TCJA Technical Glitches, Minority Investments in Foreign Corps.

To the Editor:

The pending Tax Cuts and Jobs Act proposes significant changes to the U.S. tax rules relating to ownership of stock in foreign corporations by U.S. persons that are U.S. shareholders (that is, they own at least 10 percent of the foreign corporation's stock). We are writing to call attention to what we believe are two unintended consequences of these rules — potentially with far-reaching effect — that relate to minority investments by U.S. shareholders. Others may disagree whether the consequences we describe here were intended by the drafters as a policy matter. We hope that drawing more focus to these issues will result in them being discussed and (if necessary) fixed before final legislation is enacted.

We believe that the fact patterns raised by these issues are quite common, and anticipate that many taxpayers will encounter them (in many cases unexpectedly) if the Tax Cuts and Jobs Act is enacted in its currently proposed form.

The first issue relates to section 245A, which provides a 100 percent dividends received deduction to corporate U.S. shareholders that receive foreign source dividends from foreign corporations (other than passive foreign investment companies). The deduction is intended to be allowed only for income arising from foreign active businesses. That goal is accomplished mechanically (in part) by using subpart F to identify passive income and not allowing a deduction to offset income reported under subpart F.

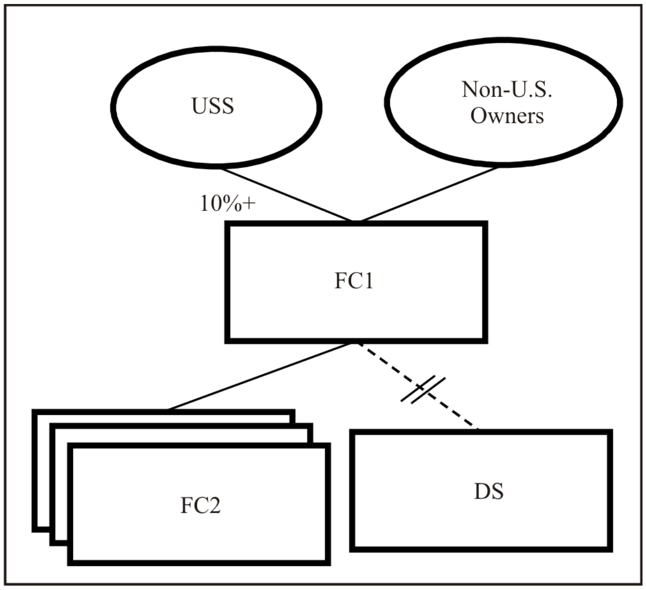
Subpart F income generally includes dividends. However, section 954(c)(6) excludes from subpart F income dividends received by one CFC from a related CFC (defined to require a more than 50 percent ownership link). Thus, if a domestic corporation (USS) owns 100 percent of the stock of a foreign corporation (FC1) which owns 51 percent of a second foreign corporation (FC2), dividends paid by FC2 to FC1 would qualify for the section 954(c)(6) exclusion, and could be paid first by FC2 to FC1 and then (under the proposed legislation) as a dividend to USS without a U.S. tax. The legislation would make section 954(c)(6) permanent (it now expires in 2020).

But suppose that USS owns less than 50 percent of the foreign corporation paying dividends. In that case, the treatment of the dividend income depends significantly on whether the stock is held directly or through another foreign corporation. If USS owns 40 percent of FC2, then dividends paid to it by FC2 would qualify under proposed section 245A, because that section does not require that the payor be a CFC. On the other hand, if USS owns 100 percent of FC1, which owns 40 percent of FC2, then there is a very different result. Dividends paid by FC2 to FC1 are subpart F income and fully taxable to USS.

This difference in the current version of the Tax Cuts and Jobs Act does not seem to us to be the result of a policy choice, and hopefully is just an unintended glitch. It could be fixed by expanding the scope of section 954(c)(6) to exclude from subpart F income dividends paid by a lower-tier corporation that would qualify for the dividends received deduction of section 245A if received directly by the applicable U.S. shareholder.

