A Note From the Editor-in-Chief

Redeploying Foreign Cash from the United States

Operating profits derived by foreign subsidiaries of a U.S. multinational generally are not subject to current U.S. taxation. Excess funds accumulated by a controlled foreign corporation (CFC), however, may become subject to U.S. tax depending on how they are utilized within the global group. Foreign tax costs also must be considered.

Often, the most straightforward way to utilize excess foreign funds is for the CFC to distribute them to its U.S. parent and manage the treasury function from the United States. The U.S. parent may then loan or contribute as capital the funds to other foreign subsidiaries. In addition, the U.S. group may use the cash for acquisitions, paying down debt, paying dividends or buying back stock.

Distributions from a foreign subsidiary to its U.S. parent generally are treated as dividends subject to U.S. taxation. The U.S. tax on such dividends may be reduced by the amount of foreign taxes deemed paid and actually paid (e.g., foreign withholding taxes) with respect to the earnings distributed. In addition, excess foreign tax credits of the U.S. consolidated group may be applied to reduce U.S. taxes. Where the foreign tax rate on earnings of CFCs is substantially lower than the U.S. tax rate, such approach to accessing foreign cash can result in incremental U.S. tax costs.

Earnings of a CFC may have been previously included in the income of the U.S. shareholders under subpart F. Such earnings may be distributed to the U.S. parent without being again subject to U.S. tax, and a distribution is considered as made first from previously taxed earnings.

Under certain circumstances, a distribution may be treated as a return of basis, and not subject to U.S. taxation. This can occur when the U.S. parent has basis in the distributing CFC’s stock and the CFC has no earnings, e.g., a top-tier foreign holding company that owns stock in operating companies. The basis may have resulted from contributions of cash or other property to the CFC or the acquisition of the CFC’s stock. The holding company could borrow to make the distribution to the U.S. parent. Certain stock redemption distributions also can be treated as a tax free return of basis.

Rather than distributing excess funds to the United States, a CFC may loan funds to its U.S. parent or to a U.S. affiliate. Code Sec. 956 provides that such a loan is treated as a deemed distribution resulting in current taxation of the CFC’s earnings. Such deemed distribution is not subject to U.S. taxation to the extent of the CFC’s previously taxed earnings. In addition, exceptions are provided for short-term loans.
A possible benefit of a loan is that it permits directly accessing excess cash of lower-tier CFCs. This may avoid foreign taxes and foreign limitations on distributions of the funds up through tiers of CFCs. In addition, the lower-tier CFC’s earnings are deemed distributed directly to the U.S. affiliate (i.e., hopscotch rule), thus avoiding dilution of high-taxed earnings of a lower-tier CFC that would occur if distributed up through a chain of CFCs with low-taxed earnings. The earnings taxed under Code Sec. 956 may be distributed in a subsequent year to the U.S. parent without being treated as a dividend.

A CFC could acquire stock in a U.S. affiliate for cash. While this generally is not a taxable transaction, Code Sec. 956 provides that such investment is treated as a deemed dividend to the U.S. shareholders of the CFC. In addition, a subsequent redemption of the shares could result in a dividend of U.S. earnings to the CFC with material U.S. tax costs (e.g., withholding taxes and subpart F income).

It is common for U.S. multinationals to restructure the ownership of their foreign subsidiaries for important business reasons. These transactions can provide opportunities to avoid foreign limitations on accessing foreign cash and reduce tax costs.

For example, assume that USP owns all of the stock of two CFCs, CFCT and CFCA, and has $1,000 of basis in the stock of CFCT. CFCA holds stock in several other CFCs, and acquires all of the stock of CFCT from USP for $1,000. CFCA has $800 of earnings with associated foreign taxes of $800, and CFCT has $500 of earnings with associated foreign taxes of $50. For U.S. tax purposes, the $1,000 payment is treated as a dividend, sourced $800 from CFCA's earnings (with $800 of taxes) and $200 from CFCT's earnings (with $20 of taxes). Generally, the foreign tax credits should eliminate the U.S. tax on the dividend.

Alternatively, where neither the acquirer nor the target has earnings, the purchase price should be a tax-free return of basis to the extent of the basis in the target’s stock. If in the above example neither CFCA nor CFCT had earnings, the $1,000 payment for the CFCT stock should not result in taxable income.

The regulations provide that a CFC that funds CFCAs’s acquisition may be considered as the deemed acquirer (and its earnings deemed distributed) where a principal purpose is to avoid the application of Code Sec. 304. Recent regulations expanded this rule to apply not only to loans and capital contributions, but also to funding “by any means,” including facilitating the repayment of a third-party obligation. In addition, the recent regulations prevent transactions intended to avoid taking into account CFTC’s earnings where CFCT is first transferred to another CFC without earnings which CFC is then acquired by CFCA. Moreover, recent regulations would require gain to be recognized to the extent the payment exceeds the earnings of CFCA and CFCT plus the basis in the CFCT shares (basis in USP's existing shares in CFCA cannot reduce any gain).

The above transaction is treated differently if, pursuant to a plan, CFCT is liquidated (or deemed liquidated as a result of a classification election) following the acquisition. This is treated as a “D” reorganization. In this case, USP has income only to the extent of the gain in the CFCT stock, which would be zero in the above example regardless of the amount of earnings of CFCA and CFCT. The Obama Administration has proposed to remove the gain limitation, which would result in dividend income to the extent of relevant earnings.

The Administration also proposed to calculate deemed paid foreign tax credits based on averaging all earnings and taxes of CFCs, which would eliminate opportunities to distribute high-tax earnings to the United States. This likely will result in increased redeployment of foreign cash from outside the United States.

ENDNOTES

1 Furthermore, some U.S. multinational groups may not be able to fully use foreign tax credits currently because of net operating losses, current year foreign losses or overall foreign losses.


4 Regulations were recently issued to prevent transactions that could result in zero basis in the U.S. affiliate’s stock, which would have avoided a deemed dividend under Code Sec. 956. See Lowell D. Yoder, Gleanings from §956 Developments, 38 TAX MGMT. INT’L J. 39 (Jan. 9, 2009).

5 T.D. 9477, Reg. §1.304-4T.

6 T.D. 9444, Reg. §1.367(a)-9T.


This article is reprinted with the publisher’s permission from the INTERNATIONAL TAX JOURNAL, a bimonthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the Journal of INTERNATIONAL TAX JOURNAL or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.