., 31.5 percent. The amount of taxes taken into account is the amount of deemed paid taxes that would accompany the FPHCI under Code Sec. 960. Accordingly, for payments received from a related person this calculation generally is based on the effective tax rate of the CFC’s general basket post-1986 pool (rather than the actual amount of taxes paid on the item of income). For example, if interest received by a Japanese CFC from a related person were subject to a 40-percent tax rate but the CFC’s post-1986 pool effective tax rate was 30 percent, the interest would not qualify for the high-tax exception. On the other hand, if a UK CFC received interest from a related person subject to a 27-percent tax rate but the post-1986 pool had a 34-percent effective tax rate, the item of income should qualify for the high-tax exception. The exception is of decreasing utility in view of the ever-shrinking list of countries with corporate tax rates higher than 31.5 percent (including countries like the U.K., Italy and Germany).

There would be no subpart F income inclusion if a CFC has an overall loss for the year. A CFC is required to calculate its separate items of subpart F income by allocating and apportioning expenses to each item. When the CFC has net dividend, interest, rent or royalty income, but an overall loss, Code Sec. 954(c) provides that such FPHCI is not currently included in the income of the CFC’s U.S. shareholders. Nevertheless, the FPHCI reduced by the loss would be recaptured in a subsequent year when the CFC has non-subpart F income.

Under the regulations the high tax exception does not apply to the extent the current E&P limitation reduces FPHCI, even if the FPHCI reduced would have otherwise qualified for the high-tax exception. As a result, such amounts would be recaptured as FPHCI in a later year. In addition, the high-tax exception is not available for recapture income. Not permitting the high tax exception to apply under these circumstances is inappropriate and may be considered as inconsistent with the Code.

ENDNOTES

1 See Notice 2007-9, 2007-1 CB 401.
2 Reg. §301.7701-3(a).
3 See T.D. 9438, 73 FR 79,334, 79,342 (Dec. 29, 2008); Lowell D. Yoder, A Note from the Editor-in-Chief, Code Sec. 954(c)(6) and the Same Country Rules for Sales and Services Income, J. TAX’N GLOBAL TRANS., Fall 2006, at 3.
4 Code Sec. 954(c)(3); Reg. §1.954-2(b)(4), (5).
5 The requirements must be satisfied for dividends for the years during which the earnings and profits distributed were earned. In addition, the stock on which the dividends are paid must have been owned directly or indirectly through a chain of qualifying corporations when the earnings and profits distributed were derived. Code Sec. 954(c)(3)(C); Reg. §1.954-2(b)(4)(ii)(A)(2).
7 Code Sec. 954(b)(4); see also Code Sec. 954(b)(3)(A) (de minimis exception).
8 Dividends, interest, rents and royalties received by a CFC from related persons generally fall in the general foreign tax credit basket, except to the extent a payment reduces the payor’s passive income. Reg. §1.904-5(c), (i).
9 Interest, rents and royalties received by a CFC from a related person fall within the passive basket if they reduce passive income of the payor. Additional rules apply when determining whether passive FPHCI qualifies for the high-tax exception. Reg. §1.954-1(d)(3)(ii).
10 Reg. §1.954-1(a)(5) & (7), (d)(4)(ii); Reg. §1.952-1(e)(4).

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