The second issue also relates to minority investments by U.S. shareholders in a foreign corporation. Suppose USS (in this case *any* domestic person, not necessarily a corporation) owns 10 percent of the stock of FC1, a foreign public corporation with worldwide operations (including some in the United States). FC1 has many foreign subsidiaries, including a wholly owned foreign corporation FC2. It also has a small wholly owned domestic subsidiary in the United States (DS) that acts as a distributor. Assume that USS is the only U.S. shareholder of FC1. The ownership structure is shown in the diagram below. Under current law, FC1 and FC2 would not be CFCs, which is appropriate because there is only one U.S. shareholder and it owns only 10 percent (directly or indirectly) of their stock, far below the "more than 50 percent" necessary for CFC status.

Under the Tax Cuts and Jobs Act, that result would appear to change. FC2 would, it seems, become a CFC, and USS would be a U.S. shareholder subject to subpart F inclusions. We believe this result was not intended and should be changed.



Both the House and Senate versions of the bill would remove section 958(b)(4), which prevents downward attribution of stock ownership from a foreign shareholder to a domestic corporation, partnership, trust, or estate to determine (among other things) whether a foreign corporation is a CFC and whether a U.S. person is a U.S. shareholder in that CFC. If section 958(b)(4) is removed, in the example above all the stock of FC2 that is owned by FC1 would be attributed to DS for purposes of testing whether FC2 is a CFC and DS is a U.S. shareholder. Since FC1 owns 100 percent of FC2 stock, DS (through attribution) would be treated as a U.S. shareholder of FC2, and FC2 would be considered a CFC. Additionally, because FC2 would be a CFC, USS, which owns indirectly (through FS1) 10 percent of the stock of FC2, would also be a U.S. shareholder with respect to FC2, and USS would be subject to current inclusion of any subpart F income of FC2. The same of course would also be true of other foreign subsidiaries of FC1 or FC2.[1]

We believe the reason the House and Senate proposed removing section 958(b)(4) was to require a domestic subsidiary of a foreign parented group that owns an interest in other foreign group companies to treat such companies as CFCs in applying subpart F, particularly in cases in which the foreign group company was historically a CFC and a majority interest was moved to foreign members of the group. In that fact pattern, the domestic subsidiary would be allocated its pro rata share of the CFC's subpart F income.

In the example above, DS does not own *any* stock in FC2, and (let us assume) FC2 has never before been a CFC. DS would not be allocated subpart F income from FC2. But under the proposal, merely because DS is a subsidiary of the foreign parented group, FC2 would become a CFC with respect to U.S. shareholders of FC1, and USS as a minority shareholder would be allocated subpart F income from FC2 and other foreign group companies even though U.S. persons do not, in form or substance, control such corporations. We believe that this is an unintended glitch which could, if it is not addressed, apply to a significant number of foreign-parented multinational groups. In addition, under the JCT description of the Senate version of the bill, this result would apply retroactively (the change would be effective for the last tax year of foreign corporations beginning before January 1, 2018). In other words, USS could become subject to tax on subpart F income derived from transactions that occurred in 2017 when USS and FC2 weren't aware that FC2 was a CFC.

The issue could be fixed in a number of ways. One way would be to retain section 958(b)(4), but turn it off for purposes of testing if stock owned by one member of a group in another member is stock in a CFC. If a group were defined to require greater than 50 percent ownership, the problem

[1]Oddly, FC2 would not be a CFC if, instead of being a sister corporation of DS, it was the parent of DS. (Because under the relevant attribution rules, DS cannot be attributed the shares of its own parent.) Even aside from our principal objections, it seems to us difficult to justify this difference in treatment.

we believe the House and Senate wanted to address would be addressed, because FC2 would be considered a CFC with respect to DS but not USS (because DS is, and USS is not, in the same group as FC2). Another approach would be to turn off section 958(b)(4) in testing if a foreign corporation is a CFC, but only when the foreign corporation had previously been a CFC within the same group.

Very truly yours,

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